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-Dr. A.P.J. Abdul Kalam

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FOCUS ON CAPITAL MARKETS

Hybrid Financial Instrument

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The hybrid financial instrument is designed to take into account – share ownership, capital markets, and business culture.[1] In cross-border transactions, the companies try to take advantage of the difference in tax policies of various jurisdictions with the use of hybrid instruments. The instruments are designed such that they are treated as debt in one jurisdiction and as equity in the other to take advantages of both the categories.[2] This paper takes three parameters, i.e. tax, corporate governance and future access to capital in the design of the hybrid financial instrument.

In cross-border transactions, the companies try to take advantage of the difference in tax policies of various jurisdictions with the use of hybrid instruments which take into account share ownership, capital markets, and business culture. The instruments are designed in such a way that they are treated as debt in one jurisdiction and as equity in the other to take advantages of both the categories. This article takes three parameters, i.e. tax, corporate governance and future access to capital in the design of the hybrid financial instrument.

TAX – CONSIDERATIONS

Debt and equity are treated differently in tax law. Debt is met with a relatively preferential treatment compared to equity since interests paid on debt are tax deductible. From this principle, the ideal logic would be that the optimal capital structure must be all debt. However, it is not so; the tax rate is cheaper on dividends paid to the investor than the interested company pay on the capital raised via debt.[3] The company will convince its investors of the benefit by raising capital by debt because of tax benefits.[4]

However, a problem arises as there exists a confusion over how to classify, for tax purposes, instruments that do not closely straightforwardly resemble 'ordinary' debt or 'ordinary' equity i.e. hybrid instruments. There is no significant theory or legal concept in tax that distinguishes debt and equity. Theoretically, debt and equity are in essence indistinguishable, and in cases of hybrid instruments, the distinction is further blurred as to whether the tax treatment of that instrument will be debt or equity.[5] The only way to enforce the distinction in the context of hybrid instruments is to characterise such instruments as either all debt or all equity. This provides companies with an opportunity to use hybrid instruments to satisfy the requirements of debt to enjoy tax benefits but also give the advantages of equity to investor. However, these over-ambitious approaches of companies sometimes lead to expensive litigations resulting in enormous amounts of money being exposed at stake[6].

[1] See Ronald J. Gilson and Mark J. Roe, 'Understanding the Japanese Keiretsu: Overlaps Between Corporation Governance and Industrial Organization', 102 Yale Law Journal 871 (1993); Mark J. Roe, 'Some Differences in Corporation Structure in Germany, Japan, and the United States', 102 Yale Law Journal 1927 (1993); Bernard S. Black and John C. Coffee, 'Hail Britannia? Institutional Investor Behavior Under Limited Regulation', 92 Michigan Law Review 1997 (1994).

[2] Tufano P., Financial Innovation, in Handbook of Economics of Finance (Constantinides G.M., Harris M. and Stulz R.M. eds), Vol. 1, Part 1, 2003, Ch. 6, at 307-335.

[3] Miller M.H., 'Debt and Taxes', The Journal of Finance, 32(2) 1977, 269 and 270, where the author says the value of the firm in equilibrium will be independent of its capital structure but "there would be no optimum debt-equity ratio for any individual firm".

[4] Farrar D. and L. Selwyn, 'Taxes, Corporate Financial Policy and Return to Investors' 20(4) National Tax Journal, 444-454; Myers S.C., 'Capital Structure', 15(2) The Journal of Economic Perspectives, 2001, 87-88; Stapleton R.C., 'Taxes, the Cost of Capital and the Theory of Investment', 82 The Economic Journal, 1972, 1273-92; Stiglitz J.E., 'Taxation, Corporate Financial Policy and the Cost of Capital', 2(1) Journal of Public Economics, 1973, 1-34.

[5] If payments to holders of both debt and equity were deductible, the corporate income tax would effectively be abolished by being reduced to a tax solely on retained earnings. Allowing deduction of payments under neither debt nor equity would require the elimination of a longstanding element of tax policy that interest payments should be deductible as an ordinary and necessary cost of doing business. Thus, either of these solutions would entail dramatic changes in the structure of the corporate income tax.

[6] Cochin International Airport Ltd. v. Presiding Officer, DRT & Ors., (2010) 173 DLT 247. See also Khoday Distilleries Ltd. v. CIT, (2009) 1 SCC 256; Narendra Kumar Maheshwari v. Union of India, 1990 (Supp) SCC 440.

In India, the use of hybrid instruments have picked up fairly recently, and use of hybrid instruments such as convertible debentures began around the 1980s. A big reason for the popularity of hybrid instruments was the tax advantage. However, the over-ambitious approach of the companies in designing hybrid instruments, focussing only on tax advantages, has resulted in litigations, especially the hybrid instrument i.e. Optionally Fully Convertible Debentures.[7] The Tribunal observed, "These tax benefits could be further optimised by hybrid financing instr*uments such as profit participating loans, convertible loans or where instrument is treated as debt in the source country of the income (i.e. resulting in tax deductible interest) and as equity in the residence country of the lender (i.e., where lender may claim the participation exemption of interest income because of its characterisation as distribution of profits)".* [8] However, a sole focus on tax benefits may result in 'Thin Capitalisation'.

Thin Capitalisation refers to a situation in which capital of a business is made up of the greater portion of debt than equity, and its such gearing or leverage ratio i.e. debt equity ratio, is too high. The tax treatment being given to the equity capital and debt capital being fundamentally different, it is often more advantageous in an international context to arrange financing of a company by loan rather than by equity. It does affect the legitimate tax revenues of the source country in which business is carried out because while dividends and interest are taxable at the same rate in the hands of the recipient in the source country, e.g. under India – Belgium tax treaty. That is how tax considerations at times do result in a company being too thinly capitalised, or, to put it differently, financed by a disproportionate ratio of debts.

A classic practical example to understand the use of tax planning using hybrid instruments can be the case of Tata Steel issuing hybrid perpetual notes in 2011 to raise $333 million of capital. Tata Steel, at the time of issue, already had a high debt-equity ratio of 2.3. Therefore, raising capital by debt was not a good option available to the company. Further, it did not want to issue equity as it would have diluted holding of the owner. They needed an in-between thing. The company opted for hybrid perpetual notes with no stated fixed maturity. Also, they are considered to be subordinate to creditors on the repayment obligations of the company and hence are expensive. However, since they have the feature of both debt as well as equity, it allows the securities to be counted as debt for tax purposes and as equity for ratings.

From capital finance perspective the hybrid instrument designed as a debt instrument. For example, Compulsorily Convertible Debentures not considered as debt for tax. There are many hybrid instruments which lie in the grey area between debt or equity for taxation.

CORPORATE GOVERNANCE - CONSIDERATIONS

Tax[9] and Regulatory[10] considerations seem to be the two straightforward considerations which come to one's mind while designing hybrid instruments for capital financing. However, the differences in tax, accounting and regulatory treatment give rise to distortions which greatly affect the more often than not neglected aspect of corporate governance.[11] The flexibility of combining governance and cash-flow rights through hybrids has real implications for the governance of companies, offering some advantages that could not achieve in the same form by simply combining standard debt and equity contracts (i.e. ordinary shares).

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ALIGNING EX-ANTE INCENTIVES

The principal-agent model has long been the dominant economic theory of corporate governance.[12] The agency costs analysis identifies problems in corporations, particularly regarding how investors of equity and debt capital find it difficult to observe to regulate managerial discretion. As a result, the directors may put into practice opportunistic behaviours such as transferring company resources for their self-enjoyment, seeking higher than market salary or job security. They need to be controlled so that a formal control and incentive compensation system is established which will eventually be reflected in the company's shares value.[13]

The existence of debt can also mitigate these agency costs of equity. In fact, the larger the part of the corporate finance financed by debt, the more control and pressure on the management the debt holders will exert and this will be useful for the shareholders too. Since debt legally obliges the company to pay out cash to satisfy the bondholders' contractual rights, the amount of 'free' cash available to managers to spend on their benefits and perquisites is reduced.[14] Managers have a strong incentive to avoid a financial distress situation, because, if the company is declared insolvent, they may lose all their benefits of control and reputation. Debt allows the company to raise new funds without diluting the shareholders' residual claim. In simple words, debt presents a right to a fixed asset rather than any ownership in the company, which is why these payoffs are less sensitive to the distribution of information.[15] However, debt finance has its agency costs. To maximise shareholders' benefit, managers may invest in a way that transfers wealth from the bondholders to the shareholders. It is so often seen that the managers exploit the limited liability of the company to invest in riskier projects with higher returns instead of choosing more valuable investments with the lower risk factor. This creates an unfair situation which acts against the debt instrument holder. In the scenario mentioned above, equity holders gain the

7. Sahara India Real Estate Exch. Cor. Ltd. & Anr. v. SEBI, AIR 2013 SC 3829.
8. Besix Kier Dabhol, S.A. v. Deputy Director of Income Tax, [2011] 131 ITD 299 (Mum).
9. Helminen M., 'Classification of Cross-Border Payments on Hybrid Instruments', (2004) IBFD Bulletin, 56–61, 57; Wittendorff J. and E. Banner-Voigt, 'Taxation of Hybrid Instruments', (2000) IBFD Derivatives and Financial Instruments, 3.
10. Weber R.H. and A. Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulations', (2008) 10 Journal of Banking Regulation, 13; Pope P.F. and Puxty A.G., 'What is Equity - New Financial Instruments in the Interstices between the Law, Accounting and Economics', (1991) 54 Mod. L. Rev., 889-911.
11. Tufano P., Handbook of Economics of Finance Vol. 1, Part 1, 2003, Ch. 6, at 307-335.
12. Hansmann H. and R. Kraakman, Agency Problems and Legal Strategies, in The Anatomy of Corporate Law, 21-22 (Kraakman et al., 2nd eds. 2009); Blair M.M. and L.A. Stout, 'A Team Production Theory of Corporate Law', (1999) 85 VA. L. Rev., 247, 248.
13. Ross S.A., 'The Determination of Financial Structure: The Incentive Signalling Approach', (1977) 8 Bell Journal of Economics, 23-40.
14. Jensen M., 'Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers', (1986) 72 The American Economic Review, 323-329.
15. Townsend R.M., 'Optimal contracts and competitive markets with costly state verification', (1979) 21 Journal of Economic Theory, 265-293; Lacker J.M. and J.A. Weinberg, 'Optimal Contracts under Costly State Falsification', (1989) 97 The Journal of Political Economy, 1345-1363.

> Thin Capitalisation refers to a situation in which capital of a business is made up of the greater portion of debt than equity, and its such gearing or leverage ratio i.e. debt equity ratio, is too high. The tax treatment being given to the equity capital and debt capital being fundamentally different, it is often more advantageous in an international context to arrange financing of a company by loan rather than by equity.

most if investment yields large returns otherwise, even if the investment fails, their risk is limited. Economists have termed this problem as "asset substitution".

Similarly, when the company's cash flow from existing assets does not provide a sufficient return for the shareholders, managers have an incentive to discriminate and eventually turn down some profitable investment opportunities. More often than not, management will choose to invest in a project only if its net present value exceeds the face value of the debt; else only creditors will benefit from this new project. This condition termed as "underinvestment" or "debt overhang".[16] If the bondholders perceive the risks of being appropriated by an overinvestment in high-risk projects or by an underinvestment in low-value projects, they may well adjust downward the price they are willing to offer for the bonds or demand a higher interest rate for the credit and thus pass back the agency costs to the company.[17]

REDUCING EX-POST CONFLICTS

Ownership is considered important for economic efficiency from the practical perspective considering that transaction costs do exist. Contractual arrangements are the tools that can be used to control conflicts that arise from managers' opportunistic decisions. They revolve around three things: firstly, information privileges; secondly, control; and thirdly, property rights. Thus, well-designed contracts enable the parties to choose optimal governance.[18] However, contracts also suffer from positive transaction costs.

These costs have two specific effects: they may preclude trade, or they may cause contracts to be incomplete. Contracts are incomplete either because terms are not specified or are not differentiated for certain possible states of the world.[19] The contract incompleteness is not only due to the cost of bargaining, but can also be because of imprecise language, which leaves it open to interpretation, limited foresight and asymmetries in information which will discourage more specific bargaining.[20] The law can address some of these incompleteness problems by providing standard terms that parties might be expected to agree to as, for example, share capital guidelines embedded in corporate legislations.

But this is not possible in every case to emulate contractually. It applies to persons who are not parties to the corporate contracts as, for example, the prohibition on the creditors of shareholders enforcing their debts against the assets of the company.[21] Since corporations run their business in the presence of uncertainty, contracts may also be incomplete due to difficulties in contemplating in advance all possible future contingencies and estimating performance under each contingency. Also, a court cannot verify the states of the world on which the parties would like to condition their contractual pay off often. An insufficiently state-contingent contract creates an incentive to renegotiate or to breach.[22] For example, an undertaking to pay a fixed interest will mean the promisor must bear the risk in case that the revenues fail, for whatever reason, to produce the expected profits.

By theory, *ceteris paribus*, a complete contract is one that confers less residual property rights. The parties will adopt a clear organisational structure that allows transparent information exchange between managers and the debt-holders to control managerial opportunism. The parties will allocate property rights in a way that allow managers to act in the interests of investors and at the same time to permit persons holding debt instruments to ensure that their costs are also adequately covered.[23]

FUTURE ACCESS TO CAPITAL

This section focusses on the importance of regulatory and future access to capital considerations to design hybrids instrument. In perfect capital markets, there is no need to construct a regulatory payoff pattern to suit companies or investors. As a result, instruments are assumed to be fairly priced and regulatory considerations are therefore irrelevant. Investors can always create any payoff structure they want, assuming that no transaction cost exists.

Companies that are regulated need to keep certain amounts of capital for regulatory reasons. Financial metrics such as debt – equity ratio play an important role in determining the credit ratings of regulated companies. These credit ratings are highly important as they serve two-forth purpose – a healthy credit rating empowers the company to ready future access to capital from markets in case of any emergency; secondly, a healthy credit rating also empowers the company to enjoy favourable investor sentiments which result in higher share value for its investors.

In the case of hybrids, the classification securities into debt and equity may not depend on their actual payoff structure. Companies may be able to issue hybrid securities to take advantage of this situation. The credibility of companies applies more generally to credit rating agencies. If these agencies are willing to give companies equity credit for certain instruments, even though the payoff structure of these instruments is more debt-like, companies can take advantage of this situation. Let us refer example of Tata Steel. The company was already suffering from a high debt – equity ratio and the owners did not want to dilute their control. Thus, neither of the conventional debt nor conventional equity instrument could have proved to be an optimum choice. This is an example of the hybrid instrument being designed taking both tax and regulatory considerations.

16. Myers S.C., 'Capital Structure', (2001) 15(2) The Journal of Economic Perspectives, 97.
17. Jensen M. and W. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency costs and Ownership Structure', (1976) 3 J. Fin. Econ., 335-336.
18. The term used by Williamson O.E., 'Market and Hierarchies: Analysis and Antitrust Implications' (New York: The Free Press 1975) 70 to denote ex post opportunism.
19. Williamson O.E., 'The Economic Institutions of Capitalism' (1985) 2 J. Fin. Econ., 256-257.
20. Schwartz A., 'Relational contracts in the courts: an analysis of incomplete agreements and judicial strategies', (1992) 21 Journal of Legal Studies, 271-318.
21. Hansmann H. and R. Kraakman, 'The Essential Role of Organizational Law', (2000) 110 Yale LJ, 387, 407-408.
22. Hart O., 'One-Share One-Vote and the Market for Corporate Control', (1988) 20 Journal of Financial Economics, 119–139.
23. Hart O., 'Firms, Contracts and Financial Structures' (1995) 18 Journal of Financial Economics, 95-96.

To illustrate further, let us consider convertible instruments. It has become a trend for foreign investors to take up convertible instruments in Indian companies. These instruments are issued as either preference shares or debentures, to begin with and are convertible into equity shares of the Indian company at a later date. The conversion usually occurs in one of two ways: firstly, either at the option of the investor; or secondly, compulsorily i.e. without any option whatsoever. From a foreign direct investment standpoint, the question is whether such convertible instruments constitute debt, thereby falling within the purview of regulations governing External Commercial Borrowings (ECBs), or whether they constitute equity, thereby falling under the guidelines pertaining to Foreign Direct Investment (FDI).

All preference shares with an option to convert into equity were treated as FDI, and thus were subjected to the sectoral caps. As regards convertible debentures, although the policy does not appear to have been entirely clear, there have been instances where convertible debentures have been allowed by the Foreign Investment Promotion Board (FIPB) under the FDI policy. The general understanding has been that wherever there was a possibility that the instrument would be converted into equity that would be treated as equity investment for FDI purposes.

However, this understanding was being exploited by the foreign companies to overcome the sectoral restrictions provided under the FDI. As a result, the policy was made significantly tighter by the Reserve Bank of India (RBI) in 2007 for preference shares and debentures, whereby, only fully and mandatorily convertible instruments are now considered to be FDI. All other preference shares and debentures, and including those that are optionally convertible, are considered to be debt and hence, governed by the guidelines on ECBs.[24] In its 2007 policy on convertible debentures, the RBI noted the reasons for this:

"It has been noticed that some Indian companies are raising funds under the FDI route through issue of hybrid instruments such as optionally convertible/ partially convertible debentures which are intrinsically debt-like instruments. Routing of debt flows through the FDI route circumvents the framework in place for regulating debt flows into the country. It is clarified that henceforth, only instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the FDI Policy and eligible to be issued to persons resident outside India under the Foreign Direct Investment Scheme in terms of Regulation 5 (1) of Foreign Exchange Management (Transfer and Issue of shares by a Person Resident outside India) Regulations, 2000 notified vide Notification No. FEMA 20/2000-RB dated May 3, 2000."

After this policy change, Indian companies have to reconsider this factor while designing hybrid instruments and this regulatory consideration makes it clear that the companies will have to issue compulsorily convertible debentures (CCD) to foreign investors if they are looking to taking advantage of the FDI sectoral caps. Funds raised through any other route would then be included in external commercial borrowing, which is subject to a company-specific ceiling of $750 million.[25] On the other hand, treating CCDs as equity would mean that such investment would have to comply with sectoral FDI limits.

Thus, these regulatory considerations play a major role when hybrid instruments are designed. Most of the instruments in recent times has been done taking regulatory considerations as determinants. However, one cannot ignore financial metrics which play an important role in determining the ease of company to future access to capital. Thus, a company might be tempted to go for a hybrid instrument having debt character to overcome the regulatory barriers of FDI, but it cannot ignore its impact on the debt – equity ratio, which will affect its power to raise capital in future and too much burden on its books will result in loss of investor confidence.

END REMARKS

The legal distinction between equity and debt can be meaningless and the results of that categorisation misleading. Hybrid instruments are blurring that distinction and providing more flexibility to corporations. The capacity of hybrids to replicate characteristics of equity or debt, depending on the situation, make these great securities tools for achieving the ideal capital structure. The flexibility accorded by these instruments provides opportunities to companies to raise capital at desired costs.

Another issue which arises while dealing with hybrid instruments is determining the status of the hybrid instrument holder. Whether the hybrid instrument holder is considered as a creditor or a shareholder? The discussion on this issue from the perspective of various jurisdictions with the help of relevant articles, judgments, examples, etc. For example, redeemable shares possess features of debt in having no management right, but since the "interest" payments are dependent upon the performance of the company, an equity feature, these instruments have been held to be in the category of stocks. The determination of the character cannot be done quantitatively. Also, the presence of any single feature cannot be regarded as the determinant either.

An important factor which is off-late being used to determine the character of the hybrid instrument is the intention. Consider this, a company needs to raise capital, and it employs a hybrid instrument to do so. On evaluation, if it is found that the rate of return provided in the instrument is much greater than the interest rate on a loan of similar risk, then it would give a strong indication that the company intended to enter into an equity relationship and not a creditor relationship. The simple logic is that had the company intended on entering into a creditor relationship then why they would pay the extra return on the instrument.

Another approach which is adopted to address the ambiguity regarding their character in case of hybrid instruments is that of fixing that anything not having the certainty of acquiring equity character shall be considered as debt and vice versa. For example, in the case of convertible debentures, compulsorily convertible debentures shall be treated as equity for tax and regulatory purposes while optionally convertible debentures shall be considered as equity only after the conversion and before conversion as debt. In the case of the compulsorily convertible debenture, there is a certainty that even though the instrument is a debenture at present, but its status is compulsorily equity.

It will be difficult to come up with a fixed rule for designing a hybrid instrument owing to the great flexibility that it provides. Also, the environment of each company varies from the other. But if designed carefully, the contractual design structure of hybrid financial instruments provide an optimal way to fill the vacuum left by conventional instruments. It is, therefore, proposed that a hybrid instrument will be designed optimally when the three parameters, tax, corporate governance and future access to capital, are considered synergistically. There is scope for hybrid financial instruments to play a more important role outside the realm of just tax arbitrage, allowing market participants to realise the potential of governance rights fully. CS

24. RBI/2006-2007/434, A.P. (DIR Series) Circular No.73, dated 8th June, 2007.
25. Master Circular No. 12/ 2013-14, RBI/ 2013-14/ 12, dated 1st July, 2013.