

Loans, Guarantees, and Investments: A Comprehensive Review of Sections 185 and 186

This article explains the key provisions of Sections 185 and 186 of the Companies Act, 2013, which regulate how companies use their financial resources when giving loans, providing guarantees or security, and making investments. Section 185 protects against conflicts of interest by restricting transactions involving directors and their connected entities, allowing only limited exceptions under strict conditions. Section 186 applies broadly to all financial exposures of a company, setting monetary limits, requiring unanimous Board approval, mandating disclosures, and restricting multi-layered investment structures. Together, they ensure responsible financial practices, enhance transparency, and safeguard corporate funds from misuse. The article aims to highlight the practical implications of these sections, clarify their differences, explain the compliance requirements, and help readers understand how these provisions strengthen corporate governance and prevent misuse of company funds.



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INTRODUCTION

Section 185 of the Companies Act, 2013, (herein after referred as the Act) restricts companies from giving loans to their directors or to individuals and related parties, essentially to prevent conflict of interest, ensure that the management acts in the interest of the company and its shareholders and it aims to promote good corporate governance and transparency. At the same time, intercorporate loans, guarantees, and investments are essential for business operations, especially within corporate groups. These financial arrangements enable smoother fund movement, support growth, and aid long-term planning. While the Board of Directors holds the authority to make such decisions, Section 179, of the Act imposes specific conditions and limits to ensure responsible use of corporate funds.

Section 186 sets out quantitative limits and compliance conditions for loans, guarantees, securities, and investments. Companies can provide loans, guarantees, security, or make investments up to **60% of their paid-up share capital, free reserves, and securities premium, or 100% of their free reserves and securities premium** — whichever is higher. If they exceed these limits, shareholder approval through a special resolution is required.

The law also restricts companies from routing investments through more than **two layers of investment companies**, subject to certain exemptions. Additionally, the Companies (Restriction on Number of Layers) Rules, 2017 limit companies to **two layers of subsidiaries**, also with exceptions.

Taken together, Sections 185 and 186 aim to balance **corporate flexibility** with **shareholder protection**. They ensure that loans, investments, guarantees, and securities are handled responsibly, without misuse of company funds, and in full compliance with the Act.

SECTION 185: LOANS TO DIRECTORS OR PERSONS IN WHICH DIRECTORS ARE INTERESTED

Section 185 of the Act imposes restrictions on advancing loans, providing guarantees, or offering security in connection with loans to directors or any entity or person with/ in whom the director of the company is related/ interested subject to certain exceptions listed in the section.

1. Prohibitions under Section 185(1)

A company is prohibited from, directly or indirectly, advancing loans, giving guarantees, or providing security in connection with loans to:

- any director of the lending company;
- any director of the holding company of the lending company;
- any partner of any director of the lending company;
- any partner of the director of the holding company;
- any relative of any director of the lending company;
- any relative of the director of the holding company;
- any firm in which any director of the lending company is a partner;
- any firm in which any director of the holding company is a partner;
- any firm in which relative of any director of the lending company is a partner; and
- any firm in which any relative of any director of the holding company is a partner.

2. Exceptions under Section 185(2)

A company may extend a loan, guarantee, or security to **any person in whom a director is interested**, subject to the following conditions:

- (a) A special resolution must be passed at a general meeting. The explanatory statement must disclose:
 - Full particulars of the proposed loan/guarantee/security;
 - The purpose for which loan will be utilized; or
 - Any other relevant information.
- (b) The borrowing entity must use the funds for its principal business activities.

3. Persons in whom a director is interested include:

- A private company where the director is a director or member;
- A body corporate where 25% or more voting power is controlled by such director (alone or together with other directors); and
- A body corporate whose Board acts on directions of the lending company's Board or its directors.

4. Example for calculation of Voting Power

- Mr. W holds 50% in X Ltd.
- X Ltd. holds 60% in Y Ltd.
- Y Ltd. holds 20% in Z Ltd.

Mr. W's indirect voting rights:

- X Ltd.: 50%
- Y Ltd.: $50\% \times 60\% = 30\%$
- Z Ltd.: $50\% \times (60\% \times 20\%) = 6\%$

Accordingly:

- X Ltd. and Y Ltd. qualify as persons in whom the director is interested.
- Z Ltd. does not qualify.

5. Exemptions under Section 185(3): The provisions of this Section do not apply to:

- Loans to managing/whole-time directors under employment conditions or approved schemes;
- A company which in the ordinary course of its business provides loans or gives guarantees or securities and is charging interest not lower than government security yields;

- Loans by a holding company to its wholly-owned subsidiary used for principal business activities;
- Any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company, provided loan is used for principal business activities.

6. Penalties for violations under Section 185(4): If any loan is advanced or a guarantee or security is given or provided or utilised in contravention of the aforesaid provisions

- Company: Fine between ₹5,00,000 and ₹25,00,000;
- Officers in default: Imprisonment up to 6 months or fine between ₹5,00,000 and ₹25,00,000 or both;
- Director or the other person to whom any loan is advanced or guarantee or security is given or provided: Imprisonment up to 6 months or fine between ₹5,00,000 and ₹25,00,000 or both.

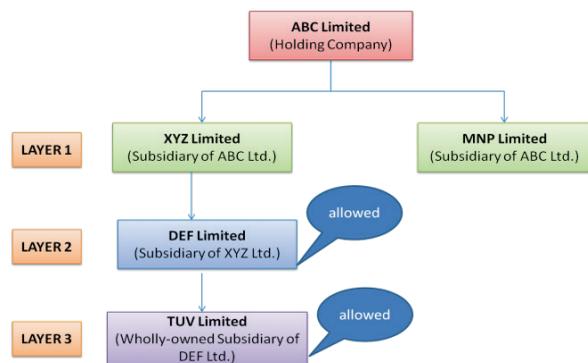
SECTION 186: LOANS TO ANY OTHER PERSON

Section 186 of the Companies Act, 2013 governs how companies can give loans, provide guarantees or security, and make investments. It applies not only to intercorporate transactions but also to loans, guarantees, or security given to **any person**. A company cannot give loans, guarantees, security, or make investments unless it follows the limits and conditions laid down under Section 186.

1. Layering restriction — Section 186(1)

A company cannot make investments through more than **two layers of investment companies**, except where:

- It acquires a foreign company that already has more layers as per its local laws; or
- A subsidiary needs an investment subsidiary to comply with legal requirements.



Under Rule 2(1) of The Companies (Restriction on Number of Layers) Rules, 2017, any layer which consists of one or more wholly-owned subsidiary shall not be taken into account

2. **Limits under Section 186(2):** A company can give loans, guarantees, security, or make investments only up to a certain limit to any other person (the term “person” does not include company employees). It cannot exceed the higher of the following:

- 60% of its paid-up share capital + free reserves + securities premium, or
- 100% of its free reserves + securities premium.

3. **Special resolution requirement under Section 186(3)**

If the total of all existing and proposed loans, investments, guarantees, or security **crosses the above limits**, the company must obtain prior approval of shareholders through a **special resolution**.

Exemptions to Section 186(3): Loans/guarantees/security to a wholly-owned subsidiary or investment by a holding company in its wholly-owned subsidiary do not require a special resolution, but must still be disclosed in financial statements.

4. **Disclosure under Section 186(4)**

The company must disclose full details of all such loans, investments, guarantees, or security in its financial statements, including the purpose for which the recipient will use the funds.

5. **Boards’ approval under Section 186(5)**

No loan, investment, guarantee, or security can be made unless a **unanimous Board resolution** is passed at a Board meeting. This resolution **cannot** be passed by circulation. Prior approval of a Public Financial Institution (PFI) is also required if any term loan is outstanding.

Provided that 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.

The Board may set an overall limit and delegate execution but cannot delegate the approval power itself.

6. **SEBI-registered companies — Section 186(6)**

Companies registered under SEBI Act, 1992 and falling under prescribed classes cannot take

intercorporate loans or deposits beyond prescribed limits and must disclose these in their financial statements.

7. **Interest rate under Section 186(7)**

No company can give a loan at an interest rate lower than the prevailing yield of 1 year, 3 year, 5 year, or 10 year Government Securities closest to the loan’s tenure. An exception exists for government-owned companies (26% or more government shareholding) giving loans for approved Research & Development projects.

8. **Restriction under Section 186(8):** A company that has defaulted on the repayment of any deposits or the interest due on them cannot give any loan, guarantee, security, or make any acquisition until the default is fully resolved.

9. **Registers under Section 186(9) and Section 186(10)**

A company that gives any loan, guarantee, security, or makes an acquisition under this section must maintain a register with the required details. This register must be kept at the company’s registered office, where members can inspect it. Members may also obtain extracts or copies from the register on payment of the prescribed fees.

A performance guarantee does not fall within the scope of Section 186 of the Companies Act, 2013, because Section 186 specifically regulates financial guarantees - that is, guarantees issued in connection with a loan, debt, or financial obligation.

ILLUSTRATIVE EXAMPLES

• A Limited has paid-up share capital of Rs. 100 crores and free reserves of Rs. 150 crores. A Limited has invested in shares of Rs. 100 crores in B Limited. A Limited has also given a guarantee for securing a term loan of Rs. 20 crores and a letter of credit facility of Rs. 30 crores to B Limited by a Bank. A Limited has also given a guarantee for the supply of goods by B Limited to a Buyer. Whether the provisions of Section 186 of the Act is complied or not?

Yes, as the guarantee given for supply of goods is not covered under Section 186 of the Act (only guarantees given or securities provided in connection with a loan are covered under Section 186).

• A Limited has a subsidiary B Limited. Further, B Limited has C Limited as its wholly-owned subsidiary. C Limited is planning to form a subsidiary, namely, D Limited.

a. Whether the formation of D Limited as a subsidiary of C Limited will be violation of the provisions of the Act.

b. If C Limited makes D Limited as an associate company instead of subsidiary.

c. **If D is a subsidiary of F Limited, incorporated in USA and C Limited acquire F Limited, whether the same will be in compliance of law?**

If C Limited forms D limited as its subsidiary, it will be a violation of Section 186 of the Act for A Limited.

If C Limited makes D Limited as an Associate Company, then there is no violation of Section 186 of the Act for A Limited.

If Company C limited acquires USA based F Limited (which has D Limited as its subsidiary) then there is no violation of Section 186 of the Act for A Limited.

- **Are performance guarantees treated as “guarantees in connection with a loan” under Section 186, or are they excluded from its compliance requirements?**

A *performance guarantee* does not fall within the scope of Section 186 of the Companies Act, 2013, because Section 186 specifically regulates financial guarantees - that is, guarantees issued in connection with a loan, debt, or financial obligation. A performance guarantee, on the other hand, is a non-financial undertaking given by a company to assure the performance of a contract or the fulfilment of certain obligations, such as timely completion of work, quality assurance, or delivery commitments. Its purpose is to secure *contractual performance* rather than a loan or financial facility. Since Section 186 deals only with situations where a guarantee is linked to a loan or financial liability, performance guarantees fall outside its purview. Therefore, while financial guarantees require compliance with the monetary limits, approvals, and disclosures mandated under Section 186, performance guarantees are considered operational in nature and are not restricted by this Section. However, companies must still ensure that such guarantees are authorised under their Articles of Association, approved by the Board, and aligned with prudent risk management practices.

- **How does Section 186 apply when a company has negative net worth or negative free reserves?**

Section 186 sets monetary limits based on a company's paid-up share capital, free reserves, and securities premium. When a company has negative free reserves or negative net worth, the Act does not expressly prescribe how the limits should be calculated. However, by applying the logic of the provision, the permissible limit under Section 186(2) effectively becomes zero, since the formula cannot yield a positive threshold when reserves are negative.

In such circumstances, any proposed loan, guarantee, security, or investment — regardless of the amount, would exceed the statutory limit, and therefore the company must obtain prior shareholder approval by special resolution under Section 186(3). This interpretation ensures prudential control over financial exposure when the company's financial position is weak.

Additionally, if the company is in default of repayment of deposits or interest, Section 186(8) prohibits it from entering into any such transactions until the default is fully rectified.

Thus, in the case of negative net worth, Section 186 operates in its strictest form, requiring enhanced shareholder oversight and preventing further financial strain on the company.

- **Can the Board delegate its powers relating to loans, investments, or guarantees under Section 186 of the Act?**

Although Section 179(3) of the Companies Act, 2013 permits the Board to delegate certain powers to a committee of directors, the managing director, the manager, or other key officers of the company, Section 186 imposes a stricter requirement on this. Any approval for loans, guarantees, security, or investments must be given with the unanimous consent of all directors present at a Board meeting.

By applying the principle of harmonious construction, it can be interpreted that while the decision itself must be approved by the full Board, the Board may delegate the execution or implementation of that already-approved decision to a committee or authorised officer. In other words, delegation is possible only after the Board has given unanimous approval for the transaction; the power to approve cannot be delegated, but the power to execute may be.

- **How are loans to LLPs treated under Sections 185 and 186 of the Companies Act, 2013? Are LLPs covered under these provisions?**

An LLP is treated as a body corporate, so loans, guarantees, or security provided to an LLP fall under Section 186, and the applicable limits, approvals, and disclosures must be followed. Under Section 185, such loans are allowed only if the LLP is not one in which a director or their relative is a partner; otherwise, the restrictions and conditions of Section 185 apply (such as requiring a special resolution and use for principal business activities). In summary, loans to LLPs are permissible but must comply with both Sections 185 and 186, depending on whether the LLP has any director-linked interest.

CONCLUSION

Sections 185 and 186 together form an essential framework ensuring that companies handle their financial transactions with integrity, transparency, and

accountability. Section 185 acts as a safeguard against conflicts of interest by restricting loans, guarantees, and securities involving directors and their associated entities, ensuring that corporate powers are not misused for personal benefit. Section 186 complements this by setting clear monetary limits, approval requirements, disclosure standards, and procedural controls for all loans, guarantees, securities, and investments made by a company. These provisions promote responsible financial management, protect shareholders' interests, and strengthen corporate governance practices. When complied with diligently, Sections 185 and 186 help companies maintain financial discipline, reduce risks of misuse of funds, and build trust among regulators, investors, and other stakeholders. Together, they reinforce the principle that corporate resources must be deployed prudently, transparently, and strictly in the interest of the company.

Aspect	Section 185	Section 186
Primary Purpose	Prevent conflict of interest by restricting loans/guarantees/security to directors and connected persons.	Regulates all loans, guarantees, securities, and investments made by a company; ensures prudent financial exposure limits.
Scope of Coverage	Applies only to directors, their relatives, partners, and entities in which directors are interested (private companies, bodies corporate with 25% voting power, etc.).	Applies to any person or body corporate , not limited to directors or related parties.
Nature of Restriction	Primarily prohibitive —certain transactions are completely barred unless exceptions apply.	Primarily regulative —allows transactions but within monetary limits and subject to approvals.
Monetary Limits	No monetary limits; restrictions depend on relationship with director.	Higher of: 60% of (paid-up capital + free reserves + securities premium) or 100% of (free reserves + securities premium).
Special Resolution Requirement	Required only when giving loans/guarantees/security to persons in whom a director is interested (under exceptions).	Required when total loans/guarantees/security/investments exceed the Section 186 limits.
Exemptions	MD/WTD loans under employee schemes, lending companies in ordinary course, loans/guarantees to wholly-owned subsidiaries, etc.	Exemptions for WOS/JV transactions (no SR needed), foreign-layering exceptions, certain SEBI-regulated companies, etc.
Layering Restriction	No layering rules.	Limits investment through more than two layers of investment companies (with exceptions).
Board Approval	Applies only when allowed under exceptions.	Mandatory unanimous Board approval at a physical meeting; circular resolution not allowed.
Interest Rate Requirement	Not specifically prescribed.	Loan interest cannot be lower than the prevailing government security yield for corresponding tenure.
Penalties	High penalties including possible imprisonment for officers and directors involved.	Penalties apply for breaching monetary limits, layering restrictions, or procedural requirements.
Overall Intent	Prevent misuse of corporate funds for personal benefit of directors.	Ensure responsible, transparent, and controlled financial exposures by companies.

REFERENCES:

- i. *Companies Act, 2013 and related rules.*
- ii. *Professional body publications and guidance notes.*
- iii. *Taxguru (explanatory articles by CAs and CS professionals).*

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