

## Charges (Sec 77) – Definition and some basic concepts

### 1. Protection to the Lender

The intent behind the section seems to ensure that all encumbrances made by the company on its property or assets or any of its undertakings are made public. This is especially required to protect the interest of the lenders to ensure that the assets being offered as security for their proposed facilities are not already encumbered. Once a charge is registered, it will be in the public domain and the lender can verify the details of financial facilities obtained and charge created on property or assets or any of its undertakings. This section serves two fold purpose: preventing the company from simultaneously borrowing on the same assets without notice to previous lender and providing clear information to the new lender about the status of the assets.

### 2. Departure from the Companies Act, 1956

In Companies Act, 1956, the definition of charge was inclusive. The term was defined to include a mortgage, whereas the definition of charge in clause (16) of section 2 of Act is – “an interest or lien created on the property of the company or its assets or any of its undertakings or both as security and includes a mortgage.” Under the Companies Act, 1956, only 9 types of charge were required to be registered whereas the provisions under Act covers any kind of interest or lien created on the property of the company or its assets as a security including mortgage.

### 3. Meaning of “charge”

A charge is a right created by a company hereinafter referred to as “the borrower” on its assets or properties or any of its undertakings present and future, in favour of a financial institution or a bank or any other lender, hereinafter referred to as “the lender”, which has agreed to extend financial assistance.

Clause (16) of section 2 of the Act defines the term charge as follows:

“charge” means an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage.

In general a charge has the following essential features:

- a) There are minimum two parties to the transaction, the creator of the charge and the charge holder.
- b) The subject-matter of charge may be on current or future assets and properties of the borrower.
- c) The intention of the borrower to offer one or more of its specific assets or properties as security for repayment of the borrowed money together with payment of interest at the agreed rate etc should manifest from an agreement entered by him in favour of the lender, written or otherwise.

Therefore one should be able to distinguish between the charge created by an act of parties or by operation of law. As the section uses the expression ‘duty of every company creating a charge’, it refers to only such charge which are created by act of parties i.e. between the company and the lender and not to charge created by way of operation of

statute or a decree. (For further analysis on the aspect of creation of charge by decree of courts please refer to the discussion under the heading 'effect of the decree of the court'.)

The Courts have repeatedly looked at the intent of the transaction rather than merely going by the name. In *Kent and Sussex Sawmills Ltd., in re* [[1947] 17 Comp Cas 169 (Ch D) mentioned in *S.T. Patil And Ors. vs Registrar Of Companies* 1998 91 Comp Cas 578 CLB. however, the same was held not to be applicable to the facts of that case.], it was held that 'Whether a particular transaction is a charge or not is to be determined not by the form in which it is couched but by looking at the substance of it. Though a document is given in the form of an assignment, if, in reality, it is an instrument creating a security, registration as a charge cannot be evaded'.

#### 4. "Charge" as defined under the Transfer of Property Act, 1882

According to section 100 of the Transfer of Property Act, 1882, where an immovable property of one person is by act of parties or operation of law made security for the payment of money to another and the transaction does not amount to a mortgage, the latter person is said to have a charge on the property, and all the provisions which apply to a simple mortgage shall, so far as may be, apply to such charge.

#### 5. Meaning of 'Interest' and 'Lien'

The key words mentioned in the definition of charge are "interest" and "lien". The meaning of "interest" as per Black's law dictionary [9<sup>th</sup> Edition, page no.885] is – 'legal share in something; all or part of a legal or equitable claim to or right in property <right, title, and interest>. Collectively, the word includes any aggregation of rights, privileges, powers, and immunities; distributively, it refers to anyone right, privilege, power, or immunity.'

The meaning of Lien as per the Black's law dictionary [9<sup>th</sup> Edition, page no. 1006] is – 'a legal right or interest that a creditor has in another's property lasting usu. until a debt or duty it secures is satisfied'. Lien was defined by Story as 'Lien, strictly, is neither a jus in rem nor a jus ad rem, but is simply a right to possess and retain property until some claim attaching to it is satisfied or discharged' [Story on Equity Jurisprudence p. 508 as quoted in the *Bank of India, Ltd. vs Rustom Fakirji Cowasjee* (1955) 57 BOMLR 850].

In the case of *K. Saradambal v Jaganathan & Bros.* [(1972) 42 Comp Cas 359 (Mad)], it was held that a holder of a lien is a secured creditor and if the lien is statutory, his claim need not be registered under section 125 of the Companies Act, 1956. Now, as per the provisions of clause (16) of section 2 read with section 77 of the Act, it is required to be registered as a charge with the Registrar.

The term 'negative lien' is not defined under any legislation in India. Generally speaking, lien (i.e a positive lien) is merely a right of a person to retain a property which is in his possession but belonging to another person till such time the debt or the obligation (for which such lien is conferred) is discharged. A negative lien, on the other hand, is right of a person to restrict another person from disposing of or creating encumbrance over the property belonging to the former which is in the latter's possession or control till the debt or other obligation (for which such negative lien is conferred) is discharged. It was held in *The Bank of India Ltd. vs Rustom Fakirji Cowasjee* [(1955) 57 BOMLR 850] that negative

lien, like other types of lien, is merely an assurance to keep the property unencumbered and does not amount to a right to sale. As per the inclusive definition of 'charge', such type of lien shall also be included.

## 6. Fixed and Floating charge

A charge may be fixed or floating depending upon its nature.

Fixed charge is a charge on a definite property which can be ascertained and the company cannot dispose of the property without the consent of the charge holder. However the company is allowed to use it for business purpose. Generally fixed charge is created on fixed assets such as plant and machinery.

Floating charge is charge on variable property which keeps on changing or moving. The property or asset of the company cannot be specifically ascertained in case of a floating charge. The Supreme Court has remarked in *Narendra Kumar Maheshwari vs Union of India & Ors* [(1989 SCR (3) 43 referring to *Palmer's company law*; page 709 and 682, *Re. Florence land & Public Works Co.*, [1878] 10 Ch. 530; re. *Colonial Trust Corporation*] as follows: "The concept of floating charge was, invented by the Victorian Lawyers only because of its special advantages inasmuch as it leaves a company free to deal with its assets in the ordinary course of business and does not require the permission of debenture-holders or debenture trustees for dealing with them or creating further charges. It has been pointed out that the business of a corporation would be paralysed if it could not deal with its assets and create future charges, ranking superior in priority, and if it would have to obtain the permission of the debenture holders for doing so." While elaborating another contour of floating charges it remarked further, "This however does not mean that the company can keep on creating future charges with superior ranking without any let or hindrance because the debenture holders/ trustees can any time move to crystallise the floating security if they feel that the security is in jeopardy." [*Narendra Kumar Maheshwari vs Union of India & Ors* 1989 SCR (3) 43]

## 7. Types of charge

The charge may be created in favour of the charge holders as per the terms and conditions agreed by the parties in the following manner:

- a) **PariPassu charge** – Under this, the charge is shared by more than one lender in the ratio of their outstanding amount. The prior consent of the existing charge holder(s) is required by the company.
- b) **Exclusive charge** – The security under the exclusive charge is provided to a particular lender only.
- c) **Further charge** – With the consent of the first charge holder, the particular assets on which charge is already created may be provided to other lenders as second charge. In case of liquidation of assets, the first charge holder has the right to recover his dues and the balance is recovered by the second charge holder followed by others.

## 8. Difference between Mortgage and charge

A mortgage deed includes every instrument whereby for the purpose of securing money advanced, or to be advanced, for an existing or future debt, one person transfers, or creates in favour of another, a right over a specified property.

In the case of *Ranjit Ray v D.A. David* [(1935) 5 Comp Cas 281 (Cal)], it was held that an assignment of book debts as security is a mortgage requiring registration as a charge under the Act.

The charge can be created in different forms including all types of mortgages such as:

- a. **Simple Mortgage:** It is an agreement only whereby the mortgagor personally binds and agrees to repay the money borrowed to the mortgagee and agrees that in the event of failure to do so, the property may be sold and the money will be realized out of the sale proceeds. However it must be registered. Simple mortgage does not refer to any property transfer at all.
- b. **Mortgage by conditional sale:** In this mortgage, the mortgagor sells the property to the mortgagee on the condition that if payment of the mortgage money is defaulted on the specific date, the sale shall become absolute, or on the condition that on repayment of the mortgage money, the mortgagee shall transfer the property back to the mortgagor.
- c. **Usufructuary Mortgage:** In this mortgage, the mortgagor delivers possession or binds himself to deliver possession of the mortgaged property to the mortgagee, and authorizes him to retain such possession and to receive rents and profits accruing from the property in lieu of interest until payment of the mortgage money. This is otherwise known as 'compensation mortgage' and 'lease with no rent and no interest payable.'
- d. **English Mortgage:** It is a transaction where the mortgagor commits himself to pay the mortgage money on a specific date and transfers the mortgaged property to the mortgagee absolutely at the time of lending, subject to the condition of transferring it back upon payment of the mortgaged money, as agreed. English mortgage involves a transfer of property to the mortgagee absolutely and on repayment the mortgagee is bound to transfer the property back to the mortgagor. This transaction being sale, it is charged to stamp duty, both times.
- e. **Equitable Mortgage:** equitable mortgage or mortgage by deposit of title deeds, the deposit of title deeds may be done orally and the conditions of loan transactions may be recorded in writing.
- f. **Anomalous Mortgage:** This mortgage is a mixture of mortgages. This is not a simple mortgage, a mortgage by condition of sale, a usufructuary mortgage, an english mortgage, or mortgage by deposit of title deeds. This is not a regular mortgage.
- g. **Hypothecation:** When a movable asset is purchased by taking a loan, giving the right to the lender to take back the asset against which loan is taken if there is any default in payment. Hypothecation over current assets such as receivables are accepted as a floating charge.

There is a clear distinction between a mortgage and a charge, the former being a transfer of an interest in immoveable property as a security for a facility whereas the latter is not a transfer, though it is nonetheless a security for the payment of an amount.

## 9. Difference between charge and pledge

A 'pledge' is a bailment of personal property as security for some debt or engagement, redeemable on certain terms, and with an implied power of sale on default. It consists of a delivery of goods by a debtor to his creditor as security for a debt or other obligation. The goods are to be held until the debt is repaid along with interest or other obligation of the debtor. After discharge from liability, the goods are to be delivered back to the pledger, the title not having changed during the continuance of the pledge. Unlike a pledge, a 'charge' is not a physical transfer of property of one to another. It is a right created in favour of one, referred to as "the lender" in the property of another (either movable or immovable), referred to as "the borrower", as security for repayment of the loan and payment of interest on the terms and conditions contained in the loan documents evidencing charge.

Both i.e. a pledge and a charge are a result of voluntary act of parties. Both create security but the nature of the security is different.

In the case of Sree Menakshi Mills Ltd. V. Registrar of Companies [(1966) 36 Comp Cas 961 (Mad)] the Madras High Court held that "Where a loan from the bank is raised by pledging fixed deposit receipts, the registration of charge is not necessary".

In case of T. Radhakrishnan Chettiar v Official Liquidator, Madras Peoples' Bank Ltd. [(1943) 13 Comp Cas 21 (Mad)] it was held that a transaction may amount to a mortgage, but if it also satisfies all the conditions of a pledge, it does not require registration. However, in view of the definition of charge under clause (16) of section 2 of the Act read with the sub-section (1) of this section, an interest includes pledge or lien etc and therefore charge needs to be created in case of pledge or lien etc also. In light of this, the above judgements may not hold good in the present scenario.

However, the Companies Law Committee in its report in para no 6.2 has deliberated and clarified that section 77(3) may provide for prescriptive powers to allow certain liens or securities or pledges to be exempted from filing. This would address the practical problems in case of transactions by NBFCs engaged in financing of assets, and for members / agents of the Clearing Corporation, etc. Accordingly, the Companies Amendment Bill, 2016 proposes to amend section 77 to provide that this section shall not apply to such charges as may be prescribed in consultation with Reserve Bank of India.