GRAVITAS LEGAL

A different prism for trust and retention account agreements to be looked through: Equity contributions in project finance

Part 2 of 3

Authored by Tanuj Sud and Apurva Bharadwaj

Introduction

In the first part of our three-part series of articles on different aspects of the trust and retention account agreements, we limited our analysis to the treatment/priority accorded to Government and Statutory Dues vis-à-vis the rights of the creditors. Continuing therefrom, in this second part, we have examined statutory and regulatory framework governing equity contributions in the context of Project Finance and (typical) treatment thereof under the trust and retention account mechanism.

Securities application money and treatment under project equity capital

Defining securities

'Securities' is defined in Section 2(81) of the Companies Act, 2013 ("**Companies Act**") to mean 'Securities' as defined under Section 2(h) of the Securities Contract (Regulation) Act, 1956. Section 2(h) of the Securities Contract (Regulation) Act, 1956 Act defines 'Securities' non-exhaustively to include shares, scrips, stocks, bonds, debentures, debenture stock or other marketable Securities of a like nature in or of any incorporated company or other body corporate, derivatives, units or any other instrument issued by any collective investment scheme to the investors in such schemes, security receipts as defined in section 2(zg) of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, units or any other such instrument issued to the investors under any mutual fund scheme, Government Securities, such other instruments as may be declared by the Central Government to be Securities; and rights or interest in Securities.

Securities application money and private placement

Securities Application Money is the amount received by a company from applicants who wish to subscribe to its Securities towards allotment of Securities. Typically, in the context of project finance (where projects are usually implemented through freshly incorporated special purpose vehicles), this money would tend to be received by the companies through the mechanism of

© Gravitas Legal 2021

private placement. 'Private Placement' means any offering of Securities or any invitation to subscribe to Securities made to a select group of persons.

Project equity capital

The promoters of a special purpose company developing a project infuse money in a project by way of subscription mainly to shares (preference and/or equity) and/or debentures (compulsorily convertible debentures and/or optionally convertible debentures and/or non-convertible debentures). Any monies infused in this manner are loosely referred to as 'Project Equity' or 'Equity Capital'[1] of the project. Simply put, any infusion by the promoters of money/capital to enable meeting the (estimated) fixed construction costs of the Project is reckoned on the 'Project Equity Capital' side of Financing Plans (simple grid type presentation of the breakup of debt and equity amounts that would go towards meeting specific line items of the overall budgeted construction costs).

Regulatory framework

As per the Report of the Companies Law Committee ("the **Committee**") issued by the Ministry of Corporate Affairs in February 2016 ("**the Report**"), Section 42 of the Companies Act (in conjunction with Section 62 of the Companies Act) lays down the framework for private placement of Securities. Section 42 of the Companies Act broadly covers the modalities governing the allotment of Securities including as to how many persons the allotment may be made to[2], the format for making applications, the treatment of monies received and penalty for not refunding the monies in the absence of allotment. Section 62 of the Companies Act, on the other hand, essentially deals with the universe of allottees irrespective of the mode (public offer, follow on offer, private placement etc.,) of allotment and the nature of the issuing company. The Committee noted in the Report that amendments had been brought in the scheme of these provisions to check the gross misuse of earlier provisions relating to private placement under the Companies Act, 1956, and felt that such requirements, which are procedural in nature and do not cause great difficulty, ought to be retained.

All types of companies, whether listed or unlisted are required to comply with Section 42 of the Companies Act and the relevant Companies (Prospectus and Allotment of Securities) Rules, 2014[3]. Further, the monies for 'Project Equity' or 'Equity Capital' can come by way of subscription to any kind of security and Section 42 of the Companies Act does not make any distinction between the Securities for these purposes[4].

[1] For the purposes of this Article we are not venturing into the tariff guidelines and Securities recognised there as part of equity contribution.

[2] Sub-Section (1) of Section 42 of the Companies Act read with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 require the issue of private placement offer letter instead of a prospectus where the number of intended subscribers is less than 50 (fifty) since, under Sub-Section (2) of Section 42 of the Companies Act, such private placement offer may be made to not more than 50 (fifty) persons in a financial year. Sub-Section (11) reiterates the position that any offer or invitation not in compliance with Section 42 of the Companies Act would be treated as a public offer and that all the provisions of the Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956 would need to be complied with.

[3] Section 42 of the Companies Act read with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 and Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 highlights the differences in procedural requirements applicable to listed and unlisted companies.

[4] In the case of the power sector, however, it may be noted that, under the Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019 (*pointed out illustratively, State Tariff Regulations may assume importance for intra-State transmission*), for the capital expenditure incurred or projected to be incurred the debt-equity ratio is considered as 70:30. If the equity actually deployed is more than 30% of the capital cost, equity in excess of 30% shall be treated as normative loan. For the purposes of this Article, we have not delved into the merits (or demerits) of each mode of equity infusion. However, it must be noted that

© Gravitas Legal 2021

Securities application money pending allotment
Securities Application Money represents an investment that has come in to a company pending the issuance of Securities. Allotment of Securities may not happen contemporaneously with the receipt of subscription money. Under the Companies Act as well as under *Master Direction – Foreign Investment in India* dated January 4, 2018 issued by Reserve Bank of India (relevant where the subscribers are resident outside India), a company has 60 (sixty) days to make allotment of Securities against the monies received.

This begs the question – As such, pending allotment, should this money be recognized as part of the 'equity' while computing Project Capital?

Securities application money – to be parked in separate bank account
Securities Application Money is brought in for a specific purpose and when a corpus is built for a specific purpose that money is deemed to be held in trust[5]. As if the statute expressly notes and propounds this principle of trust, notably, proviso to Section 42(6) of the Companies Act states that the entire amount raised by the issue of offer or invitation will have to be parked in a separate bank account and cannot be used until allotted.

Refund of securities application money
Under Section 42(6) of the Companies Act, Securities Application Money against which allotment has not taken place within the prescribed timeline is meant to be refunded together with interest at the rate of 12% per annum applicable from the expiry of the 60th day. Therefore, the statutory prescription becomes either: (a) to allot Securities within 60 (sixty) days of receipt of Securities Application Money; or (b) refund the Securities Application Money together with the interest prescribed in relation thereto. Section 42 of the Companies Act, in no uncertain terms, requires Securities Application Money to be kept in a separate bank account in a scheduled bank, and imposes a restriction on utilization of such Securities Application Money for any purpose other than adjustment against allotment of Securities or for the repayment of monies where the company is unable to allot Securities. Section 42 of the Companies Act also heavily penalizes the company if the company, upon failing to allot Securities, fails to repay this money to the applicants within 15 (fifteen) days.

Conclusion
The fact that that the Securities Application Money till the time its allotted, is required to be held in trust in a separate bank account and that there is penalty imposed upon any company violating the norms, this money cannot be applied as part of Project Equity Capital. Ideally, therefore, a separate and distinctly identifiable sub-account should be created wherein Securities Application Money is credited upon infusion by promoters/subscribers. Based on the scheme of the Companies Act (as elucidated above) it appears that this money can flow down from the specific sub-account to the Construction Account (or such equivalent account,

---

the assumptions contained in the aforesaid Tariff Regulations, interest on servicing of unsecured loan is comparatively less than the rate of return of equity. From a tax perspective as well, Securities reflective of the character of debt may also be friendlier.

[5] In *Ganesh Export And Import Co. vs. Mahadeolal Nathmal*, AIR 1956 Cal 188, the Hon'ble Calcutta High Court has held, "*...The test as to whether there is a loan or a trust in such a case appears to be this: where money is paid merely on condition of repayment and payment of interest till then, there is only a loan; but where the main condition on which money is paid shows that the corpus of the fund is being handed over in confidence to be held for the benefit of some person or object, the provision for payment of interest is only a provision for an increase or improvement of the fund and there is no loan but a trust, despite such provision which does not in any way negative a trust*".

© Gravitas Legal 2021

however nomenclated) only upon allotment of Securities towards the same having been made. It is only thereafter (that is after allotment and consequent flow down into the Construction Account) that such money should be treated as part of the equity side of the Project Capital and can be utilized in the construction expenditure.

In case of financing of projects, Reserve Bank of India has mandated that either the promoters bring their entire contribution upfront before the bank starts disbursing its commitment or they bring in equity funds proportionately as the banks finance the debt portion[6]. As such under the loan agreements, bringing of upfront equity is recorded as a pre-disbursement condition. However, can mere receipt of Securities Application Money (prior to allotment) be regarded as fulfilment of this pre-disbursement condition? The answer ought to be in the negative, but this is an area yet developing an open to interpretation.

The foregoing, therefore, leaves us with the question whether the pre-disbursement condition of bringing in upfront equity should be retained as is, OR whether there is a need to make suitable amendments thereto to specifically establish linkages to allotment/corresponding confirmations from the subscribers?

When viewed from the perspective of the Companies Act and/or the RBI norms in this respect, treating Securities Application Money on the 'equity' side of the Project Capital pending allotment can be contentious. It may therefore be appropriate to examine this issue more deeply and consider reflecting appropriate drafting changes in the financing documents.

*****

www.gravitaslegal.co.in Gravitas Legal email@gravitaslegal.co.in

New Delhi
C-91, 2nd Floor, Panchsheel Enclave, New Delhi – 110017 | Phone: (+91) (11) 45671111
908, 9th Floor, P.P Towers, Netaji Subhash Place, Pitampura, New Delhi – 110034 | Phone: (+91) (11) 47065978

Mumbai
102, 1st Floor, Vikas Building, Bank Street Fort, Mumbai – 400001 | Phone: (+91) (22) 49725818

Disclaimer:
This communication is meant for information purposes only and does not constitute legal advice by the firm or its members. Should you have any queries on any aspect of this communication, please contact us.

[6] Para 2.3.22.1 – Master Circular – Loans and Advances – Statutory and Other Restrictions dated July 1, 2015 issued by Reserve Bank of India.

© Gravitas Legal 2021