

In brief: security interests and guarantees in India

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Security interests and guarantees

Collateral and guarantee support

Which entities in the organisational structure typically provide collateral and guarantee support for bank loan financings? Are there limitations on which entities in the organisational structure are permitted to provide such support?

Typically, the company with the longest credit history and most assets in a group structure provides the collateral and guarantee support. This may be the parent, subsidiary or an associate company of the primary borrower.

The Companies Act 2013 restricts the issuance of guarantees by companies to guarantee loans taken by any director of the company or any other person in whom the director is interested. However, the law provides for practical exemptions to this rule, whereby a holding company may provide a guarantee or security for a loan taken by a wholly owned subsidiary or a loan taken by a subsidiary from a bank or financial institution, provided that the loan is utilised by the wholly owned subsidiary or subsidiary for its principal business activities. The law has been further liberalised to permit companies to issue a guarantee towards a borrowing by any person in whom a director is interested by seeking approval from the company shareholders through a special resolution, provided that the loan is used for the principal business activities of the borrower. The Companies Act also prescribes limits on the guarantees that can be issued.

Guarantees provided by Indian companies as credit support towards loans taken by their overseas subsidiaries must be reported to an authorised dealer bank. These guarantees need to be capped at 400 per cent of the net worth of the guarantor and should have a specific expiry. The approval of the RBI will be required for providing a guarantee beyond the stipulations.

Payment of stamp duty on the deed of guarantee is necessary to ensure enforceability of the guarantee document in a court in India.

The ECB guidelines permit the creation of security or granting of guarantees in favour of foreign lenders to extend credit support for the lending, by obtaining the approval of the authorised dealer bank. In certain cases, RBI approval is required for creation of the security or providing guarantees.

What types of obligations typically share with the bank loan obligations in the collateral and guarantee support? If so, are all such obligations equally and ratably covered by the collateral and guarantee support?

Derivative transactions typically share the same collateral and guarantee support extended towards a bank loan on a pari passu basis. Depending on the nature of the transaction, derivative transactions may also be secured by a standalone security package.

Commonly pledged assets

Which categories of assets are commonly pledged to secure bank loan financings? Describe any limitations on the pledge of assets.

The assets over which security interest is most commonly created are:

- immovable assets;
- tangible and intangible movable assets (eg, raw materials, receivables, current assets, equipment, furniture and vehicles);
- financial instruments (eg, shares, debentures and bonds);
- cash deposits; and
- intellectual property (eg, copyrights, trademarks and patents).

Limitations extend towards the type of asset being secured. For example, it is not possible to create a mortgage over future assets (however, a charge over future assets may be created through a hypothecation). Third-party approvals may also be required on certain assets (eg, the creation of mortgage over a tenant's leasehold interest over a property may require the consent of the property's owner).

Creating a security interest

Describe the method of creating or attaching a security interest on the main categories of assets.

A security interest over assets is created either by way of mortgage, pledge or hypothecation. It is usually possible to create security interest over almost all assets of an entity. In practice, each type of asset usually requires a different type of security interest to be created. Separate security documents would need to be executed depending on the type of security interest. For example, a security interest by way of equitable mortgage would need its own set of documents (declaration and memorandum of entry) evidencing the creation of the mortgage that will be separate from a hypothecation or pledge.

Perfecting a security interest

What steps are necessary to perfect a security interest on the main categories of assets? What are the consequences of failing to perfect a security interest?

There are different perfection requirements involved for different categories of assets being secured. However, the most common procedures are:

- applicable stamp duty and registration fees must be paid;
- requisite filings with the company registry and information utility under the Insolvency and Bankruptcy Code are required to record the security interest;
- certain lenders are required to register their mortgages with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI);
- corporate authorisations of the security provider should be in place; and
- all third-party consents are required to be obtained.

Failure to make the filings with the company registry will result in the creditor not being identified as a secured creditor during insolvency and bankruptcy proceedings.

Future-acquired assets

Can security interests extend to future-acquired assets? Can security interests secure future-incurred obligations?

Security interests can be created over future movable property. However, security interests on future immovable property cannot be created prior to the immovable property being acquired by the security provider. Assets can secure future-incurred obligations in India. However, enforcement of these rights is questionable.

Maintenance

Describe any maintenance requirements to avoid the automatic termination or expiration of security interests.

Generally, there are none. However, in instances when a term deposit for a specific duration is placed as security for a debt and the term deposit matures without an automatic renewal provision being present, the security would stand terminated.

Release

Are security interests on an asset automatically released following its sale by the debtor? If so, are the releases mandated by law or contract?

Specific charge satisfaction forms must be filed with the company registry, the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) and information utility under the Insolvency and Bankruptcy Code, if applicable, for releasing security which was recorded with the company registry, CERSAI and information utility, respectively.

A deed of release or reconveyance is entered into between the mortgagor and mortgagee, which is subsequently registered, to release a charge created on an immovable property by way of an English mortgage.

The title deeds must be returned to the mortgagor in case of an equitable mortgage. Where the equitable mortgage is registered in a specific state, a release deed must also be registered with the relevant authority to perfect the release of security.

Pledged share certificates must be returned to the shareholder, if in physical form, upon the release of security. Requisite forms must be filed with the depository participant if the shares are held in dematerialised form.

A deed of release must be executed between the security provider and security holder and filed with the necessary authority to ensure release over intellectual property rights.

The releases are mandated both under law and contract.

Non-fulfilment of guarantee obligations

What defences does a guarantor have against claims for non-fulfilment of guarantee obligations? Can such defences be waived?

The concept of guarantee is governed by the Indian Contract Act, 1872. A guarantor is usually liable to the same extent as the borrower; however, there are exceptions to this general rule. The guarantor may be discharged from liability in the event of variance in the terms of the contract between the borrower and the creditor, without the guarantor's consent. A guarantor may be discharged if the creditor makes a composition with, or promises to give time to, or agrees not to sue, the borrower. Another defence available to the guarantor is when the borrower is discharged from liability due to a contract with the creditor for discharge or due to an omission by the creditor. In this case, since the borrower is discharged of liability, the guarantor too is discharged of the obligations under the guarantee.

These defences are usually specifically waived in the guarantee document.

Parallel debt requirements

Describe any parallel debt or similar requirements applicable in a secured bank loan financing where an agent acts for multiple investors.

There are no such requirements. It is very common for banks to appoint security agents or trustees to safeguard the security in a syndicated loan where multiple investors are involved. For more information, refer to question 6.

Enforcement

What are the most common methods of enforcing security interests? What are the limitations on enforcement?

Asset classification norms by the RBI mandate banks to classify a loan as a non-performing asset and provision for it accordingly if the loan has been in default for a continuous period of 90 days. Banks and specific financial institutions have the right to enforce their security interest without court intervention once the account is classified as a non-performing asset. The procedure for these lenders to enforce without court intervention is laid down under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002. A notice must be provided to the defaulting entity to repay all dues within 60 days of the date of the notice. If the defaulting party fails to make such payment and does not contest the notice, the lenders have the right to take possession of the secured property and auction it to realise its dues. This right of the lenders also extends to third-party security providers. Lenders not covered under the SARFAESI Act must initiate action in accordance with the dispute resolution mechanism laid down in the financing documents.

Security interest created by a hypothecation or pledge has contractual remedies where the lenders may dispose of the assets without the intervention of courts. This is usually practically difficult for hypothecation, as the lenders do not have possession of the secured assets.

Lenders also have the right to initiate insolvency proceedings immediately upon the occurrence of a payment default. RBI has the power to direct banks to initiate insolvency proceedings against a select few debtors. RBI has recently used these powers and identified certain accounts which would need to be referred to insolvency. RBI has also recently changed its stressed asset resolution regulations and instructed banks to commence a resolution process upon the occurrence of a payment default. There are heavy provisioning requirements that the banks need to comply with in the event of failing to timely conclude a resolution plan and refer the account to insolvency.

Fraudulent conveyance and similar doctrines

Describe the impact of fraudulent conveyance, financial assistance, thin capitalisation, corporate benefit and similar doctrines on the structure of bank loan financings.

Fraudulent Conveyance

Under the provisions of the Insolvency and Bankruptcy Code 2016, the liquidator has the power to question certain past transactions (usually up to the past two years from the date of commencement of insolvency proceedings) of the company and make an application to the tribunal to reverse such transactions. These transactions include preferential transactions, undervalued transactions, extortionate credit transactions or fraudulent transactions. For example, if a company disposed of an asset that was undervalued, such a transaction may be reversed by a tribunal, or the debtor must make a payment in favour of, or to the benefit of, a creditor that puts the said creditor in a more beneficial position.

Financial Assistance

There are provisions under the Companies Act 2013 which prohibit public companies from giving financial assistance for the purpose of purchasing or subscribing to its own shares or in its holding company. This does not apply to banks acting in their ordinary course of business. The Banking Regulation Act also restricts banking companies from granting:

- loans and advances on the security of its own shares;
- loans and advances to or on behalf of any of its directors;
- loans and advances to any firm in which any of its directors is interested as partner, manager, employee or guarantor;
- loans or advances to any company or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor, or in which the director holds substantial interest; or
- loans and advances to any individual in respect of whom any of its directors is a partner or guarantor.

Non-compliance with the above restrictions may result in monetary and administrative penalties applicable under the law.

Thin capitalisation

There are no specific debt-to-equity ratios or thin capitalisation rules under Indian law. However, transfer pricing regulations should be adhered to when dealing with group entities.

Corporate benefit

For every guarantee, it is necessary that a consideration is involved. As per the Indian Contract Act 1872, any promise made to the lender by the borrower is sufficient consideration for the guarantor. The Companies Act 2013, contains provisions where a holding company may grant a loan or give any guarantee or provide any security in connection with a loan taken by its subsidiary, provided that the loan is utilised by the borrower for its principal business activities. For more information, refer to question 17.