



1. Introduction

One of the most debated issues under the Companies Act, 2013 is whether the conversion of a loan or debenture into equity shares should be undertaken under Section 62(3) of the Companies Act, 2013 (Act) or whether it constitutes a preferential allotment requiring compliance with Section 62(1)(c) read with Section 42 of the Act. The distinction is significant because Section 62(3) exempts qualifying transactions from the procedural framework governing further issue of share capital, whereas Section 62(1)(c) mandates compliance with the preferential allotment provisions, including shareholder approval, valuation requirements and, where applicable, the private placement framework. An incorrect classification may expose the company and its officers to regulatory action and may affect the validity of the allotment.

The Companies Act, 2013 establishes a structured framework for the issue of further share capital. Section 62 generally requires that any subsequent issue of shares be made by way of a rights issue, an employee stock option scheme or a preferential allotment. However, recognising the commercial realities of corporate financing, the legislature carved out a limited exception under Section 62(3) for the conversion of loans or debentures into equity where such conversion arises from a pre-existing contractual arrangement approved by the shareholders before the loan is raised or the debentures are issued.

The scope of this exception has assumed increasing practical significance with the growing use of convertible financing by private companies, start-ups, venture capital investors and promoter groups. Companies frequently raise funds through shareholder loans, promoter funding, convertible debentures and other hybrid instruments that incorporate a future conversion mechanism. While the subsequent conversion of such instruments into equity is a common commercial practice, the statutory route governing such conversion is often misunderstood. A widespread misconception is that every conversion of debt into equity automatically falls within Section 62(3). This overlooks the conditional nature of the provision, which applies only where the increase in subscribed capital results from the exercise of an option attached to the loan or debenture and such option was approved by the shareholders through a special resolution before the financing arrangement came into existence.

The real legal enquiry, therefore, is not whether a loan has been converted into equity, but whether the right to receive equity existed at the inception of the financing transaction or was created subsequently. Where the conversion merely gives effect to a contractual right approved in advance by the shareholders, Section 62(3) may apply. Conversely, where the parties decide to convert an existing loan into equity through a subsequent arrangement, the transaction may amount to a fresh issue of shares attracting the preferential allotment provisions.

The importance of this distinction has been reinforced by recent adjudication proceedings initiated by the Ministry of Corporate Affairs, which underscore that Section 62(3) is a narrow statutory exception and not a general exemption for all debt-to-equity conversions. Companies must therefore carefully evaluate the nature of the conversion mechanism before determining the applicable statutory route.



This article examines the legislative framework of Section 62(3), analyses its interplay with Sections 62(1)(c) and 42 of the Companies Act, 2013, identifies the statutory conditions governing the exemption, and proposes a principled framework for distinguishing genuine contractual conversions from preferential allotments. It also considers the emerging regulatory approach and highlights the practical implications for Company Secretaries, legal practitioners and corporate advisors involved in structuring debt-to-equity conversions.

2. Legislative Framework of Section 62

Section 62 of the Companies Act, 2013 regulates the manner in which a company having a share capital may issue further shares after its initial allotment. The provision seeks to balance two competing objectives. On the one hand, it protects existing shareholders against arbitrary dilution of their ownership. On the other hand, it permits companies to raise additional capital through commercially recognised modes subject to appropriate shareholder approval and procedural safeguards.

Section 62 may broadly be divided into four categories:

First, Section 62(1)(a) embodies the principle of pre-emptive rights by requiring that further shares be offered to existing equity shareholders in proportion to their existing shareholding. This ensures that existing members are afforded an opportunity to maintain their percentage ownership before shares are offered to outsiders.

Secondly, Section 62(1)(b) enables companies to issue shares under employee stock option schemes. Such issues are intended to promote employee participation in the ownership of the company and require approval of the shareholders by way of a special resolution.

Thirdly, Section 62(1)(c) permits the company to issue shares to any person, whether or not such person is an existing shareholder or employee, provided the issue is approved by the shareholders through a special resolution and complies with the applicable statutory requirements. This forms the statutory basis for preferential allotments, including private equity investments, promoter infusions and strategic investments.

Finally, Section 62(3) carves out a limited exception to the above framework. It provides that *nothing contained in Section 62 shall apply to an increase in the subscribed capital of the company caused by the exercise of an option attached to the debentures issued or loans raised by the company to convert such debentures or loans into shares, provided that the terms of issue of such debentures or loans containing the conversion option have been approved before their issue by a special resolution passed by the company in general meeting.*



Unlike the preceding provisions, Section 62(3) does not prescribe a separate mode of issuing shares. Rather, it recognises that where the shareholders have already approved a financing arrangement containing a conversion mechanism before the funds are raised, it is unnecessary to require the company to undertake a fresh exercise under Section 62 when the conversion eventually takes place.

The distinction is important. Section 62(3) is not intended to facilitate fresh capital raising through conversion of existing debt. Instead, it enables the implementation of contractual rights that were approved by the shareholders at the inception of the financing arrangement. The subsequent issue of shares is therefore treated as the fulfilment of an existing contractual obligation rather than a fresh decision to issue capital.

The Act thus recognises two distinct situations. In one case, the company consciously decides to issue shares to a person who previously had no entitlement to receive equity. Such an issue is governed by Section 62(1)(c). In the other, the company merely gives effect to a contractual conversion right that already existed when the financing arrangement was approved by the shareholders. Such transactions fall within the limited scope of Section 62(3), provided the statutory conditions are satisfied.

3. Section 62(3) is an exception, not an independent mode of issue

A common misconception is that Section 62(3) constitutes an independent mechanism for issuing shares. Such an interpretation is not supported by the language of the statute.

Unlike Section 62(1)(a), Section 62(1)(b) or Section 62(1)(c), Section 62(3) does not prescribe any procedure for issuing securities. It neither authorises an allotment nor prescribes the manner in which shares are to be issued. Instead, it merely declares that the provisions of Section 62 shall not apply where the increase in subscribed capital occurs pursuant to a qualifying conversion option.

The provision, therefore, operates as a statutory exemption rather than as a source of power to issue shares. The company's authority to allot shares continues to arise from its Memorandum and Articles of Association, the Companies Act and the contractual arrangements entered into with the lender. Section 62(3) merely relieves the company from complying with the procedural requirements otherwise applicable under Section 62.

4. Essential ingredients of Section 62(3)

The exemption under Section 62(3) is attracted only when the following requirements are fulfilled:

First, the company must have raised a loan or issued debentures.

The provision expressly refers to "debentures issued or loans raised". It is therefore confined to financing transactions that create a debtor-creditor relationship. The expression "loan" has not been defined under the Companies Act, 2013 and must accordingly be understood in its ordinary commercial sense. Whether the lender is a promoter, shareholder, financial institution or third party is immaterial. What is relevant is the existence of a genuine lending arrangement.



Secondly, the loan or debenture must contain an option permitting its conversion into equity shares.

The statute does not contemplate an independent agreement executed after the borrowing has taken place. Instead, it requires the conversion option to be attached to the loan or debenture itself. The conversion right must therefore form part of the original financing arrangement.

Thirdly, the shareholders must approve the conversion terms before the loan is raised or the debentures are issued.

This requirement is mandatory. The proviso to Section 62(3) specifically requires prior approval by way of a special resolution. The timing of shareholder approval is therefore not merely procedural but goes to the very root of the exemption.

Finally, the increase in subscribed capital must occur because the conversion option has been exercised.

The issue of shares must be the direct consequence of implementing the contractual conversion mechanism. If the shares are issued for any other reason or pursuant to a subsequently negotiated arrangement, the causal connection contemplated by Section 62(3) may no longer exist.

Each of these conditions performs an independent statutory function. Failure to satisfy any one of them may deprive the company of the benefit of the exemption.

5. Meaning of the Expression "Option Attached to the Loan"

Among all the expressions employed in Section 62(3), the phrase "option attached to the debentures or loans" deserves particular attention.

The Act neither defines the word "attached" nor explains the manner in which the option should exist. Consequently, the expression must be interpreted in its ordinary legal and commercial sense.

An option can be said to be "attached" to a loan only when it forms an integral part of the original lending transaction. The lender advances funds with the knowledge that, subject to the agreed terms, the debt may subsequently be converted into equity. Correspondingly, the company raises funds knowing that repayment may ultimately take place through the issue of shares instead of cash.

The conversion mechanism is therefore not an afterthought but one of the essential commercial terms on which the financing arrangement is concluded.

This interpretation is also consistent with the proviso to Section 62(3), which requires shareholder approval before the loan is raised. If the conversion option could be introduced subsequently, the requirement of prior shareholder approval would lose much of its significance.

Accordingly, the option should either be incorporated in the principal loan agreement itself or form part of contemporaneous transaction documents that collectively constitute the financing arrangement.



6. Prior shareholder approval and exercise of the conversion option

The proviso to Section 62(3) requires that the terms of issue containing the conversion option must be approved by the shareholders through a special resolution **before** the debentures are issued or the loan is raised. The timing of this approval is not merely procedural; it is the foundation of the statutory exemption.

The requirement ensures that existing shareholders evaluate and approve the potential dilution of their shareholding before the company receives the funds and before the lender acquires any contractual right to convert the debt into equity. Shareholder approval is therefore prospective rather than retrospective and reflects an informed commercial decision at the inception of the financing arrangement.

Act reads, "before the issue of such debentures or the raising of the loans", making it evident that the approval must precede the financing transaction itself. If the special resolution is passed after the loan has already been disbursed, the shareholders are no longer approving the terms of a proposed financing arrangement; they are merely ratifying an existing transaction. Such an interpretation would render the statutory requirement of prior approval otiose and defeat the legislative intent underlying the provision.

The requirement of prior shareholder approval is closely linked to another essential condition under Section 62(3), namely that the increase in subscribed capital must result from the exercise of the option attached to the loan or debenture. The expression "exercise of the option" establishes a direct relationship between the contractual conversion right and the subsequent allotment of shares. In other words, the increase in subscribed capital must be the consequence of enforcing a conversion mechanism that formed part of the original financing arrangement and was approved by the shareholders before the funds were raised.

Where a company raises funds under a loan or debenture carrying a pre-agreed conversion option, the possibility of future dilution is known to all stakeholders from the outset. The lender advances funds with a contractual expectation of conversion, while the shareholders consciously approve the potential alteration of the company's capital structure before the financing is completed. The subsequent allotment of shares is therefore not a fresh capital-raising exercise but merely the implementation of rights that were approved at the inception of the transaction.

Conversely, where a company initially raises an ordinary loan without any conversion mechanism and subsequently decides to settle the outstanding debt through the issue of equity shares, the increase in subscribed capital cannot be said to result from the exercise of an option attached to the original loan. Instead, the allotment arises from a fresh commercial arrangement between the parties, whereby a new conversion right is created after the financing transaction has already been concluded. Such a transaction falls outside the scope of Section 62(3), as the increase in subscribed capital is attributable not to the exercise of an existing contractual right but to a subsequent agreement to issue shares.



Accordingly, the twin requirements of “prior shareholder approval” and “exercise of the original conversion option” are complementary safeguards embedded in Section 62(3). Together, they ensure that the exemption applies only where the allotment of shares represents the implementation of a conversion mechanism contemplated and approved at the inception of the financing arrangement, and not where the parties subsequently decide to convert an existing debt into equity.

7. Can the conversion option be modified after the Loan is raised?

A practical issue frequently encountered is whether the parties may amend the terms of a convertible loan after its disbursement.

Commercially, parties may revise:

- the conversion price;
- the conversion ratio;
- the conversion period;
- valuation methodology; or
- other commercial terms.

The legal implications depend upon the nature of the amendment. Minor modifications that merely facilitate implementation of the original conversion mechanism may not necessarily alter the character of the transaction. However, where the amendment creates a conversion right that did not previously exist, or fundamentally alters the nature of the parties' rights and obligations, it becomes difficult to contend that the subsequent allotment arises from the exercise of an option originally attached to the loan.

Accordingly, while modifications to the mechanics of conversion may, depending on the facts, remain consistent with Section 62(3), the creation of an entirely new conversion entitlement after the loan has been raised is unlikely to satisfy the statutory requirement.

8. When Section 62(3) cannot be used

Section 62(3) cannot be invoked merely because a lender and the company subsequently agree to convert a loan into equity.

The exemption is unavailable where:

- The original loan agreement did not contain a conversion clause;
- The conversion clause was introduced through a later amendment;
- Shareholder approval was obtained after the loan was raised;
- The conversion terms were never approved by shareholders; or
- The company seeks to settle an existing debt by issuing shares without any pre-existing conversion right.

In such situations, the conversion effectively amounts to a fresh issue of shares and must be undertaken through the preferential allotment route under Section 62(1)(c).

Illustrative Scenarios



a. Scenario A – Valid conversion under Section 62(3)

ABC Private Limited raises a loan of ₹10 crore from a lender. The loan agreement contains a conversion clause permitting conversion into equity after three years at a predetermined valuation. Prior to availing the loan, shareholders approve the conversion terms through a special resolution.

After three years, the lender exercises the conversion option.

Result: Section 62(3) applies. No preferential allotment process is required.

b. Scenario B – Preferential allotment required

XYZ Private Limited borrows ₹10 crore from a lender without any conversion clause. Two years later, the parties agree to convert the outstanding loan into equity shares.

Result: Section 62(3) is unavailable because no conversion option existed when the loan was raised. The company must undertake a preferential allotment under Section 62(1)(c).

c. Scenario C – Delayed shareholder approval

A company raises a convertible loan in January. The shareholders approve the conversion terms by a special resolution in June, and conversion occurs in December.

Result: Section 62(3) conditions are not satisfied because approval was not obtained prior to raising the loan. Preferential allotment provisions may become applicable and the company may face regulatory exposure.

9. Key Takeaways

- i. Section 62(3) is an exception and not an alternative method of allotment.
- ii. The conversion option must be embedded in the original loan or debenture documentation.
- iii. Shareholders must approve the conversion terms before the loan is raised or debentures are issued.
- iv. If either condition is absent, conversion into equity must ordinarily proceed through the preferential allotment route under Section 62(1)(c).
- v. Companies should evaluate the structure at the financing stage itself to avoid future compliance complications.

Conclusion

The distinction between Section 62(3) and Section 62(1)(c) is fundamentally a question of timing and pre-existing contractual rights. Where shareholders have approved a conversion mechanism before the company raises funds, the subsequent conversion merely gives effect to an existing right



and falls within the protective ambit of Section 62(3). Conversely, where the conversion proposal emerges after the borrowing has already been made, the issuance of shares constitutes a fresh allotment requiring compliance with the preferential allotment framework under Section 62(1)(c).

Given the increasing scrutiny by regulatory authorities, companies should carefully structure convertible instruments at inception and ensure strict adherence to the statutory prerequisites before relying on the exemption under Section 62(3).

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