

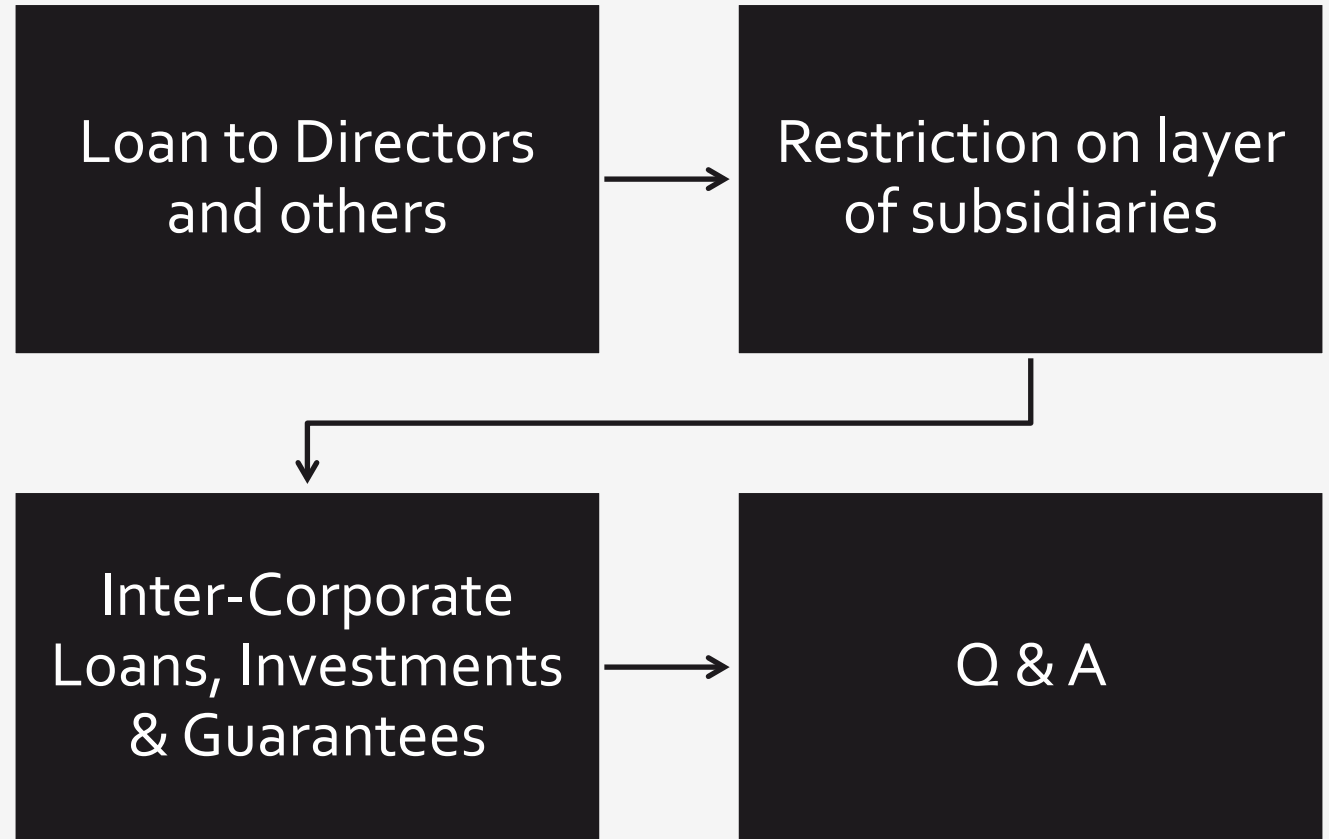


Anshu Agarwal

Inter Corporate Loans, Investment, Guarantees

Agenda of today's discussion

August 27, 2022





*Loan to Directors &
others*

Section 185

Journey So far

Corresponding sections 295 & 296 of the Companies Act, 1956 were not applicable to private companies.

Section 185 came into force on 12-09-2013.

Applicable to all companies public and private.

Giving loans etc to directors and other persons associated to directors was a complete prohibition section.

Exemption notification dated 5/06/2015 - exemption to private company, Nidhi Company and Government company.

Through the Companies (Amendment) Act, 2017 w.e.f. 07/05/2018- New section was substituted - Shift from prohibition to regulation.

Section 185

Overview

Prohibited Bucket

any director, director of its Holding company, any Partner, Relative of such director, Firm in which Such Director or Relative is partner

Regulated Bucket

Person in whom director is interested

- Private Company - Director/Member
- Body Corporate – 25% voting power
- Accustomed to act

By passing special resolution, explanatory statement and Utilisation for Principal Business Activities

Permitted Bucket

- (i) MD/WTD in certain situation,
- (ii) Ordinary course of business
- (iii) Loan/ Guarantee/ Security to WOS, and
- (iv) guarantee/ security to subsidiary – Principal Business Activities

Section 185

Prohibited Bucket

No company shall, **directly or indirectly, advance any loan**, including any loan represented by a **book debt** to, or give any guarantee or provide any security in connection with any loan taken by, —

- (i) **any director** of company, or
- (ii) of a company which is **its holding company** or
- (iii) **any partner** of any such director or
- (iv) **relative** of any such director; or
- (v) any **firm** in which any such director or relative is a partner.

“Genuine trade advance” shall be outside the purview of section 185

Section 185

Prohibited Bucket

What is not a loan—can't be converted as loan?

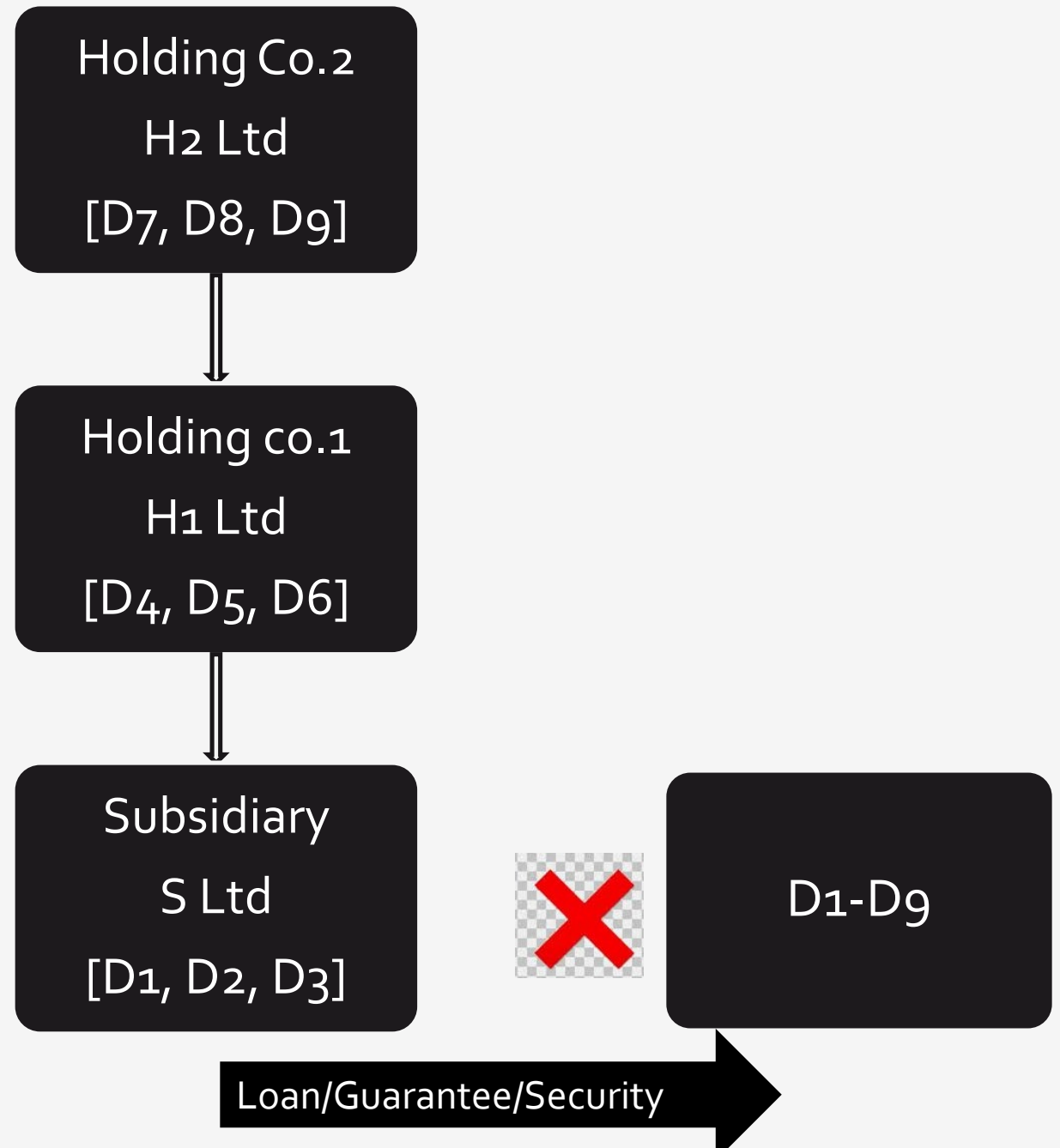
Dr. Freddie Mehta Vs. Union of India (1991) 70 Comp Cas 210 (Bom)

The Court said, "leaving the purchase money unpaid is leaving a debt unpaid. **Every loan is a debt but every debt is not a loan.** The purchase money due to the plaintiff is a debt due to the plaintiff but is not a loan or a transaction which is in substance a loan"

The word "**indirectly**" can't be read as **converting** what is **not** a loan into **a loan.**

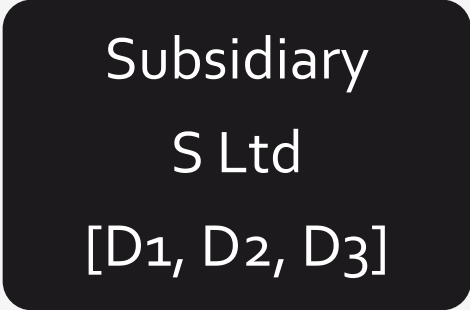
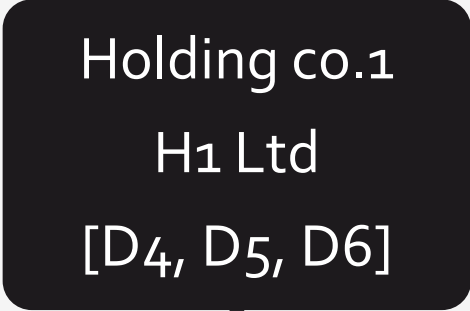
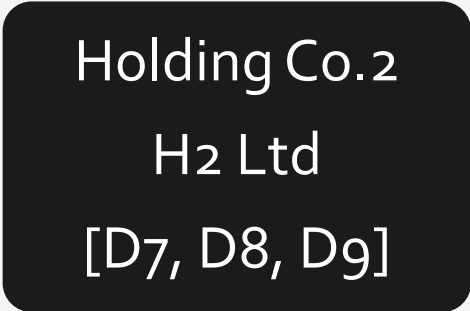
Section 185

Prohibited Bucket



Section 185

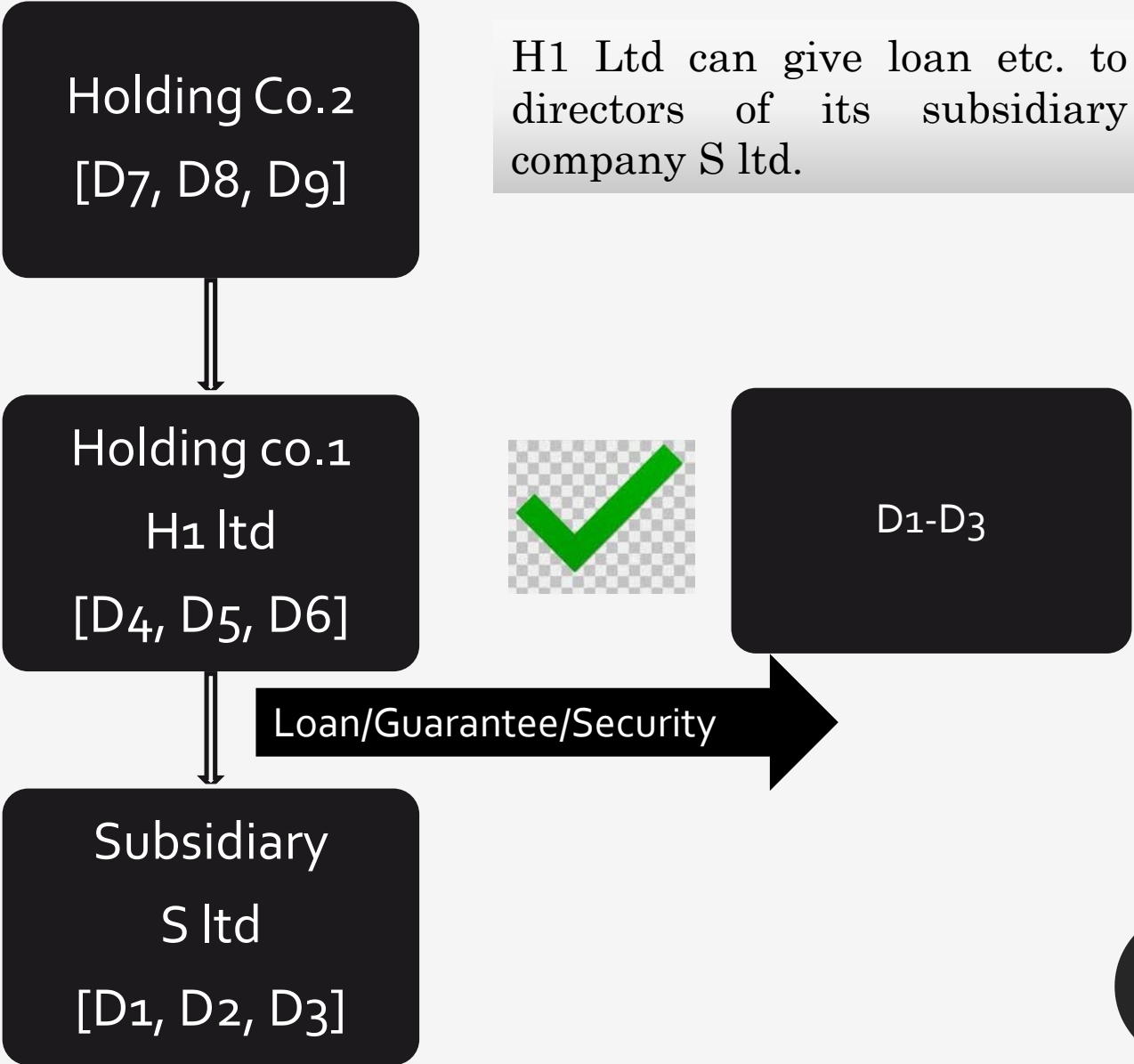
Prohibited Bucket



If S Limited wants to give loan, etc. to XYZ then D1 to D9 or their relatives should not be partners of XYZ



Section 185



Section 185

Regulated Bucket

Section 185(2)

A company **may** advance any loan including any loan represented by **a book debt**, or give any guarantee or provide any security in connection with any loan taken by **any person in whom any of the director of the company is interested**, subject to the condition that—

(A) a **special resolution** is passed by the company in general meeting:

Provided that the **explanatory statement** to the notice for the relevant general meeting shall disclose the **full particulars** of the loans given, or guarantee given or security provided and the **purpose** for which the loan or guarantee or security is proposed to be utilized by the recipient of the loan or guarantee or security and any other relevant fact; and

(B) the loans are utilised by the borrowing company for its **principal business activities**.

Section 185

Regulated Bucket

Section 185(2)

Any person in whom any of the
director of the company is
interested

Explanation—For the purposes of this sub-section, i.e. sub-section (2) of 185, the expression "any person in whom any of the director of the company is interested" means

(a) Any **private company** of which any **such director** is a **director or member**;

(b) Any body corporate at a general meeting of which **not less than twenty-five per cent. of the total voting power** may be **exercised or controlled** by any **such director**, or by two or more such directors, together; or

(c) Any body corporate, the Board of directors, managing director or manager, **whereof is accustomed to act** in accordance with the **directions or instructions** of the board, or of any director or directors, of the lending company.

Section 185

Regulated Bucket

Section 185(2)

Accustomed to act

There should be clear indication of regular and usual practice of Directions or Instructions.

It is a question of fact not presumption even in case of WOS or even one or more directors/employees of holding com. are directors of subsidiary company.

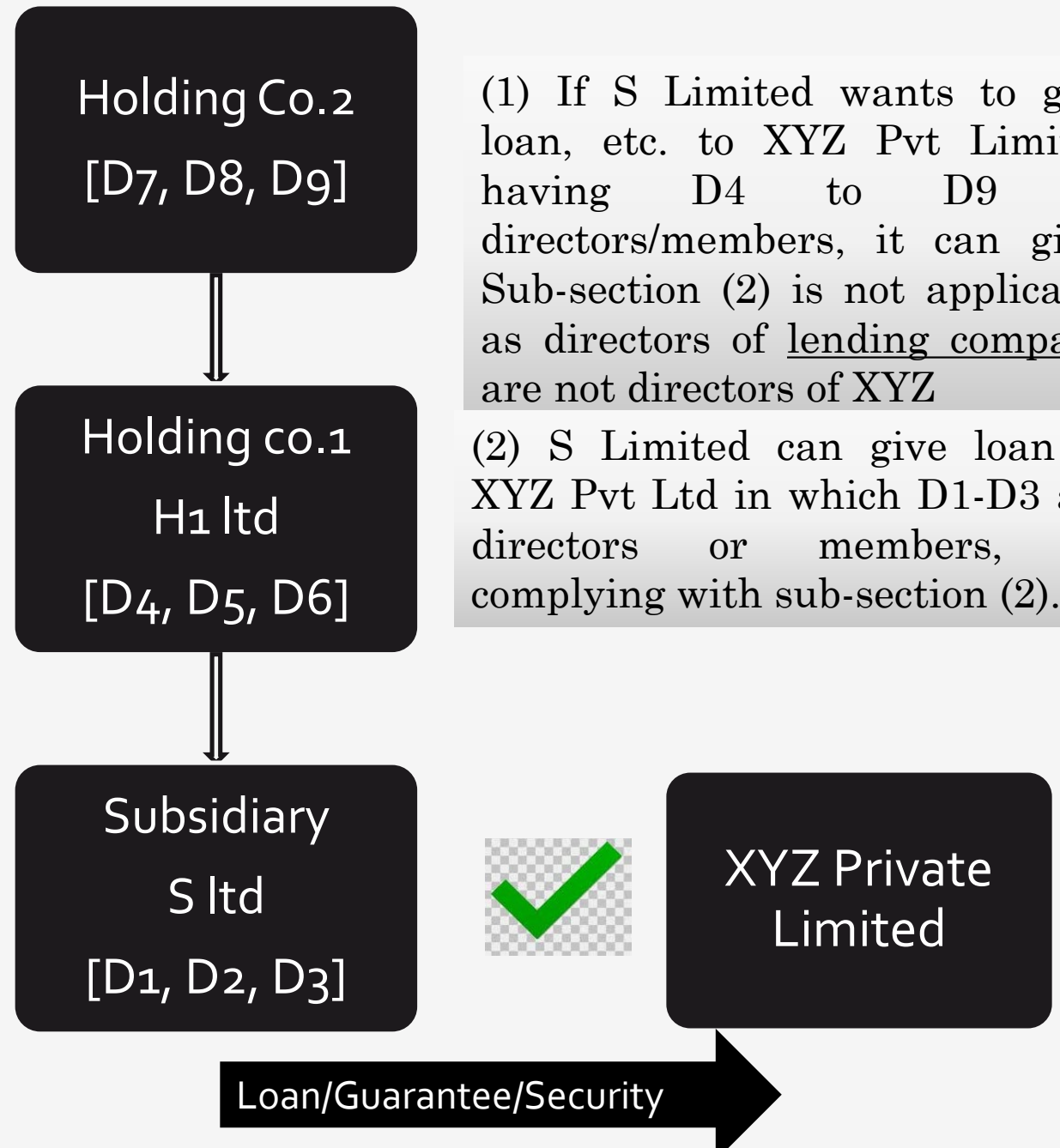
Holding - Subsidiary company
Whether clause (c) applicable automatically?
Many decided case laws say "No" in view of lack of evidence of "Directions" or "Instructions" issued and followed.

Facts should be established case by case.
SC says in [Balwant Rai Saluja V Air India Ltd (AIR 2015 SC 375)]
Corporate veil of WOS can not be lifted/pierced. They were separate legal entities and management of business of subsidiary was under its own BoD even though board is controlled by holding including removal of the directors/chairman.

This expression used many other sections
2(59);2(60);2(69);2(76);219(c) 336 & 386.

Section 185

Regulated Bucket



(1) If S Limited wants to give loan, etc. to XYZ Pvt Limited having D4 to D9 as directors/members, it can give. Sub-section (2) is not applicable as directors of lending company are not directors of XYZ

(2) S Limited can give loan to XYZ Pvt Ltd in which D1-D3 are directors or members, by complying with sub-section (2).

S Ltd. can give loan to XYZ Limited even if D1/D2/D3 singly or together are holding 25% or more voting power of XYZ Limited, subject to compliance with sub-section (2)

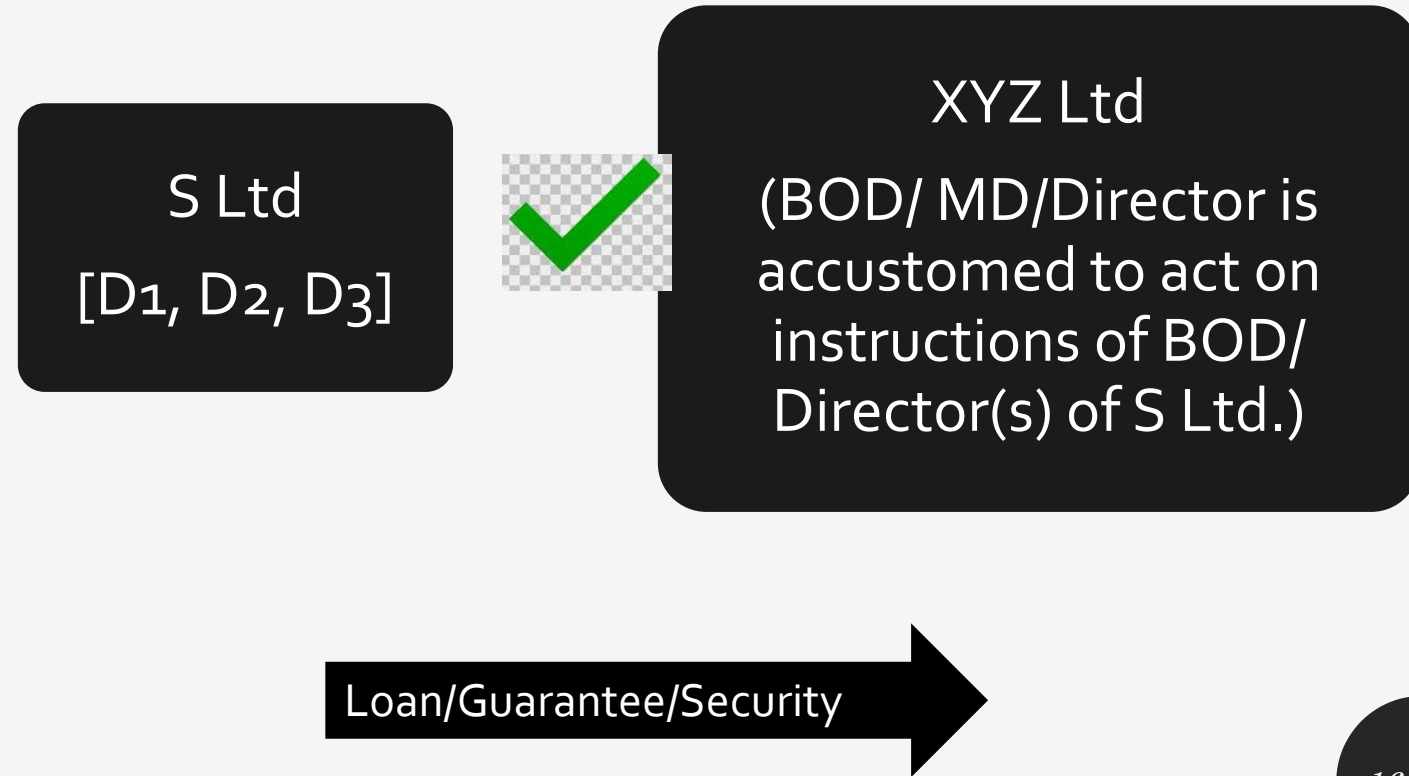
Section 185

Regulated Bucket



Section 185

Regulated Bucket



Section 185

Permitted Bucket

Section 185(3)

Only Loan

-To **MD/WTD** as part conditions of service to all employees or
-pursuant to a **scheme** approved by **SR**

-Provide in the **ordinary course of business** where **interest charged** not less than prevailing yield of

G Sec of 1 year, 3 year, 5 year or 10 year

-Made by **holding company to WOS**

-WOS to utilise money in its **principal business activities**

Guarantee or security provided

- by holding company in respect of loan made to WOS or loan made by **bank or FI** to subsidiaries

- subsidiary to utilise money in its **principal business activities**

Critical Issues

Section 185 & 186

Whether below transactions would be covered under Section 185?

Loan to **trust** where directors of company are interested

Loan to **LLP** where directors are partners/ relatives are partners.

Guarantee / security for loan availed by MD/WTD whether exempted?

Loan to **manager** of the company?

Loan to a **subsidiary** company (non-WOS)?

Loan from **subsidiary to holding** company, whether permitted?

Section 185

Who are exempted

Who are exempted from section 185

Private company

- 1.No body corporate as its **member**.
- 2.Borrowing from bank /FI/body corporate less than **twice** paid up capital or **Rs.50 cr** whichever **lower**.
- 3.No repayment **default subsisting** in such borrowings.

Nidhi company,

1. The **loan** is given to a **director** or **his relative** in their capacity as **members**
2. Such transaction is disclosed in the **annual accounts** by a note.

Government company,

1. Approval of the Ministry or Dept of the CG which is **administratively** in charge of the company, or, as the case may be, the State Government before making any loan or giving any guarantee or providing any security under the section

Section 185

Punishment

Punishment for Contraventions		
Company Fine – 5Lakh to 25Lakh	Officer in default Imprisonment-6 months or Fine - 5Lakh to 25Lakh or Both	Director or other person to whom loan etc. provided :Imprisonment-6 months or Fine - 5Lakh to 25Lakh or Both



*Inter-corporate
Loans, Investments &
Guarantees*

Section 186

Section 186(1)

Companies not to have more than
2 layers of investment subsidiary

186.(1) Without prejudice to the provisions contained in this Act, a company shall unless otherwise **prescribed**, make investment through **not more than two layers** of **investment companies**.

Exemption

(1) While **acquiring foreign company**, which has investment subsidiaries beyond two layers as per the laws of such foreign country; and

(2) For the purpose of meeting the **requirement under any law**, rules or regulations for the time being in force.

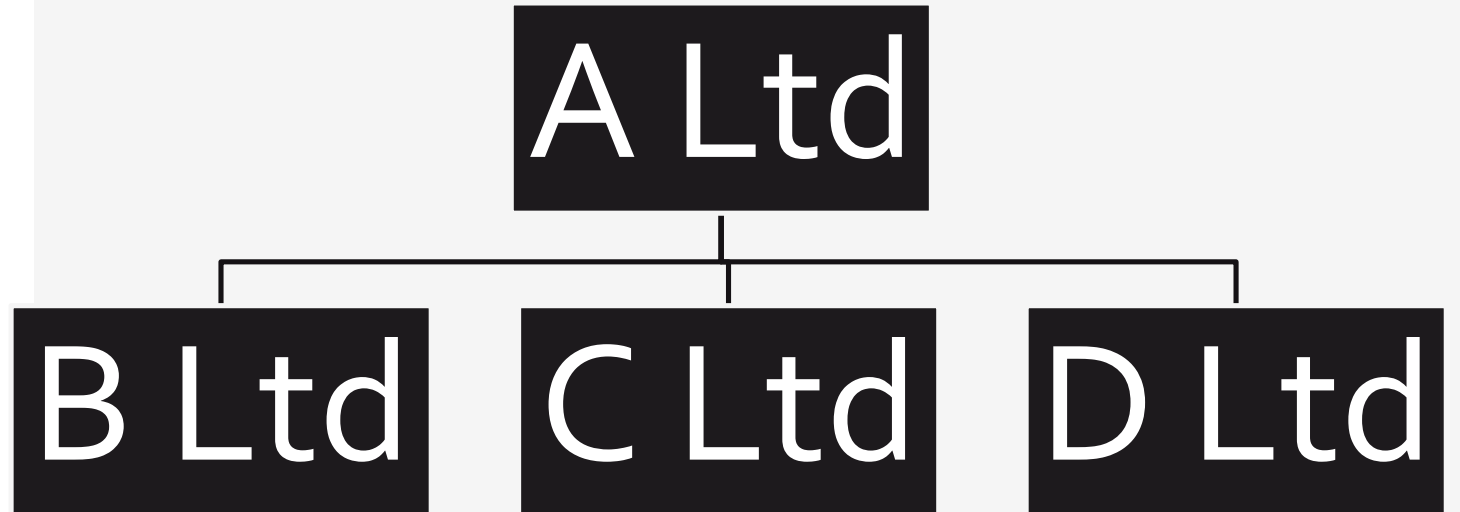
Additional Compliance: All Companies

The provisions of the Companies (Restriction on number of Layers) Rules, 2017 made under **proviso to section 2(87)** also to be complied with as the said sub section is in addition to and not **in derogation** of any other provisions of the Act.

Section 186

Section 186(1)

No restriction on horizontal layering



Section 186

Proviso to section 2(87)

Restriction on no of layers of
subsidiary

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graph TD; H[H Ltd.] --- S1[S1 Ltd. (WOS)]; S1 --- S2[• S2 Ltd.]; S1 --- S3[• S3 Ltd.];
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H Ltd.

S₁ Ltd. (WOS)

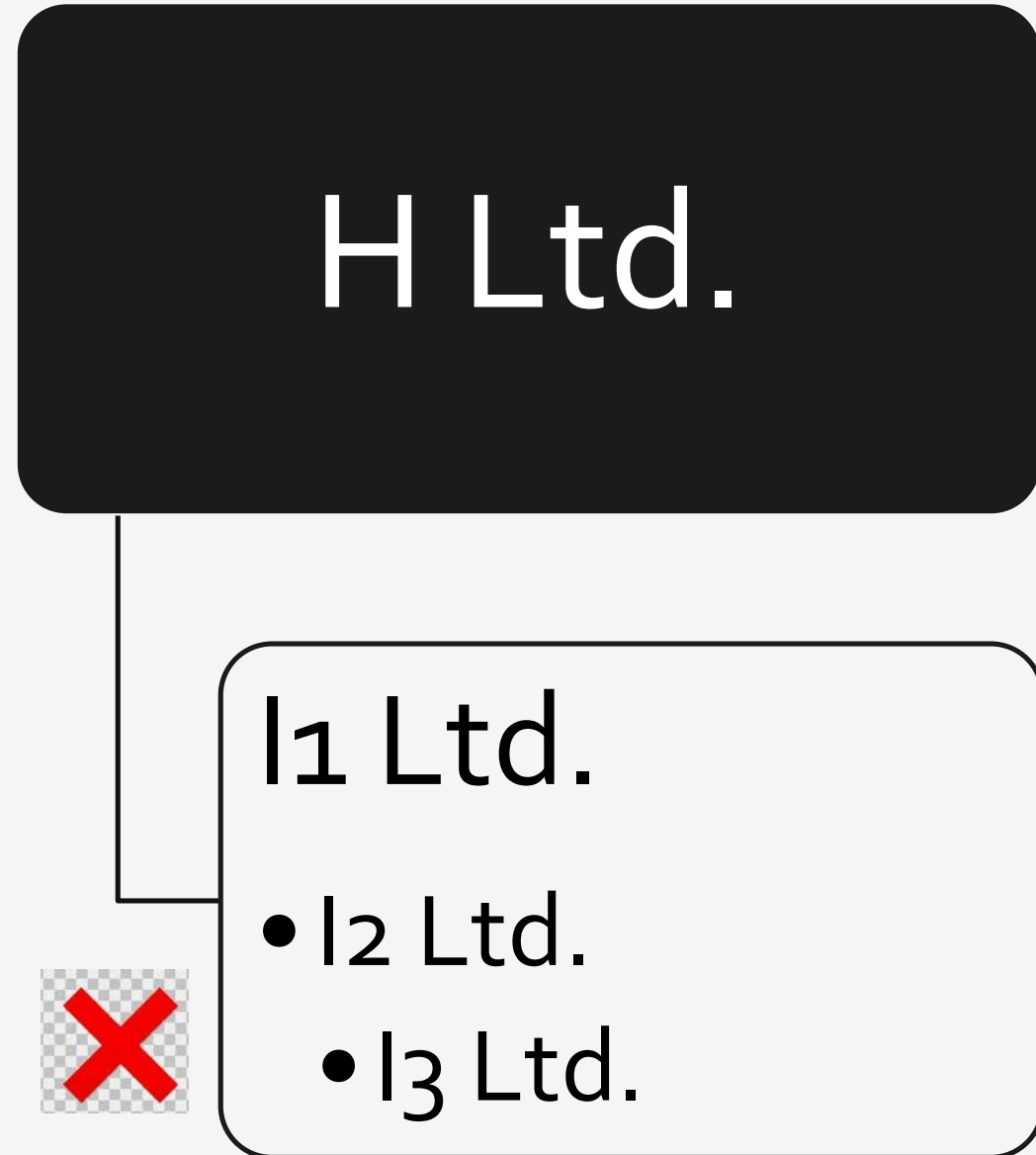
- S₂ Ltd.
- S₃ Ltd.

Section 186

Section 186(1)

Restriction on Vertical layering

In the same example even if one of subsidiary is WOS it would not be permitted structure as more than 2 companies in the structure are investment companies



Section 186

Section 186(1)

Meaning of Investment Company

NBFC - The company will be treated as a non-banking financial company (NBFC) if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) **and** income from financial assets is more than 50 per cent of the gross income.

Explanation under Section 186

The expression “**Investment company**” means a company whose **principal business** is the **acquisition of shares**, debentures or other securities (**Loans not included**)

A company will be **deemed** to **be principally engaged** in the business of acquisition of shares, debentures or other securities,

If its assets in the form of **investment in shares**, debentures or other securities constitute not less than **fifty percent** of its **total assets**, **OR**

If its **income derived** from investment business constitutes not less than **fifty percent** as a proportion of its **gross income**.

Impact:

A company shall unless otherwise prescribed, make investment through not more than two layers of investment companies [section 186(1)]

Section 186

Section 186(1)

Section 186 Vs Proviso to section
2(87)

Due to this deeming provision, there is a possibility that the status of the company may change **from year to year**. For one financial year it is an investment company and for very next financial year it may not be so.

Layering Rules as per Section 2(87) are not applicable on Banking companies, NBFC's, Insurance Companies, and Government Companies, whereas Section 186(1) applies to all Companies, however select class of Government Companies are exempted.

This would be applicable on **prospective basis and not retrospective basis**. (although layering rules were introduced in Sept 2017, 186 (1) was notified right from April 1, 2014)

Section 186

Proviso to section 2(87)

Restriction on no of layers of
subsidiary

From 20-09-2017, no company shall have more than **two layers** of subsidiaries:

Exception 1: One layer consisting of one or more wholly owned subsidiary(ies) is exempted from counting two layers.

Exception 2: Acquiring of a company incorporated outside India with subsidiaries beyond two layers as per the laws of such country **is exempted** from counting two layers. .

Existing Company having **more** than two **layers** as on 20-09-2017 **can continue** to hold such layers and were to file from CRL-2 with 150 days. But it can't have additional new layers further. Subsequently if it reduces the layers, it can continue to hold reduced layers or maximum allowed layers under this rule.

Section 186

Proviso to section 2(87)

Restriction on no of layers of
subsidiary

Section 186 Vs Proviso to section 2(87)

This rule is not applicable to a **banking company, non-banking financial** company, **insurance** company and a **government** company.

No- derogation with proviso to 186(1)

This rule can't be in derogation of proviso to sub-section(1) of s.186. It seems that they can not only acquire foreign subsidiaries having more layers but also, to meet the requirement of law, have more than two layers of investment subsidiary companies.

Non-compliance

For the company and officer- fine upto Rs. 10,000 and continued one daily upto Rs.1,000

Section 186

Implications of being Investment
Company

Restriction of not more than two layer of investment companies

Exemption from compliance of Section 186(2) for Investment activities of an Investment Company

Implication while calculating net profit as per Section 198 for CSR and Managerial Remuneration limits

Prohibition for buy-back – through investment company- Section 70

Reporting requirement by Statutory Auditors- Section 143 (1)(c)

Calculation of Effective Capital as per Schedule V

Section 186

Disclosure in Financial Statement

As per amended Schedule III- the following disclosure shall be required to be given from FY 2021-22 onwards in the financial statement of Companies

Text of Schedule III:

Where the company **has not complied with the number of layers** prescribed under clause (87) of section 2 of the Act read with Companies (Restriction on number of Layers) Rules, 2017, **the name and CIN of the companies beyond the specified layers and the relationship/extent of holding of the company in such downstream companies**

Section 186

Section 186(2)

Investment, loan, guarantee or
security

No company shall directly or indirectly

Give any loan to any person or other body corporate

Give any **guarantee** or provide **security** in connection with a loan
to any other body corporate or **person**

Acquire by way of subscription, purchase or otherwise, **the securities** of any other **body corporate**

Exceeding **60%** of its **paid-up share capital, free reserves and securities premium account**; or **100%** of its free reserves and securities premium account, **whichever is more**.

Person does **not include employees** .

Section 186

Section 186(2)

Free reserves

As per Section 2(43) "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that—

(i) any amount representing **unrealised gains, notional gains** or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any **change** in carrying amount of an asset or of a liability recognized in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value,

Shall not be treated as Free reserves;

Section 186

Section 186(3)

If aggregate of loan etc. exceed
limit

prior approval by way of **special resolution**

Shareholders approval by way of special resolution would **not be required** if a company:

Gives loan or guarantee or provide security to its **wholly owned subsidiary company or joint venture companies; or**

Acquire by way of subscription, purchase or otherwise securities of its **wholly owned subsidiary companies**

Whether exemption is only from seeking shareholders approval or from entire section

Whether post investment, the said investment amount will **get added to the limit under section 186(2)**

Section 186

Section 186(5)

Consent of directors and prior approval of PFI (defined in 2(72))

No investment shall be made or loan or guarantee or security given by the company unless the **resolution sanctioning it** is passed at a meeting of the Board with **the consent of all the directors present at the meeting** and the prior approval of the public financial institution concerned where any **term loan is subsisting**, is obtained:

prior approval of a **public financial institution** shall not be required where the aggregate of the loans and investments so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate, along with the investments, loans, guarantee or security proposed to be made or given does not **exceed the limit** as specified in subsection (2), **and** there **is no default in repayment** of loan instalments or payment of interest thereon as per the terms and conditions of such loan to the public financial institution.

Section 186

Section 186(6) & (7)

Not exceeding limits / rate of
interest / defaults /register

Intermediaries registered u/s 12 of SEBI Act must not **take inter-corporate** loans and deposits **in excess** of the limits specified under the **regulations applicable** to such company. (186(6))

No loan can be given at a **rate of interest lower** than the **prevailing yield** of one year, three year, five year or ten year government security closest to the tenor of the loan.(186(7))

If a company is **in default in repayment of any deposit** or interest thereon, it cannot give loan, guarantee or security or make acquisition till such default is subsisting.(186(8))

Register in form **MBP-2** to be maintained within 7 days of transaction .(186(9))

Section 186

Section 186(11)

Exemptions

Nothing contained in this section, except sub-section (1), shall apply—

To any **loan** made, any **guarantee** given or any **security** provided or any investment made by a **banking company**, or an **insurance company**, or a **housing finance** company in the ordinary course of its business, or a company established with the object of and engaged in the business of **financing industrial enterprises**, or of providing **infrastructural facilities**;

Rule 11 (2) companies (meetings of the board and its powers) rules, 2014

For the purposes of clause (a) of sub-section (11) of section 186 the expression "business of financing industrial enterprises" shall include, with regard to a **non-banking financial company** registered with Reserve Bank of India, "business of giving of **any loan to a person** or providing any guaranty or security for due repayment of any loan availed by any person in the ordinary course of its business".

Section 186

Section 186(11)

Exemptions

to any investment—

(i) made by an **Investment company**;

(ii) made in **shares allotted** in pursuance of clause (a) of sub-section (1) of section 62 or in shares allotted in pursuance of **rights issues** made by a body corporate;

(iii) made, in respect of investment **or lending activities**, by a **non-banking financial company** registered under chapter III-B of the Reserve Bank of India Act, 1934 and whose principal business is **acquisition of securities**.

Section 186

Section 186(11)

Exemptions

Govt. Companies engaged in defence production –entire section not applicable.

Other Govt. Co, other than a listed company, :- entire section not applicable. But it should obtain the approval of the Ministry or Department of the Central Government which is administratively in charge of the company, or, as the case may be, the State Government before making any loan or giving any guarantee or providing any security or making any investment under the section. - [Notification dated 5th june, 2015.](#)

Specified IFSC public companies and private companies(Notification dated. 04-01-2017)- Sub-section (1) is not applicable. Sub-section (2) & (3) also not applicable –BR either in meeting or circular. For sub-section (5) circular resolution is also valid.

Section 8 companies :- while giving a loan to a Company having 25% paid-up held by CG/SG for funding industrial research and development projects in furtherance of its objects as stated in its memorandum of association, sub-section (7) –rate of interest is not applicable. [Notification dated 5th june, 2015.](#)

Section 186

Section 186

Points of Caution

Two conditions to be checked i.e.

Firstly it should be investment in securities and

secondly it should be investment in bodies corporate

Guarantee and security in connection with loan only are covered under section 186 and hence performance guarantee, contract of indemnity etc shall not trigger section 186

Critical Issues

Section 185 & 186

Whether entity wise shareholders approval required or blanket approval can be taken?

Whether contribution in **LLP** would get covered in sub-section 186(2)?

Whether loan to a **trust** would get covered in sub-section 186(2)?

Loan by Indian holding company to its **Foreign subsidiary**?
Whether can be given below relevant **G sec rate**?

Whether **Fair value of** investments to be considered while calculating the limits u/s 186 (2) or **historical cost**?

Critical Issues

Section 185 & 186

Whether investments made **towards Right issue** to be considered while calculating the limits prescribed in the section?

Whether investment in **debentures (NCD/ OFCDS etc)** to be considered as **loan or investment**?

Does the **coupon rate** on the issue of debenture (being a security) should be fixed in accordance with Section 186 (7) of the Act? The explanation provided in **Section 372A** of Companies Act, 1956 to the effect that **"loan" includes debentures** or any deposit of money made by one company with another company, not being a banking company, is not provided in Section 186. Therefore, compliance of Section 186 (7) will **not be mandatory** in case of issue of debentures

Critical Issues

Section 185 & 186

Can a **subsidiary** company give loan to its **holding company**

Whether providing of guarantee/ security in connection with non **fund based facilities (eg. LC/BG)** will trigger section 186

Whether there can be a **general delegation** of items falling u/s 186?

Whether **loan and investment etc** of **Company A** which got merged into **Company B** should be considered **while calculating the limits of 60%/100%**

Section 186

Section 186(11)

Punishment

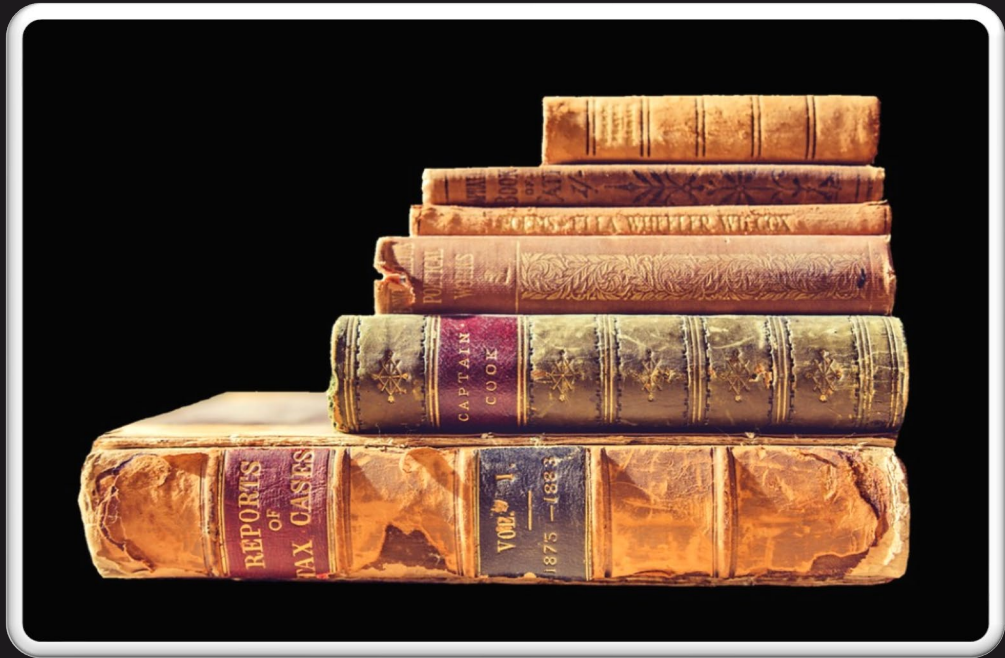
Punishment for contravention of section 186:

By a company - fine from Rs.25,000 to Rs.5 lakh; and

By officer in default - imprisonment up to 02 years **and** fine from Rs.25,000 to Rs.1 lakh

Making section 186 **non-compoundable** in totality.

Section 441 as amended: - notwithstanding anything contained in the Code of Criminal Procedure, 1973 (2 of 1974), any offence punishable under this act (whether committed by a company or any officer thereof) **not being an offence punishable with imprisonment only, or punishable with imprisonment and also with fine** may, either before or after the institution of any prosecution, be compounded by.....!



Thank You