
THE LEGAL DISTINCTION BETWEEN DEBT AND EQUITY: JUDICIAL TRENDS AND DOCTRINAL CLARITY IN INDIA

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ABSTRACT

The distinction between debt and equity has long occupied a central position in corporate finance law. In India, the complexity of this distinction arises from statutory frameworks, judicial pronouncements, and regulatory instruments that often overlap or contradict each other. Debt instruments confer fixed obligations, while equity represents residual claims, yet hybrid instruments blur this binary. Compulsorily Convertible Debentures (CCDs), Optionally Convertible Debentures (OCDs), and Convertible Notes (CNs) have intensified doctrinal ambiguity by combining features of both categories. Courts and regulators in India, including the Supreme Court and the Securities and Exchange Board of India (SEBI), have grappled with these issues. For instance, the Supreme Court in *Narendra Kumar Maheshwari v. Union of India* [1989] AIR SC 2138 declared that CCDs did not postulate repayment of principal, thereby classifying them as equity. In contrast, rulings of the Authority for Advance Rulings and the Income Tax Appellate Tribunal have often treated CCDs as debt until conversion. Similarly, the recent judgment in *IFCI Limited v. Sutanu Sinha* (2023) reinforced the “repayment of principal” test, confirming that CCDs constitute equity for insolvency purposes. This paper critically evaluates judicial and regulatory treatment of borderline instruments in India, analysing whether existing frameworks provide clarity or perpetuate confusion. It investigates implications of such distinctions on capital structuring, taxation, insolvency proceedings, and foreign investment compliance under FEMA and RBI directions. By drawing upon statutory analysis, case law, structured finance literature, and global comparative approaches, research seeks to determine whether India requires doctrinal clarity through legislative safe harbour provisions or whether property-law-based methodology would better serve market needs. The findings underscore the urgent necessity for harmonization across corporate, insolvency, and securities laws to restore investor confidence and ensure efficient capital formation in Indian financial markets.

Keywords: Debt, Equity, Compulsorily Convertible Debentures, Insolvency Regulatory Framework

1. INTRODUCTION

1.1 Background and Significance of Research Problem

The separation between debt and equity is fundamental to corporate governance and corporate finance law [1]. Debt represents fixed contractual obligations, whereas equity implies ownership rights and residual interest [2]. In India, this distinction governs taxation, voting rights, and insolvency distribution under the Insolvency and Bankruptcy Code, 2016 (IBC) [3]. The Companies Act, 2013, defines instruments like debentures and shares, yet hybrid securities resist neat classification.

The Reserve Bank of India (RBI) recognizes CCDs as equity instruments for FDI purposes, while IBC jurisprudence places emphasis on repayment obligations [4]. Borderline financial instruments complicate this demarcation. CCDs are treated as equity because conversion is mandatory, while OCDs and CNs allow repayment and therefore may retain debt characteristics [5]. Preference shares and instruments like Masala Bonds further blur categorization when examined under insolvency or tax contexts. The problem is not confined to statutory law alone. Judicial reasoning in *Narendra Kumar Maheshwari v. Union of India* [1989] AIR SC 2138 and *IFCI Limited v. Sutanu Sinha* (2023) illustrates divergent treatment by courts depending on context [6].

The lack of doctrinal consistency has led to regulatory arbitrage, compliance burdens, and uncertainty for investors. The significance of this problem lies in its wide-ranging implications. Classification determines creditor hierarchy in insolvency, tax deductibility of interest, applicability of SEBI regulations, and permissibility of foreign capital inflows under FEMA [7]. Structured finance instruments like securitization and covered bonds also hinge upon this distinction, as bankruptcy remoteness depends upon true sale doctrines [8]. Without coherence, the Indian market risks reduced investor confidence and systemic instability.

1.2 Research Objectives

The researcher has formulated following research objectives:

1. Analyse statutory framework governing debt and equity classification in India.
2. Evaluate judicial approaches in interpreting hybrid financial instruments.

3. Examine impact of doctrinal ambiguity on taxation, insolvency, and foreign investment.
4. Propose reforms for harmonisation and greater legal certainty.

1.3 Research Questions

The researcher has formulated following research objectives:

1. How do Indian statutes and regulations define and distinguish debt from equity?
2. How have courts treated borderline instruments such as CCDs and OCDs?
3. Does current approach ensure clarity, predictability, and investor confidence?
4. What reforms or doctrinal shifts are required for consistency?

1.4 Research Hypotheses

The researcher has formulated following research hypotheses:

1. Hybrid instruments blur debt-equity divide, leading to inconsistent judicial outcomes.
2. The repayment of principal test provides limited clarity and causes fragmentation.
3. Regulatory frameworks of RBI, SEBI, and MCA lack harmonisation, creating compliance issues.
4. Legislative safe harbour provisions or property-law approaches can enhance doctrinal clarity.

1.5 Research Methodology

The research adopts doctrinal methodology by examining statutory texts, judicial decisions, and regulatory circulars. Analytical methods are applied to trace evolution of judicial reasoning and to identify inconsistencies across tribunals and courts. Comparative analysis is used by studying US safe-harbour provisions, European approaches to covered bonds, and La Porta's law and finance thesis on investor protections¹. Primary sources include statutes like

¹ Financial Sector Legislative Reforms Commission, Report Vol I (2013).

Companies Act 2013, IBC 2016, SEBI Regulations, and FEMA directions. Case laws such as *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138, *Sahara India Real Estate v SEBI* (2012) 10 SCC 6603, and *IFCI Limited v Sutanu Sinha* (2023) form judicial foundation. Secondary sources include Vinod Kothari's 2024 commentary on CCDs, S&R Associates' note on hybrid instruments, and academic literature on structured finance and corporate debt markets in India.

1.6 Literature Review

- **Flannigan, R, 'The Debt-Equity Distinction' (2011) Social Science Research Network**

Flannigan's foundational work examines conventional understanding of debt-equity distinction as difference between fixed and contingent participation. The author illuminates how common law, and statutory developments crystallized this fundamental distinction in corporate finance. This literature addresses functional equivalence criticisms and uncertainty challenges faced by debt-equity classification. The work provides theoretical foundation for understanding debt and equity as distinct categories despite their overlapping characteristics. However, research gap exists in contextualizing these principles within Indian corporate law framework and judicial precedents. The study lacks empirical analysis of how courts apply these theoretical distinctions in practice.²

- **Hutchison, C, 'The Historical Origins of Debt-Equity Distinction' (2015) 18 Florida Tax Review 95**

Hutchison traces historical evolution of debt-equity distinction through comprehensive analysis of legislative history and business lobbying efforts. The research demonstrates how this distinction emerged as unintended consequence of short-term political decisions rather than conscious policy goal. This literature provides valuable historical perspective on debt-equity classification development across jurisdictions. The work contributes to understanding how temporary historical contingencies created persistent legal consequences. Research gap includes limited analysis of how historical origins influence contemporary Indian judicial

² Robert Flannigan, 'The Debt-Equity Distinction' (2011) Social Science Research Network https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1744140.

approaches. The study focuses primarily on American tax law evolution without comparative analysis of other legal systems.³

- **Schön, W and others, 'Debt and Equity: What's Difference? A Comparative View' (2021) Max Planck Institute**

This comparative study analyses debt-equity features under corporate law, accounting law, and tax law across six major jurisdictions including United Kingdom. The research demonstrates how debt-equity divide differs for individual income taxation, corporate income taxation, and international taxation purposes. This literature offers crucial comparative perspective on debt-equity classification across multiple legal systems. The work highlights variations in regulatory approaches and their practical implications. However, research gap exists in including Indian legal framework within comparative analysis. The study lacks examination of emerging economies' approaches to debt-equity distinction.⁴

- **Stein, T SS, 'Debt as Corporate Governance' (2023) 74 Hastings Law Journal 1281**

Stein develops integrated theory of corporate governance that accounts for firm's debt beyond traditional equity-only paradigm. The research reveals how debt covenants create governance mechanisms through poison pills, board restrictions, and operational constraints. This literature expands understanding of debt's role in corporate governance beyond mere disciplinary function. The work demonstrates how debtholders actively participate in corporate governance through contractual arrangements. Research gap includes limited analysis of debt governance mechanisms within Indian corporate governance framework. The study focuses on American corporations without examining different ownership structures prevalent in Indian companies.⁵

- **Sarkar, J and Sarkar, S 'Debt and Corporate Governance in Emerging Economies: Evidence from India' (2005) Indira Gandhi Institute Working Paper**

This empirical study analysis debt's disciplinary role in Indian corporations using large cross-section of listed manufacturing firms. The research examines group-affiliated versus non-affiliated companies to understand ownership structure impact on debt governance. This

³ Camden Hutchison, 'The Historical Origins of Debt-Equity Distinction' (2015) 18 Florida Tax Review 95.

⁴ Wolfgang Schön and others, 'Debt and Equity: What's Difference? A Comparative View' (2021) Max Planck Institute for Tax Law and Public Finance

⁵ Tomer S Stein, 'Debt as Corporate Governance' (2023) 74 Hastings Law Journal 1281.

literature provides crucial empirical evidence on debt governance in Indian corporate context. The work demonstrates how institutional changes strengthen disciplining effect of debt over time. However, research gap exists in examining legal framework developments since 2005. The study predates significant corporate law reforms including Companies Act 2013 and Insolvency and Bankruptcy Code 2016.⁶

2. LEGAL AND REGULATORY FRAMEWORK

2.1 Statutory Provisions Defining Debt and Equity

2.1.1 THE COMPANIES ACT, 2013

The **Companies Act, 2013** is principal legislation for defining corporate capital structures in India. Section 2(30) defines debentures inclusively, covering bonds or any instrument acknowledging debt, regardless of whether secured or not⁷. Section 42 regulates private placement of securities, including debentures and hybrid instruments. Section 55 deals with preference shares, quasi-equity instrument with priority dividend rights but limited voting power. Section 62 regulates further issue of share capital and governs conversion of debentures into equity shares through preferential allotments⁸. Convertible notes issued by startups are recognised under section 2(81) and related notifications, allowing them as short-term debt instrument convertible into equity. The Act thus places debt and equity at two ends of spectrum but acknowledges hybrid instruments as falling within its ambit.

2.1.2 SECURITIES EXCHANGE BOARD OF INDIA

The **SEBI (Issue and Listing of Debt Securities) Regulations 2008** (ILDS Regulations) specifically govern public issue and listing of corporate bonds. These regulations mandate disclosure norms and listing conditions for debt securities, clarifying investor rights against issuers⁹. The **SEBI (Alternative Investment Funds) Regulations 2012** recognise hybrid securities like CCDs and OCDs as permissible investment instruments for Category II and III

⁶ Jayati Sarkar and Subrata Sarkar, 'Debt and Corporate Governance in Emerging Economies: Evidence from India' (2005) IGIDR Working Paper No WP-2005-007.

⁷ Companies Act 2013, s 2(30).

⁸ Companies Act 2013, ss 442, 55 62.

⁹ SEBI (Issue and Listing of Debt Securities) Regulations 2008.

funds. SEBI has also issued circulars distinguishing equity-like instruments from debt instruments in context of disclosure and valuation norms, thereby influencing classification.

2.1.3 FOREIGN EXCHANGE MANAGEMENT ACT, 1999

The **Foreign Exchange Management Act, 1999** and associated RBI Directions create another axis of classification. The RBI, through Master Directions, recognises fully and compulsorily convertible debentures as equity instruments for foreign direct investment purposes, whether convertible or non-convertible debentures are treated as external commercial borrowings (ECB)¹⁰. This dual regime seeks to prevent regulatory arbitrage where debt is routed through FDI channel.

2.1.4 INSOLVENCY AND BANKRUPTCY CODE, 2016

The **Insolvency and Bankruptcy Code, 2016** adds another statutory layer by defining “financial debt” under section 5(8). The definition includes money borrowed against payment of interest but does not cover contributions that are purely equity in nature¹¹. This distinction has created disputes on whether hybrid instruments like CCDs qualify as financial debt, affecting creditor rights in insolvency resolution processes.

2.2 Judicial Pronouncements

2.2.1 In *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138, Supreme Court held that compulsorily convertible debentures did not contemplate repayment of principal, thereby excluding them from traditional category of debt¹². This case laid down basis for treating CCDs as equity-like instruments under Indian law.

2.2.2 In *IFCI Limited v Sutanu Sinha* Civil Appeal No 4963 of 2019 (SC, 1 November 2023), Supreme Court reaffirmed “repayment of principal” test, ruling that CCDs were equity instruments in context of corporate insolvency resolution process. The Court emphasised that absence of repayment obligation removes such instruments from ambit of financial debt under

¹⁰ Reserve Bank of India, Master Direction – External Commercial Borrowings, Trade Credit and Structured Obligations (2017).

¹¹ Insolvency and Bankruptcy Code 2016, s 5(8).

¹² *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138.

section 5(8) of IBC¹³.

2.2.3 By contrast, *Sahara India Real Estate Corporation Ltd v SEBI* (2012) 10 SCC 603 dealt with optionally fully convertible debentures. SEBI argued, and Court accepted, that OCOCDs, since they gave holder option for repayment, retention of debt until conversion¹⁴.

2.2.4 The Monopolies and Restrictive Trade Practices Commission (MRTPC), in *DGIR v Deepak Fertilisers* 81 Comp Cas 3341, clarified that CCDs could not be treated as equity immediately upon issue. They remained debt until actual allotment or conversion, particularly relevant if company faced winding up before conversion¹⁵.

Rulings by Authority for Advance Rulings and Income Tax Appellate Tribunal have also emphasised that CCDs are to be treated as debt until their conversion. These decisions reinforced view that, for taxation purposes, interest paid on CCDs before conversion is deductible, distinguishing them from equity dividends¹⁶.

2.3 Regulatory Guidance and Circulars

The Reserve Bank of India has consistently issued **Master Directions on ECBs and FDI** since 2017, affirming that fully and compulsorily convertible debentures are equity instruments, while optionally convertible or non-convertible instruments fall within ECB framework¹⁷. This separation ensures that debt inflows are subject to repayment and interest servicing regulations, whereas equity inflows are monitored under FDI policy. SEBI has issued multiple circulars regarding hybrid instruments. It clarified that hybrid securities must be classified based on economic substance, not mere nomenclature. For valuation and disclosure, SEBI requires issuers to disclose conversion terms and whether repayment of principal is contemplated¹⁸.

The **Ministry of Corporate Affairs (MCA)** introduced recognition of convertible notes for startups through its notification dated 29 June 2016. Convertible notes, repayable or convertible

¹³ IFCI Limited v Sutanu Sinha Civil Appeal No 4963 of 2019 (SC, 1 November 2023).

¹⁴ *Sahara India Real Estate Corporation Ltd v SEBI* (2012) 10 SCC 603.

¹⁵ *DGIR v Deepak Fertilisers* 81 Comp Cas 341 (MRTPC).

¹⁶ Authority for Advance Rulings, AAR No 769 of 2007; ITAT Bengaluru, CAE Flight Training (India) Pvt Ltd v ACIT ITA No 2006/Bang/2017.

¹⁷ RBI, Master Direction – Foreign Investment in India (2017, updated 2020).

¹⁸ SEBI, Circular on Disclosure Requirements for Hybrid Securities (2019).

within five years, are treated as debt instruments until conversion¹⁹. This measure aimed at encouraging up fundraising while ensuring investor protection.

2.4 Comparative Statutory Approaches

The **United States Bankruptcy Code** provides statutory safe harbour provisions for securitisation transactions, ensuring that true sale of assets cannot be recharacterized as debt in bankruptcy proceedings²⁰. This safe harbour removes uncertainty and shields structured finance transactions from insolvency clawbacks. The **European Union framework on covered bonds** allows dual recourse treatment. Investors in covered bonds have recourse both to issuer and to dedicated pool of collateral, providing them with quasi-equity security while maintaining debt characteristics²¹.

For India, these comparative frameworks highlight absence of clear statutory safe harbours for hybrid instruments. The reliance on judicial interpretation of repayment obligations creates doctrinal uncertainty. Adoption of statutory safe harbour provisions, similar to US bankruptcy law, ordeal recourse mechanisms, like covered bonds, could vide certainty for classification of CDCs, OCD, and convertible notes. This would reduce reliance on case law and harmonise approaches across company, securities, and insolvency laws.

3. FINANCIAL AND POLICY CONTEXT

3.1 Economic Role of Debt and Equity

Debt reduces cost of capital because interest payments are tax deductible while dividends on equity are not²². Equity increases flexibility but dilutes ownership rights and raises weighted average cost of capital. Investors prefer clear risk allocation. Debt imposes fixed obligations on borrower and ensures predictable returns for lenders²³. Equity allows participation in profits but exposes investors to residual claims only after debt is serviced²⁴.

¹⁹ MCA Notification, 'Companies (Acceptance of Deposits) Amendment Rules' (29 June 2016).

²⁰ US Bankruptcy Code, 11 USC § 741 et seq.

²¹ European Banking Authority, Covered Bonds Directive (EU) 2019/2162.

²² Rafael La Porta et al, 'Law and Finance' (1998) 106(6) Journal of Political Economy 1113.

²³ Charles P Normandin, The Changing Nature of Debt and Equity: A Legal Perspective (Conference Paper, 1989).

²⁴ Companies Act 2013, ss 43, 55.

Investor protection differs because creditors rely on contractual rights and securities while shareholders rely on voting powers and corporate governance mechanisms. In insolvency, section 53 of Insolvency and Bankruptcy Code, 2016 prioritises secured creditors and operational creditors above shareholder's, reflecting hierarchical importance of debt²⁵. This distinction also shapes corporate governance since debt disciplines management through repayment obligations, while equity disperses control among investors.

3.2 Hybrid Instruments in Indian Markets

Compulsorily Convertible Debentures (CCDs) are favoured instrument for private equity investors because they provide interim certainty and eventual ownership²⁶. Optionally Convertible Debentures (OCDs) and Convertible Notes (CNs) add further flexibility. They allow investors to choose between repayment or conversion depending on performance. These instruments merge debt-like downside protection with equity-like upside potential. Policy rationale lies in attracting foreign direct investment while curbing misuse of debt inflows through FDI route²⁷.

The Reserve Bank of India expressly recognises CCDs as equity instruments in FDI policy but classifies other debentures as external commercial borrowings²⁸. Venture capital funds and alternative investment funds increasingly rely on CCDs and CNs for structuring deals since they combine valuation advantages with regulatory acceptance. Investors gain comfort in fixed return covenants before conversion, while issuers defer dilution of shareholding. This dual function makes hybrid instruments integral to capital structuring in India.

3.3 Market Practices and Challenges

The Nishith Desai Associates Report *Debt Funding in India* highlights how companies use Masala Bonds, ECBs, Nonbanking Financial Companies (NBFCs), and alternative Investment Funds (AIFs) to meet capital needs²⁹. Masala Bonds allow rupee denominated offshore borrowing, reducing exchange risk for Indian issuers but shifting it to foreign investors. ECBs remain significant, subject to sectoral caps and end-use restrictions under RBI

²⁵ Insolvency and Bankruptcy Code 2016, s 53.

²⁶ Vinod Kothari, Understanding Compulsorily Convertible Debentures (2024).

²⁷ S&R Associates, Compulsorily Convertible Debentures: Whether Debt or Equity (2024).

²⁸ Reserve Bank of India, Master Direction – Foreign Investment in India (2020).

²⁹ Nishith Desai Associates, Debt Funding in India (2019).

Master Directions³⁰. NBFCs function as shadow banks providing flexible debt structures, while AIFs use private credit strategies to bridge financing gaps.

Despite innovations, corporate debt market in India remains stagnant. Studies show that most corporate bonds are privately placed rather than publicly issued because disclosure and listing norms under SEBI regulations are burdensome³¹. Public issues require extensive documentation under SEBI (ILDS) Regulations, 2008, whereas private placements involve minimal disclosure. As result, institutional investors dominate, and retail participation is limited. The SSRN paper on corporate debt markets notes that stringent disclosure requirements and limited liquidity discourage issuers and investors alike³².

Structured finance practices such as securitisation and covered bonds also face legal challenges. The doctrine of true sale is not clearly codified in India. Courts rely on case-specific analysis to determine whether assignment of receivables constitutes genuine transfer or disguised borrowing³³. Absence of statutory safe harbour provisions, unlike United States Bankruptcy Code, creates uncertainty for investors in securitised instruments. Bankruptcy remoteness of special purpose vehicles remains vulnerable under Insolvency and Bankruptcy Code in absence of explicit legislative protection.

3.4 Policy Concerns

Regulatory arbitrage persists because issuers may structure instruments as equity to circumvent restrictions applicable to debt. The RBI's classification of CCDs as equity for FDI and ECBs as debt leaves scope for manipulation³⁴. Companies have sometimes preferred FDI route to avoid compliance burdens of ECB frameworks. This undermines objective of maintaining macroeconomic stability through external borrowing controls. Systemic risk is also evident in securitisation markets. The case of Dewan Housing Finance Corporation Limited (DHFL) exposed weaknesses in credit risk transfer mechanisms and highlighted need for strong due diligence standards³⁵. RBI guidelines on securitisation, particularly 2021 framework, now

³⁰ RBI, Master Direction – External Commercial Borrowings, Trade Credit and Structured Obligations (2017).

³¹ SEBI (Issue and Listing of Debt Securities) Regulations 2008.

³² Ashish Virmani and Jayant Raghu Ram, 'Corporate Debt Market in India: Review of Framework for Disclosures and Listing' (SSRN, 2020).

³³ Aditya S Jain, 'Squinting on True Sale Doctrine in Indian Securitization' in Legal Research on Structured Finance (Wadia Ghandy Award Compendium, 2023).

³⁴ FEMA (Transfer or Issue of Security by Person Resident Outside India) Regulations 2017.

³⁵ RBI, Guidelines on Securitisation of Standard Assets (2021).

emphasise minimum risk retention and disclosure norms. Yet, regulatory gaps remain in ensuring bankruptcy remoteness and protecting investors from contagion risks. Investor protection and corporate governance are impacted when classification of instruments is uncertain. Creditors risk losing enforceability in insolvency if instruments are reclassified as equity. Shareholders may also face unexpected dilution if convertible instruments are triggered during distress. Lack of doctrinal clarity undermines market confidence. The FSLRC Report, 2013, underscored importance of harmonised definitions and consistent regulatory oversight across sectors. Without such reforms, India's corporate finance landscape remains vulnerable to fragmentation and uncertainty.

4. CRITICAL ANALYSIS: JUDICIAL TRENDS AND DOCTRINAL AMBIGUITIES

4.1 Judicial Approaches to Debt–Equity Classification

Indian courts have primarily relied on “repayment of principal” test to distinguish between debt and equity³⁶. The test asks whether instrument envisages repayment of principal or not. If repayment exists, instrument is classified as debt, if not, as equity. This test, reiterated in *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138 and reaffirmed in *IFCI Limited v Sutanu Sinha* Civil Appeal No 4963 of 2019 (SC, 1 November 2023)), has offered clarity in insolvency contexts³⁷. Yet, it risks oversimplification because hybrid securities often combine debt-like covenants with equity-like conversion rights.

Contradictions emerge when insolvency law rulings are compared with taxation decisions. The Authority for Advance Rulings in AAR No 769 of 2007 held that CCDs remain debt until conversion, thereby allowing deduction of interest³⁸. Similarly, Income Tax Appellate Tribunal in *CAE Flight Training (India) Pvt Ltd v ACIT* ITA No 2006/Bang/2017 treated CCDs as debt instruments before conversion³⁹. In contrast, insolvency decisions such as *IFCI Limited* place CCDs firmly within category of equity. These divergences highlight doctrinal uncertainty across legal domains.

The contrast between *Sahara India Real Estate Corporation Ltd v SEBI* (2012) 10 SCC 603

³⁶ *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138.

³⁷ *IFCI Limited v Sutanu Sinha* Civil Appeal No 4963 of 2019 (SC, 1 November 2023).

³⁸ Authority for Advance Rulings, AAR No 769 of 2007.

³⁹ *CAE Flight Training (India) Pvt Ltd v ACIT* ITA No 2006/Bang/2017.

and *IFCI Limited* further demonstrates inconsistency⁴⁰. In *Sahara*, optionally convertible debentures were treated as debt because of repayment options, while *IFCI Limited* treated CCDs as equity regardless of investor expectations. This divergence underscores fragmented approach to classification and absence of unified doctrinal principle.

4.2 Doctrinal Uncertainty in Structured Finance

Structured finance transactions depend heavily on legal clarity regarding asset transfers. In securitisation, true sale doctrine ensures that receivables transferred to special purpose vehicle are not recharacterized as debt⁴¹. Indian courts, however, use factor-based approach, analysing substance over form. Factors such as transfer of risks, recourse provisions, and rights of substitution are scrutinised to determine whether transaction constitutes genuine sale or disguised financing⁴².

The Reserve Bank of India guidelines on securitisation, particularly 2021 framework, attempt to codify elements of true sale by requiring clean transfer and risk retention⁴³. Yet, unlike United States Bankruptcy Code which provides explicit safe harbour provisions protecting securitisation from recharacterization, Indian law leaves matter to judicial discretion⁴⁴. This absence of statutory certainty affects investor confidence. Market participants face uncertainty about whether securitisation structures will withstand insolvency scrutiny.

The impact on securitisation market stability is significant. Without clarity, institutional investors demand higher risk premiums, making structured finance costlier for issuers. The Dewan Housing Finance Corporation Limited (DHFL) case illustrated systemic risks when securitised portfolios faced questions of recovery during insolvency⁴⁵. Investor confidence weakens when judicial outcomes are unpredictable, slowing down development of structured debt markets in India.

4.3 Regulatory Fragmentation

Parallel definitions across different regulators have compounded confusion. The Reserve Bank

⁴⁰ *Sahara India Real Estate Corporation Ltd v SEBI* (2012) 10 SCC 603.

⁴¹ Aditya S Jain, 'Squinting on True Sale Doctrine in Indian Securitization' in Legal Research on Structured Finance (Wadia Ghandy Award Compendium, 2023).

⁴² Vinod Kothari, Understanding Compulsorily Convertible Debentures (2024).

⁴³ RBI, Guidelines on Securitisation of Standard Assets (2021).

⁴⁴ US Bankruptcy Code, 11 USC § 741 et seq.

⁴⁵ RBI, Report on DHFL Resolution and Market Lessons (2021).

of India treats CCDs as equity under FDI policy but classifies other debentures as ECBs⁴⁶. The Securities and Exchange Board of India applies disclosure norms to hybrid instruments based on economic substance rather than formal labels⁴⁷. The Ministry of Corporate Affairs, through its 2016 notification, introduced convertible notes as debt instruments convertible into equity at later stage⁴⁸.

The Insolvency and Bankruptcy Code define “financial debt” broadly but excludes equity, thereby complicating classification of borderline instruments. The lack of unified statutory definition of “equity instrument” or “financial debt” has led to inconsistent enforcement. Companies face different regulatory outcomes depending on which statute applies.

Investors must evaluate risks across multiple legal frameworks rather than relying on single coherent doctrine. The Financial Sector Legislative Reforms Commission in 2013 explicitly called for harmonisation of financial sector definitions to avoid such overlaps⁴⁹. Yet, recommendation remains unimplemented, perpetuating fragmentation across corporate finance regulation.

4.4 Comparative Perspective

Comparative insights highlight structural gaps in India. La Porta’s seminal study on legal origins established that common law jurisdictions generally offer stronger investor protections compared to civil law systems⁵⁰. This distinction extends to how debt and equity are regulated. In common law countries like United States and United Kingdom, courts rely more on disclosure rules and contractual enforcement, reducing ambiguity. The US practice emphasises safe harbour provisions for securitisation and clear Internal Revenue Service rules on debt-equity classification. The UK similarly applies disclosure-based frameworks under Financial Conduct Authority to distinguish hybrid instruments. By contrast, Indian law remains dependent on case-specific judicial reasoning, leaving investors uncertain⁵¹. Lessons for India lies in adopting balanced approach. Excessive creditor protection could stifle capital formation, while excessive equity treatment risks creditor insecurity. Incorporating safe harbour rules for

⁴⁶ RBI, Master Direction – Foreign Investment in India (2020).

⁴⁷ SEBI, Circular on Disclosure Requirements for Hybrid Securities (2019).

⁴⁸ MCA Notification, ‘Companies (Acceptance of Deposits) Amendment Rules’ (29 June 2016).

⁴⁹ Financial Sector Legislative Reforms Commission, Report Vol I (2013).

⁵⁰ Rafael La Porta et al, ‘Law and Finance’ (1998) 106(6) Journal of Political Economy 1113.

⁵¹ Charles P Normandin, The Changing Nature of Debt and Equity: A Legal Perspective (Conference Paper, 1989).

securitisation and uniform statutory definition of hybrid instruments could align India's framework with international best practices. Such reforms would enhance predictability, **investor confidence, and systemic stability.**

5. SUGGESTIONS AND REFORM PROPOSALS

5.1 Doctrinal Clarity

A statutory definition distinguishing debt and equity is essential under **Companies Act, 2013** and **Insolvency and Bankruptcy Code, 2016**⁵². At present, reliance on judicial interpretation creates doctrinal inconsistency. Codifying meaning of debt and equity would reduce reliance on fragmented case law. The definition should extend to hybrid instruments and expressly cover compulsorily convertible and optionally convertible securities.

Incorporating “repayment of principal plus residual interest” test within legislation would provide certainty. This test should codify approach taken in *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138 and reaffirmed in *IFCI Limited v Sutanu Sinha* Civil Appeal No 4963 of 2019 (SC, 1 November 2023)⁵³. An instrument should be classified as debt if repayment of principal is contemplated, even optionally. Conversely, if repayment is absent and conversion into equity is mandatory, instrument should be treated as equity. Such legislative codification would prevent divergent outcomes across taxation, insolvency, and regulatory spheres.

5.2 Regulatory Harmonisation

Alignment of definitions across **Reserve Bank of India, Securities and Exchange Board of India, Ministry of Corporate Affairs, and insolvency and Bankruptcy Code** is vital. Presently, CCDs are treated as equity under FDI policy, but same instruments are treated as debt under tax rulings until conversion⁵⁴. This inconsistency creates regulatory arbitrage. Harmonisation would reduce compliance burdens and provide predictability to issuers and investors. Safe harbour provisions for true sale transactions must be introduced, following US

⁵² Companies Act 2013; Insolvency and Bankruptcy Code 2016.

⁵³ *Narendra Kumar Maheshwari v Union of India* [1989] AIR SC 2138; *IFCI Limited v Sutanu Sinha* Civil Appeal No 4963 of 2019 (SC, 1 November 2023).

⁵⁴ Authority for Advance Rulings, AAR No 769 of 2007; *CAE Flight Training (India) Pvt Ltd v ACIT* ITA No 2006/Bang/2017.

model under Bankruptcy Code⁵⁵. In securitisation, Indian courts use factor-based approach, leading to uncertainty over whether transfers constitute genuine sales. Codifying safe harbour would insulate securitisation from recharacterization as secured borrowing during insolvency, enhancing investor confidence. The FSLRC Report, 2013, already recommended uniformity and predictability across financial sector reregulation, steps to be implemented⁵⁶.

5.3 Policy Measures

Strengthening corporate debt market is policy imperative. Implementation of **Patil Committee Report** recommendations would simplify disclosure frameworks for corporate bonds⁵⁷. Present SEBI norms under ILDS Regulations, 2008 require extensive disclosure, making issuers prefer private placements. Allowing abridged disclosures for already listed companies would reduce costs and incentivise public issuances. Encouragement of covered bonds and dual recourse instruments would add depth to Indian debt markets.

The European framework allows bondholders recourse to both issuer and collateral pool, offering security without undermining debt features⁵⁸. India can adopt similar dual recourse model to attract institutional investors. Clarity on FDI versus ECB route for hybrid instruments is also necessary. Presently, issuers use CCDs under FDI rules to bypass ECB restrictions. Clearer definitions and thresholds can prevent arbitrage while maintaining balance between encouraging capital inflows and preserving macroeconomic stability⁵⁹.

5.4 International Best Practices

The US safe harbour approach to securitisation under **11 USC § 741** protects asset-backed securities from being recharacterized as debt⁶⁰. This certainty encourages structured finance, lowers transaction costs, and promotes market stability. India should adopt comparable statutory safe harbours, reducing dependence on discretionary judicial analysis. The European Union's covered bonds framework under Directive (EU) 2019/2162 provides investors with dual recourse rights. It ensures both repayment from issuer and access to ring-fenced collateral

⁵⁵ US Bankruptcy Code, 11 USC § 741 et seq.

⁵⁶ Financial Sector Legislative Reforms Commission, Report Vol I (2013).

⁵⁷ R H Patil Committee Report on Corporate Debt Markets (2005).

⁵⁸ European Banking Authority, Covered Bonds Directive (EU) 2019/2162.

⁵⁹ Reserve Bank of India, Master Direction – External Commercial Borrowings, Trade Credit and Structured Obligations (2017).

⁶⁰ US Bankruptcy Code, 11 USC § 741 et seq.

pool⁶¹. Adoption of similar regime in India could broaden investor confidence and diversify funding sources. Clearer accounting and tax guidelines are also needed. The **IFRS treatment of hybrid instruments** offers principle-based framework distinguishing liability from equity based on contractual obligations⁶². Incorporating IFRS standards into Indian GAAP and tax laws would create uniformity between financial reporting and statutory interpretation, reducing litigation risks.

6. Conclusion

Doctrinal tensions in India's debt–equity classification reflect inconsistent judicial and regulatory approaches. Courts have applied repayment of principal test, yet rulings diverge between taxation and insolvency contexts. Regulators apply parallel definitions without harmonisation, creating compliance challenges. The lack of statutory clarity has fostered incoherence across corporate law, insolvency frameworks, and market practices. Statutory clarity and harmonisation are crucial to resolve these inconsistencies. Introducing unified definitions, safe harbour provisions, and simplified disclosure regimes would improve predictability. Comparative lessons from US and EU underline importance of safe harbours and dual recourse instruments in strengthening financial markets. The future trajectory must focus on aligning India's frameworks with global standards. Hybrid instruments will continue to dominate capital structuring. ESG finance and cross-border flows will add new complexities. Doctrinal clarity, harmonisation, and adoption of international best practices will ensure that India's corporate finance law evolves in stable and investor-friendly manner.

⁶¹ European Banking Authority, Covered Bonds Directive (EU) 2019/2162.

⁶² International Accounting Standards Board, IAS 32 Financial Instruments: Presentation (IFRS).

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