

GN-12

GUIDANCE NOTE

ON

LOAN TO DIRECTORS AND LOAN, INVESTMENT, ISSUE OF GUARANTEE AND SECURITY BY COMPANIES (SECTIONS 185 & 186 OF THE COMPANIES ACT, 2013)



**THE INSTITUTE OF
Company Secretaries of India**

भारतीय कम्पनी सचिव संस्थान

IN PURSUIT OF PROFESSIONAL EXCELLENCE

Statutory body under an Act of Parliament

(Under the jurisdiction of Ministry of Corporate Affairs)

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Preface

The corporate landscape in India has evolved significantly, and with it, the governance framework has become more robust and intricate. The Companies Act, 2013, embodies this evolution, particularly in its provisions related to loans, investments, guarantees, and securities, which are pivotal for maintaining the integrity and financial prudence of corporate practices. Among these, Sections 185 and 186 play a crucial role in regulating the dealings between companies and their directors, and in governing the financial transactions that companies undertake.

The Institute of Company Secretaries of India (ICSI), as a premier institution committed to promoting good corporate governance, is pleased to present this **Guidance Note on Loan to Directors and Loan, Investment, Issue of Guarantee and Security by Companies (Sections 185 & 186 of the Companies Act, 2013)**. This Guidance Note has been meticulously prepared with the objective of making the provisions of these sections more accessible and understandable to professionals and stakeholders alike.

In our endeavour to enhance understanding and compliance, this Guidance Note has been crafted with a focus on clear and concise language, structured formatting, and a logical compilation of all provisions related to Sections 185 and 186. By presenting these sections together, we aim to offer a seamless flow and deeper insight into the legal framework, making it easier for practitioners to navigate and apply these provisions.

This publication goes beyond mere statutory interpretation. The publication includes relevant illustrations to clarify the law, and practical insights are provided through a Q&A format, addressing common scenarios and queries that professionals encounter. Furthermore, references to pertinent case laws have been incorporated to offer a judicial perspective and enrich the understanding of these sections.

This Guidance Note also addresses frequently asked questions, ensuring that recurring doubts and ambiguities are comprehensively covered, thereby serving as a one-stop reference for practitioners.

I place on record my sincere thanks to all the members of the Secretarial Standards Board (SSB) of the ICSI for their invaluable contributions during the formulation and finalization of this Guidance Note. Their collective expertise and dedication, under the exemplary leadership of CS Nagendra D. Rao, Chairman SSB and Former President, ICSI have been instrumental in shaping this comprehensive Guidance Note. Their

commitment to promoting clarity and accessibility in corporate governance is truly commendable, and I extend my deepest appreciation for their efforts.

I commend the dedicated efforts put in by CS Iqra Jabeen Ansari, Executive (Academics), CS Pradeep Chandra Joshi, Executive (Academics) and CS Richa Gupta, Executive (Academics) under the guidance of CS Anamika Chaudhary, Joint Director, in bringing out this Guidance Note. Their hard work and commitment, coupled with the stewardship of CS Asish Mohan, Secretary, ICSI, have been pivotal in the successful completion of this Guidance Note.

I am confident that this Guidance Note will be an invaluable resource for company secretaries, legal professionals, and corporate executives, aiding them in ensuring compliance with the law and fostering sound corporate governance practices.

I urge my professional colleagues to diligently ensure compliance with the provisions of Sections 185 and 186 and to actively promote good corporate governance in line with the guidance provided in this Note.

As improvement is a continuous process, this principle also applies to this Guidance Note. I would be personally grateful to the readers for their valuable suggestions and comments to further enhance this publication.

(CS B. Narasimhan)

President

The Institute of Company Secretaries of India

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GUIDANCE NOTE ON LOAN TO DIRECTORS AND LOAN, INVESTMENT, ISSUE OF GUARANTEE AND SECURITY BY COMPANIES (SECTIONS 185 & 186 OF THE COMPANIES ACT, 2013)

INTRODUCTION

Section 185 of the Companies Act, 2013 (hereinafter referred to as “the Act”), prohibits / restricts companies from providing loans to directors 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.

Transactions involving inter-corporate loans and investments etc. by companies, play a pivotal role in the growth of industries as such transactions do provide necessary funds for the group companies or other companies to ensure robust corporate functioning in the light of requirement of funds.

Predominantly, under the broad scheme of the Act, the power to invest the funds of the company is essentially vested upon the Board under section 179 of the Act. However, the Act, has also imposed certain restrictions on investments that a company can make and loans it can provide. Moreover, giving a corporate guarantee or providing the security is also as crucial as giving a loan, because the person (in whose favour the guarantee or security is given or provided, as the case may be) can decide to invoke the guarantee or security under certain situations, and in such cases the company shall be liable to honour the obligations undertaken by it. Thus, apart from loans and investments, restrictions are also placed on the provision of guarantees that the company can give or the security it can provide, in connection with a loan.

The Act, has made provisions with regard to companies giving directly or indirectly any loan or guarantee or providing security or making an investment in the securities of other body corporate by way of subscription, purchase, or otherwise to the extent of 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 unless approval of the members is taken by way of a special resolution exceeding these limits. Further, the Act, prohibits making any investment through more than two layers of investment companies subject to exemptions as provided. It may be

noted that while section 186 of the Act, prohibits making of any investment through more than two layers of investment companies, whereas, the Companies (Restriction on Number of Layers) Rules, 2017 restricts a company from having more than two layers of subsidiaries (not necessarily restricted to investment subsidiaries) subject to exemptions as provided therein.

Considering the above legal framework concerning loans/investments etc., this guidance note broadly contemplates various propositions emanating from the applicable legal provisions concerning loan to directors, investments, loans, guarantees and security by the company, with a view to provide necessary guidance on applicable compliances under the Act.

SCOPE

The scope of this guidance note is limited to the applicable provisions of the Act, and relevant rules made thereunder, including relevant circulars/clarifications issued.

DEFINITIONS

The following terms are used in this Guidance Note with the meanings specified:

“Act” means the Companies Act, 2013 (Act No. 18 of 2013) or any previous enactment thereof, or any statutory modification thereto or re-enactment thereof and includes any Rules and Regulations framed thereunder.

“Board of Directors” or “Board”, in relation to a company, means the collective body of the directors of the company.

“Committee” means a committee mandatorily required to be constituted by the Board under the Act or the Listing Regulations.

“Financial Institution” includes a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934.

“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.

“Investment Company” means a company whose principal business is the acquisition

of shares, debentures or other securities and 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 per cent of its total assets, or if its income derived from investment business constitutes not less than fifty per cent of its gross income.

“Listing Regulations” means the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, including any amendment thereto.

“Specified IFSC public company” means an unlisted public company which is licensed to operate by the Reserve Bank of India or the Securities and Exchange Board of India or the Insurance Regulatory and Development Authority of India from the International Financial Services Centre located in an approved multi services Special Economic Zone set-up under the Special Economic Zones Act, 2005 (28 of 2005) read with the Special Economic Zones Rules, 2006.

“Specified IFSC private company” means a private company which is licensed to operate by the Reserve Bank of India or the Securities and Exchange Board of India or the Insurance Regulatory and Development Authority of India from the International Financial Services Centre located in an approved multi services Special Economic Zone set-up under the Special Economic Zones Act, 2005 (28 of 2005) read with the Special Economic Zones Rules, 2006.

Words and expressions used and not defined herein shall have the same meaning respectively assigned to them under the Act, the Listing Regulations and the Secretarial Standards issued by the Institute of Company Secretaries of India, as may be applicable.

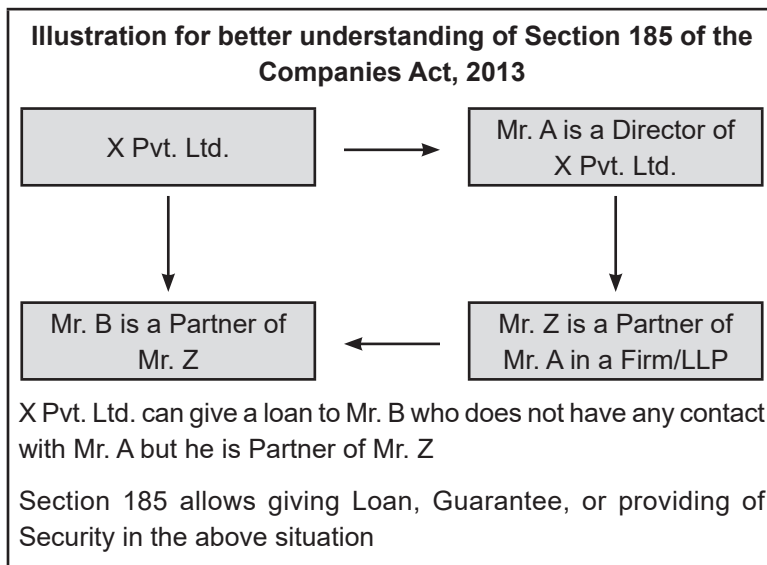
GUIDANCE NOTE

1. LOANS TO DIRECTORS

Section 185 of the Act prohibits the advance of 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 said section.

Sub-section (1) of section 185 of the Act provides that 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, –

- (a) any director of company, or of a company which is its holding company or any partner or relative of any such director; or
- (b) any firm in which any such director or relative is a partner.



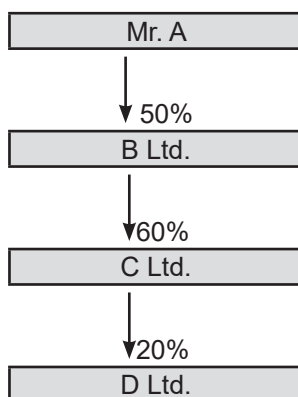
However, with the exception provided in sub-section (2) of section 185 of the Act, a company may advance any loan including any loan represented by a book debt, or give any guarantee or provide any security in connection with any loan taken by “any person in whom any of the director of the company is interested”, as per Explanation given below, subject to the condition that –

- (a) a special resolution is passed by the company in a general meeting. For this purpose 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 utilised 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.

Explanation. – For the purposes of this sub-section, the expression “any person in whom any of the directors 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.

**Illustration for better understanding of computing Voting Power
under Section 185(2) of the Companies Act, 2013**



Mr. A's voting powers shall be:

- 50% in B Ltd.;
- 30% in C Ltd. (50% x 60%) and
- 6% in D Ltd. [50% x (60% x 20%)]

Accordingly, B Ltd. and C Ltd. shall be the "Person in whom the Director of the Company is interested"

D Ltd. will not be deemed to be the person in whom the director is interested

Section 185(3) of the Act, further clarifies that nothing contained in sub-sections (1) and (2) shall apply to-

- (a) the giving of any loan to a managing or whole-time director –
 - (i) as a part of the conditions of service extended by the company to all its employees; or
 - (ii) pursuant to any scheme approved by the members by a special resolution; or
- (b) a company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans an interest is charged at a rate not less than the rate of prevailing yield of one year, three years, five years or ten years Government security closest to the tenor of the loan; or
- (c) any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company; or

- (d) 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 that the loans made under clauses (c) and (d) are utilised by the subsidiary company for its principal business activities.

Section 185(4) of the Act deals with penal provisions and states that if any loan is advanced or a guarantee or security is given or provided or utilised in contravention of the aforesaid provisions-

- i. the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees;
- ii. every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees; and
- iii. the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

Query 1: Section 185 of the Act restricts loans to a private company in which the director of the company is a director or member. Will the restriction apply even if the director of lending company merely holds a single equity share in the private company?

View: Yes, in the absence of any carve-out/exemption made for any minimum shareholding, such restriction would apply even if the director of the lending company is holding merely one equity share (thus becoming a member) in the borrowing company.

Query 2: If the answer to above question is in affirmation, whether the same would still apply if the director of lending company merely holds preference share (as against equity share) in the private company?

View: The term 'member' includes both equity shareholder and preference shareholder. Accordingly, in the absence of any specific carve-out/exemption for preference shareholder (who is otherwise a member in the company), such restriction would apply even if the director of the lending company is holding preference shares.

Query 3: Section 185 of the Act covers both direct and indirect loans provided to directors and others. What is an indirect loan?

View: The word/expression 'indirectly', as embodied under section 185(1) of the Act,

does unambiguously carry the intention of these provisions to the effect that the company is not only restricted from, *inter alia*, directly giving any loan to any of its directors (or related persons/entities of such director) but also restricted from adopting a circuitous route for giving such loan, which may otherwise qualify as 'indirect' loan to directors (or related persons/entities). While the word/expression 'indirectly' has not been defined (rightly so), one is inevitably required to adopt a 'see-through' approach while examining the applicability of section 185 of the Act in given set of facts and circumstances.

Under English law "Indirect loans" have been categorised as "Quasi-loans".

For example, where funds have been routed by a company through some structure involving a number of intermediaries in place, and the trail of money involved in such structure can be related/traced from the lending company and the beneficiary (*i.e.* the director of the lending company or related persons/entities of such director), in such a case it can be concluded that since the ultimate objective was to make aforesaid funding available to the director of the lending company (or related persons/entities of such director) through the use of intermediaries, therefore, the provisions of section 185 of the Act are applicable in such cases.

Query 4: Does section 185 of the Act bring in the concept of a shadow director?

View: Yes. The expression "accustomed to act in accordance with the directions or instructions of" as used in the Explanation under section 185 of the Act signifies that it visualizes the existence of the above concept.

There is, however, a basic presumption that a properly constituted Board of directors of any company acts as per its own wisdom in the best interest of the company.

Directors of every company are presumed to be acquainted with their duties and liabilities in law, and therefore, the presumption to be made at the threshold is that every Board is independent, and is not the directing mind of another person or entity, unless it is established to the contrary. When it is alleged, that the Board is, in fact, accustomed to act as per the instructions, the duty of discharging the onus is on the person making such allegation. [*Refer to landmark decision in Hydrodan (Corby) Ltd. Re, (2 BCLC 180) (1994)*]

In the *Re Hydrodan (Corby) Ltd.* case, the criteria for identifying a shadow director were laid out. It requires substantiating that the person, although not formally designated as a director, actively guides and influences the company's management by issuing instructions to appointed directors. This guidance must be shown to be consistently followed and intentionally adhered to over time.

Query 5: Whether the list of persons / entities for the purpose of 'loan to Directors' as covered under the 'prohibited category' under section 185(1) of the Act, is exhaustive or inclusive?

View: The aforesaid list is exhaustive in nature.

Query 6: For the purposes of 'Loans to Directors' under section 185 of the Act, who all are the persons / entities covered under the prohibited category?

View: The "prohibited category", for the purpose of section 185 of the Act, comprises of the following persons/entities:

1. any director of the lending company;
2. any director of the holding company of the lending company;
3. any partner of any director of the lending company;
4. any partner of the director of the holding company
5. any relative of any director of the lending company;
6. any relative of the director of the holding company
7. any firm in which any director of the lending company is a partner;
8. any firm in which any director of the holding company is a partner
9. any firm in which relative of any director of the lending company is a partner and
10. any firm in which any relative of any director of the holding company is a partner

Query 7: What is the meaning of expression, 'accustomed to act' as referred to in Explanation (c) to section 185 (2) of the Act?

View: It may be noted that the expression 'accustomed to act' is not a question of law rather a subject matter of given facts/circumstances. The term, 'accustomed to act' simply implies the actions of a director are influenced or instigated by the directions of a third party. In other words, in the context of section 185 of the Act, this expression requires that the Board of Directors must be someone who are influenced by another to accomplish the other person's purposes and objectives. The Board of Directors must comprise of persons who act on the directions or instructions of the concerned third person(s) as a matter of regular practice. The expression 'accustomed to act' refers to acts not on one individual occasion but acts done over a period of time (*i.e.*, in a customary manner) and as a regular course of conduct.

Having said the above, the position has to be analyzed and decided on the exact facts and circumstances of each case. Accordingly, in order to arrive at a conclusion as to whether the Board of Directors of first company are 'accustomed to act' as per the instructions/directions coming from the director(s) of the second company, it must be shown, *inter alia*, that the directors of the first company did not exercise any discretion or judgment of their own, but merely acted in accordance with the instructions/directions of the director(s) of the second company.

It has to be demonstrated by way of evidence that the directors of the borrower company have no authority to exercise any discretion or judgment of their own and that they only answer to the call of the lender company as observed by the Court in *Hydrodam (Corby) Ltd (Supra)*.

Therefore, as a matter of necessary guidance, in order to identify as to whether the Board of Directors of one company is accustomed to act in accordance with directions or instructions of other person(s), it becomes essential to consider, *inter alia*, the following broad aspects:

1. who are the directors of the company, whether *de facto* or *de jure*;
2. that the other person(s) have directed these directors how to act in relation to the company's conduct;
3. that these directors actually acted in accordance with such directions; and
4. that these directors were accustomed to act so. Primarily, a Board of Directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the Board of Directors did not exercise any discretion or judgement of its own, but acted in accordance with the directions of other.
5. reference also has to be made to the decision in *Secretary of State for Trade and Industry v. Becker* (2003) 1 BCLC 555 where it was noted that to show that a person is a shadow director it must be proved that *de jure* directors followed a consistent pattern of compliance with the instructions of the shadow director.

Query 8: What is the meaning of the term "a loan represented by book debt" as contemplated under Section 185? Whether credit sales will be considered as a book debt?

View: Book debt is the money that a customer owes to a company for goods or services purchased on credit. Any debit in the books of accounts for any sale or service provided to a recipient is a trade debt which arises in the ordinary course of business of such entity.

As per the Cambridge Dictionary, book debt is defined as “money that a company has not yet received from customers who owe it, as recorded in the company’s accounts”.

As per Black’s Law Dictionary, book debt is defined as “sum of money due to a business in the ordinary course of a business. It has been described as a debt that would normally be entered in the books of the business regardless of whether or not it is in-fact entered.”

To ascertain whether a transaction is a loan or not following need to be considered:

- surrounding circumstances,
- relationship and character of the transaction, and
- the manner in which parties treated the transaction.

Hence, with reference to each such transaction (if they relate to book debts) as entered into with the lending company’s directors and “other person in whom the Directors are interested”, the nature of such transactions would invariably have to be examined in detail to decide if they qualify to be loan to director.

[*supra* *Fredie Ardeshir Mehta (Dr.) v. Union of India* (1989) 2 CLA 244 (Bom): (1991) 70 Comp Cas 210(Bom): (1991) 1 Comp LJ 437 (Bom)]. The debt can properly be called a book-debt, whether it is in fact entered in the books of the business or not. [*Paul & Frank Ltd. v. Discount Bank Overseas Ltd.* (1967) 37 Comp Cas 76 (Ch.D) : (1966) 2 All ER 922: (1967) 1 Comp LJ 56].

The book debt first must be qualified as a Loan to be covered under this section. Merely credit sales or other receivables is not a book debt for this section.

Query 9: For a Loan to be represented by a book debt, is it required that from its very inception, the book debt has to be in the nature of a Loan to the Director?

View: Section 296 of the Companies Act, 1956 had an express clarification that section 295 of the Companies Act, 1956 shall apply to any transaction represented by a book debt only if it was from its inception in the nature of a loan or an advance.

When sections 295 and 296 of the Companies Act, 1956 got merged with section 185 of the Act, this explicit mention did not find a place in section 185 of the Act. As such there is no such equivalent clarification in the Act.

Hence, it is not essential that a book debt right from inception has to be in the form of a loan. In case there are any changes that are made to the terms of the book debt resulting in the provision of a longer credit period or any other additional advantage that is not available to other debtors is provided to the director then it

may be considered that the book debt has transformed into a loan represented by the book debt from the date of alteration/relaxation of the terms.

Thus, if certain goods are sold to a director on normal credit terms and if no attempt is made for recovery even after the credit period has expired, it may be construed as loan to a director in the guise of a book debt.

Query 10: What major variations in the terms of book debts of a Company would be required, to be tested for loan represented by a book debt so altered?

View: Section 185 of the Act does not specifically lay down any criterion/parameters for testing of loans represented by book debts in the context of variations to the terms of such book debts. The purpose of section 185 of the Act is to prevent situations where directors or any person in whom any of the director of the company is interested are unduly favoured or benefitted from the company's resources at the expense of the shareholders. Therefore, while assessing if the book debts (with so altered terms) might be considered as loan to director, amongst others, one may consider major variations to the normal terms of the book debt such as extended credit period, relaxation in provision of customer advance as applicable to other customers, frequency of such variation, any other additional advantage (which are generally not made available to other debtors).

Additionally, it may be noted that as part of CARO, the statutory auditors are required to comment on book debts *vis-a-vis* loans. In discharge of their obligations under CARO, the statutory auditors would holistically see whether the company has (not) given any loans within the meaning of Section 185 of the Act. If yes, whether provisions of sections 185 would have been complied with.

Query 11: Book debt transaction falls outside the disguise of a loan at the inception. However thereafter based on variations made to the terms, it may get reclassified as a loan represented by a book debt. In this case at what stage would the Company be required to take necessary approvals?

View: Each time there is a variation/relaxation proposed to be made to the terms pertaining to a restricted category, it needs to be first tested for reclassification as a loan represented by a book debt. Approval of the Board and shareholders (by special resolution) should be taken prior to making any variation to the terms of the book debt which would result in the book debt getting transformed into the guise of a loan. However, it may be noted that wherever the loans are prohibited such variation shall not take place and it may lead to non-compliance of the provisions of section 185.

Query 12: In case the book debt (based on variations made to the terms) gets reclassified to be loan represented by a book debt and which falls under the restricted category - is it a non-compliance?

View: Yes, in case of a book debt pertaining to a restricted category which due to its reclassification falls under the category of a loan represented by a book debt, the same shall be treated as non-compliance in case prior approvals (of the Board and that of the shareholders) as required under Section 185, are not obtained.

Query 13: In case the answer to the above query is yes, from which date it would be treated as non-compliance i.e., whether from the date of inception or from the date of variation? What is the period for rectification available with the Company?

View: Since the book debt gets reclassified into a loan from the date on which the terms of the book debt have been varied, the period for non-compliance would be triggered from the date of variation. There is no period of rectification provided under Section 185.

In case any loan is advanced or a guarantee or security is given or provided or utilised in contravention of section 185 of the Act:

- i. the company shall be punishable with a fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees;
- ii. every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees; and
- iii. the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

Query 14: What are the broad parameters required to be considered for classifying variation in book debts as loan in substance? For instance, whether the variation in book debts *vis-a-vis* demand of the product or creditworthiness of the customer needs to be seen to classify book debts of a company as loan in substance?

View: When classifying book debts of a company as loan in substance, one, amongst others, may take into consideration the relevant factors, including:

1. *Variation in book debts*: The fluctuation or pattern in the book debts over time can indicate whether they are akin to loans. If there is a consistent increase or decrease in book debts without corresponding sales or purchases, it might suggest that these debts are akin to loans.
2. *Demand for the Product*: Understanding the demand for the company's product or service can provide insights into the nature of book debts. If there is a high demand and sales are growing, it is less likely that book debts represent loans.
3. *Creditworthiness of the Customer*: Assessing the creditworthiness of customers is crucial. If the company is extending credit period specifically pertaining to a restricted category and if such category of persons has poor credit histories or those who are unlikely to repay, it is likely to be resembled a loan arrangement.
4. *Terms of Payment*: Examining the terms of payment can also be indicative. If the company is offering extended payment terms to customers, it may resemble a loan rather than a standard trade receivable.

In essence, the classification of book debts as loans depends on a holistic assessment of various factors as stated above.

Query 15: Since book debt is money that a customer owes to a company for goods or services purchased on credit, is it required for the CFO/CS/Secretarial Auditor to check each transaction pertaining to a restricted category and confirm that such debit in the Books of Accounts for the Sale or Service provided to such a recipient is a trade debt which arises in the Ordinary Course of Business of such entity?

View: Whilst CFO/CS/Secretarial Auditor would not ideally be in a position to check each transaction pertaining to the restricted category, the following steps may be considered:

- i. *Reviewing transactions*: Review all transactions pertaining to a restricted category to ensure they are properly documented and recorded.
- ii. *Confirmation of nature*: Any debts arising from these transactions are indeed trade debts resulting from the sale of goods or provision of services in the ordinary course of business.
- iii. *Compliance with applicable law/regulations*: Ensure that these transactions comply with relevant laws, regulations, and accounting standards regarding related-party transactions.

- iv. *Disclosure*: Any significant transactions with related parties should be disclosed in the financial statements, along with explanations of their nature and terms.

Query 16: Whether all Book Debts be considered as loans?

View: Courts have held in various judgments that credit extended beyond the normal credit limit and period may be considered in the nature of loans and hence provisions of section 185 of the Act shall get attracted to such book debts also.

In these judgments, the Court had also articulated on the meaning of an “indirect loan”, and opined that the term “indirectly” cannot be read as converting “what is not a loan into a loan”.

In any agreement by which company’s property was sold to a director partly for cash and partly on credit, it was held that section 295 of the Companies Act, 1956, does not have application (*supra-Freddie Ardeshtir Mehta v. Union of India*) (70 Comp Cases 210). The above rationale would not have held good under section 185 of the present Act as book debts are also to be considered as part of loans. For the same reasons, a transaction involving sale of goods to a director could also come under the ambit of section 185 of the Act if the book debts are outstanding beyond the agreed credit period or the circumstances otherwise so require.

Accordingly, one has to holistically consider the relevant aspects (including those referred in the immediately previous two questions) for assessing if the debt be considered as a loan in essence or at what stage such debt stood transpired into a loan.

Query 17: Does section 185 of the Act apply to a hire purchase or lease transaction?

View: No, it applies only to loan transactions. Therefore, it is advisable to examine the detailed terms of such hire purchase or lease, to obviate any unforeseen applicability of Section 185.

Query 18: Where a director is provided advance salary subject to adjustment against his salary in due course or recovery over a short period, will it be considered as a loan?

View: Prima facie, no. However, if the advance is provided in the guise of a loan, then it would get covered. [*M.R. Electric Components Ltd. v. Assistant Registrar* (61 Comp Cas 8)].

Query 19: Is a letter of comfort a Guarantee?

View: No, a letter of comfort is a document that indicates one party's intention to ensure that another party complies with the terms of a financial transaction without guaranteeing performance in the event of default. However, if the language in document is such that it actually contains a 'financial commitment or an obligation' in essence, then this is likely to be construed as guarantee, and be covered accordingly within the ambit of Section 185. Hence, whether a letter of comfort is a guarantee or not depends upon the relevant factors of the transaction concerned.

Query 20: A director has been provided a corporate credit card by a company for business expenditure and if the director uses it for personal purposes and has agreed that he will pay the same to the Company. If some of the expenses incurred by him are for his personal purpose and the company pays the dues to the credit card issuing bank. In such circumstance, till the time the amount is reimbursed by the director to the Company, would it be treated as a loan by the company to the concerned director requiring compliance of section 185 of the Act ?

View: Any advance or interest given for expenses to be incurred on behalf of the company would be considered as a loan to the extent it remains unadjusted for a reasonable time, for the purpose of section 185 of the Act.

Using the same matrix and logic, the company may not be incorrect in taking a stand that if similar expenses of a personal nature are to be reimbursed generally by the company's employees within a particular period of time (in any case within reasonable time period), and the director also reimburses the expenses within such period of time, then the same should not be treated as a loan as the period is in line with those applicable to other employees.

It is advisable for the Director to pay such expenses to the company before the company pay the dues against the credit card.

Query 21: Is there any specific disclosure requirement under Schedule III of the Act for loans granted under section 185 of the Act?

View: Yes, loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated under the sub-head of '*Trade receivables*' as appearing under '*Current assets*'.

Exemption from the applicability of the provisions of section 185 to a Private Company

Ministry of Corporate Affairs (“MCA”) vide notification dated 5th June 2015 provided that provisions of section 185 of the Act shall not apply to a private company-

- (i) in whose share capital no other body corporate has invested any money;
- (ii) if the borrowings of such a company from banks or financial institution or any body corporate is less than twice its paid-up share capital or fifty crore rupees, whichever is lower; and
- (iii) such a company is not in default in repayment of such borrowings subsisting at the time of making transactions under this section.

Query 22: Section 185 of the Act is exempted for private companies that satisfy the conditions laid down in notification dated 5th June 2015. This notification was issued under the original version of section 185 of the Act which has been revamped on 7th May 2018. However, the notification has not been reiterated after the introduction of the fresh provision. Is the exemption to be considered as still valid?

View: Exemption notification of 5th June 2015 should ideally hold good, accordingly, the exemption should be available to a private limited company even after 7th May 2018 amendment vide the Companies (Amendment) Act, 2017. It may be noted that the relevant circulars/notification issued by the regulator generally represent its understanding of the statutory provisions and are binding on them. [Reference *Assistant Commissioner of Income Tax (Exemptions) v. Ahmedabad Urban Development Authority (AUDA)* 16 2022 SCC Online SC 1461. Also refer to *PS Bedi v. ROC* (1986) (60 Comp Cas 1061 (Delhi)).

2. LOAN AND INVESTMENT BY COMPANY

Section 186 of the Act deals with giving of loan, guarantee or providing of security and making investment by the companies. The section not only deals with inter-corporate loan, guarantee or security but also giving loan, or guarantee or providing security to ‘any person’. Section 186 of the Act restricts the power of a company to make investment, give loan, guarantee or provide security to any person or body corporate, or to ‘make investment to acquire securities of any other body corporate, etc. unless otherwise than in accordance with the provisions of this section.

This section corresponds to Section 372A of the Companies Act, 1956 and seeks to provide the manner and limits up to which a company shall give any loan or give any guarantee or provide any security in connection with a loan to any other body corporate or person and acquire by way of subscription, purchase or otherwise, the securities of any other body corporate. It further provides that the companies

providing loan or guarantee or providing security or making investment shall disclose in financial statements the full particulars of the same. It also provides for the manner in which statutory register to this effect will be kept by a company to record therein the transactions and the manner in which such registers shall be available for inspection. However, certain categories of companies are exempted from the provisions of this section. Furthermore, for the purpose of this section, the Central Government has prescribed the applicable rules.

Without prejudice to the provisions contained in the Act, section 186(1) provides that a company shall not make investment through more than two layers of investment companies. However, this shall not affect,-

- (i) a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;
- (ii) a subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

Section 186(2) of the Act provides that no company shall directly or indirectly –

- (a) give any loan to any person or other body corporate;
- (b) give any guarantee or provide security in connection with a loan to any other body corporate or person; and
- (c) acquire by way of subscription, purchase or otherwise, the securities of any other body corporate,

exceeding sixty percent of its paid-up share capital, free reserves and securities premium account or one hundred percent. of its free reserves and securities premium account, whichever is more.

Explanation:- For the purposes of sub-section (2), the word “person” does not include any individual who is in the employment of the company.

Section 186(3) of the Act further provides that where the aggregate of the loans and investment so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceed the limits specified under sub-section (2) of section 186 of the Act, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting.

Though the investments made or loans or guarantees given are exempted under the provisions of section 186(11) of the Act, such investments or loans or guarantees

shall be included for aggregating of the loans and investment for the purpose of arriving at the limits under this sub-section.

Provided that the special resolution as mentioned above is not required where a loan or guarantee is given or where a security has been provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition is made by a holding company, by way of subscription, purchase or otherwise of, the securities of its wholly owned subsidiary company.

However, such investments made, loans or guarantees given or security provided shall be included for aggregating of the loans and investment for the purpose of arriving at the limits under this sub-section as mentioned above.

Provided further that the company shall disclose the details of such loans or security or acquisition in the financial statement as provided under sub-section (4) of section 186 of the Act.

Section 186(4) of the Act provides that the company shall disclose to the members in the financial statement the full particulars of the loans given, investment made or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilised by the recipient of the loan or guarantee or security.

Section 186(5) of the Act provides that 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.

Therefore, there must be a specific resolution for every investment made or loan given by the company. Since the words used are “unless the resolution sanctioning it is passed at a meeting of the Board with the consent of the directors present at the meeting” such resolution must be a prior resolution and hence cannot be passed by way of a circular resolution. It may also be noted that the consent shall be unanimous consent of the directors present at the meeting and not of the unanimous consent of the Board. Though under section 179 of the Act such power may be delegated however under section 186 of the Act such power can’t be delegated. The Board may decide the upper limit of the investments to be made or loans or guarantees to be given or securities to be provided and thereafter it may delegate such power to the finance committee or any individual to execute such decision.

However, 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 investment, loan, guarantee or security proposed to be made or given does not exceed the limit as specified in sub-section (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(6) of the Act provides that no company, which is registered under section 12 of the Securities and Exchange Board of India Act, 1992 and covered under such class or classes of companies as may be prescribed, shall take inter-corporate loan or deposits exceeding the prescribed limit and such company shall furnish in its financial statement the details of the loan or deposits.

It has been stated under Rule 11(3) of the Companies (Meetings of Board and its Powers) Rules, 2014, that no company registered under section 12 of the Securities and Exchange Board of India Act, 1992 and also covered under such class or classes of companies which may be notified by the Central Government in consultation with the Securities and Exchange Board, shall take any inter-corporate loan or deposits, in excess of the limits specified under the regulations applicable to such company, pursuant to which it has obtained the certificate of registration from the Securities and Exchange Board of India.

Section 186(7) of the Act provides that no loan shall be given under this section 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.

However, nothing contained in this sub-section shall apply to a company in which twenty-six per cent or more of the paid-up share capital is held by the Central Government or one or more State Governments or both, in respect of loans provided by such company for funding Industrial Research and Development projects in furtherance of objects as stated in its memorandum of association. (MCA notification dated 13th June 2017)

MCA clarification:

MCA vide its general circular dated 9th April 2015 clarified that in cases where the effective yield (effective rate of return) on tax-free bonds is greater than the prevailing yield of one-year, three year, five-year or ten-year Government Security closest to the tenor of the loan, there is no violation of sub-section (7) of section 186 of the Act.

Section 186(8) of the Act provides that no company which is in default in the repayment of any deposits or in payment of interest thereon, shall give any loan or give any guarantee or provide any security or make an acquisition till such default is subsisting.

It is pertinent to note that the prohibition from giving any loan or guarantee or provide any security is only in case of default in the repayment of any deposits and not in case of mere non-repayment of deposits which may be on account of any dispute, or procedural requirements or any prohibition order from any regulatory authority.

Section 186(9) of the Act provides that every company giving loan or giving a guarantee or providing security or making an acquisition under this section shall keep a register which shall contain such particulars and shall be maintained in such manner as may be prescribed.

According to section 186(10) of the Act, the said register shall be kept at the registered office of the company and shall be open to inspection and extracts may be taken therefrom by any member, and copies thereof may be furnished to any member of the company on payment of such fees as may be prescribed.

Section 186(11) of the Act provides that nothing contained in this section, except sub-section (1), shall apply –

- (a) 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”;

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 guarantee or security for due repayment of any loan availed by any person in the ordinary course of its business” [Rule 11 (2) of the Companies (Meetings of Board and its Powers) Rules, 2014]

The expression “infrastructural facilities” means the facilities specified in Schedule VI. **(For easy reference Schedule VI is placed at Annexure-I.)**

- (b) 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 of the Act 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(12) of the Act empowers the Central Government to make rules for the purposes of this section.

Section 186(13) of the Act provides penal provisions which states that if a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend

to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees. From above, it may be noted that offence contemplated herein above, is a non-compoundable offence.

Explanation- For the purposes of this section, –

the expression “investment company” means a company whose principal business is the acquisition of shares, debentures or other securities and 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 per cent. of its total assets, or if its income derived from investment business constitutes not less than fifty per cent. as a proportion of its gross income.

Rule 12 of the Companies (Meeting of Board and its Powers) Rules, 2014 provides for maintenance of Register of loans, guarantee, security and acquisition made by the company as under:

- (1) Every company giving loan or giving guarantee or providing security or making an acquisition of securities shall, from the date of its incorporation, maintain a register in **Form MBP 2** and enter therein separately, the particulars of loans and guarantees given, securities provided and acquisitions made as aforesaid.
- (2) The entries in the register shall be made chronologically in respect of each such transaction within seven days of making such loan or giving guarantee or providing security or making acquisition.
- (3) The register shall be kept at the registered office of the company and the register shall be preserved permanently and shall be kept in the custody of the Company Secretary of the company or any other person authorised by the Board for the purpose.
- (4) The entries in the register (either manual or electronic) shall be authenticated by the Company Secretary of the company or by any other person authorised by the Board for the purpose.
- (5) For the purpose of sub-rule (4), the register can be maintained either manually or in electronic mode.
- (6) The extracts from the register maintained under sub-section (9) of section 186 of the Act may be furnished to any member of the company on payment of such fee as may be prescribed in the Articles of the company which shall not exceed ten rupees for each page.

The format of MBP-2 is placed at Annexure-II.

Exemptions from the applicability of the provisions of section 186

Government Company

Section 186 of the Act shall not apply to a Government company: -

- (a) engaged in defence production;
- (b) other than a listed company, in case such company obtains 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.

(MCA Notification dated 5th June, 2015)

Specified IFSC Public/Private Company

In case of a Specified IFSC public company or Specified IFSC private company, as the case may be –

1. The Board can exercise powers under section 186(5) of the Act by means of resolutions passed at meetings of the Board of Directors or through resolutions passed by circulation;
2. Sub-sections (2) and (3) of section 186 of the Act shall not apply if a company passes a resolution either at meeting of the Board of Directors or by circulation;
3. Sub-section (1) of section 186 of the Act shall not apply.

(MCA Notifications dated 4th January, 2017)

Query 23: Section 186(7) of the Act states that no loan shall be given under this section 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. Can we extend the carve out provided under sub-section (2) of section 186 of the Act to sub-section (7) of section 186 the Act?

View: Yes, sub-section (7) of section 186 of the Act deals with levying a rate of interest on loan given by the company. Since section 186(2) of the Act deals with granting of loan and explanation to section 186(2) of the Act specifically excludes employees, the same carve out stands extended to sub-section (7) of section 186 of the Act.

Query 24: Can a holding company in India give an inter-corporate loan at a rate of interest lower than the prescribed thresholds, i.e., the prevailing yield of one year, three years, five years, or ten years Government Security closest to the tenor of the loan to a foreign wholly owned subsidiary? Will this be in compliance to section 186(7) of the Act?

View: Section 186(7) of the Act provides that no loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three years, five years or ten years Government Security, closest to the tenor of the loan. The expression “Government Security” is not defined in the Companies Act, but is defined in section 2(b) of the SCRA, 1956. Section 2(95) of the Act states that if a word or expression is not defined in the Act, the definition given in the Securities Contracts Regulation Act, 1956 (‘SCRA’), may be applied. Section 2(b) of the Securities Contract regulations Act, 1956 defines “Government Security” as “*a security created and issued, whether before or after the commencement of this Act, by the Central Government or a State Government for the purpose of raising a public loan and having one of the forms specified in clause (2) of section 2 of the Public Debt Act, 1944.*” Only securities issued by the Central or State Government (for the purpose of raising public loan) fall within the ambit of this provision.

As section 186(2)(a) of the Act uses the words – “*give any loan to any person or other body corporate*” – thus, inter-corporate loans given to any company incorporated outside India (i.e., a body corporate) shall fall within the ambit of section 186 of the Act. Therefore, Section 186(7) of the Act would cover loan granted by a holding company to its foreign subsidiaries (being body corporate).

Example: ABC Ltd. is a public listed company incorporated in India. XYZ is a wholly owned subsidiary of ABC Ltd. and is incorporated in the UK. A wholly owned subsidiary such as XYZ may not be capable of borrowing directly from the market and is therefore dependent on the holding company (ABC) for funding.

Now, if ABC grants a loan to XYZ, Section 186(7) of the Act shall apply. In accordance with section 186(7) of the Act, the rate of interest on the loan cannot be lower than the prevailing yield of one year, three years, five years or ten years Government Security rate closest to the tenor of the loan.

The interest rates in India are likely to be significantly higher than the rates prevalent in the UK. Such rate restrictions may also create transfer pricing issues under the laws of the jurisdiction of the host country where the subsidiary is located. The Board/Governing Body of such overseas subsidiary will have to justify the borrowing at such a high interest rate, to the tax authorities in such foreign jurisdiction.

Through a clarificatory circular issued on 9th April, 2015, the MCA has clarified that in cases where the effective yield (effective rate of return) on tax-free bonds is greater than the prevailing yield of one year, three years, five years or ten years Government Security closest to the tenor of the loan, there shall be no violation of Section 186(7) of the Act.

Applying this matrix of looking at the effective yield on the loan and not just the rate of interest which is supported by the above referred MCA circular, an alternative mechanism that can be used is that for a transaction, where the borrower has agreed to bear the foreign exchange risk arising out of the exchange rate fluctuation, by way of hedge or otherwise, one may look at the effective return on investment (ROI) to the lender, viz. interest rate plus the benefit of extra rupees received due to rupee depreciation *vis-a-vis* the foreign currency, say USA Dollar (USD), to determine the actual rate of interest as per Section 186(7) of the Act. The effective yield has to be tested at the time of sanctioning the loan.

Query 25: If a company incorporated under the Act subscribes to the optionally convertible debentures (OCDs) issued by a foreign subsidiary even if such OCDs have a coupon rate below the threshold provided in section 186(7) of the Act. Would such an act of the company in India be tantamount to subscription, to the securities of any other body corporate coming under the purview of section 186(2)(c) of the Act or would it be treated as loan given to any person or any body corporate attracting section 186(2)(a) of the Act thereby requiring compliance of section 186(7) of the Act?

View: If a company subscribes to securities, including OCDs issued by another body corporate, it should fall under the purview of section 186(2)(c) of the Act. This means that the company needs to ensure compliance with the provisions of section 186 of the Act, which includes not exceeding the prescribed limits for making investments and associated compliances such as maintenance/update of statutory register etc. It may also be noted that even under the prescribed format of Schedule III, the disclosure of such subscription in OCDs is reported under the head 'investment in debentures/ bonds'.

Such OCDs / bonds should be considered as a debt for the purpose of the ODI Rules and the Foreign Exchange and Management Act, 1999 ("FEMA").

Query 26: Can the company take a stand that irrespective of the treatment of OCDs etc. in FEMA, the act of subscription to securities (OCD being a security) of any other body corporate would come under the purview of section 186(2)(c) of the Act?

View: While the treatment of OCDs and similar instruments under FEMA is

relevant for compliance with FEMA regulations, it does not necessarily dictate how these instruments are treated under the Act.

Thus, regardless as to how OCDs are treated under FEMA regulations, if a company subscribes to securities (say OCDs), it would be governed by the provisions of Section 186(2)(c) of the Act.

Query 27: Should a company deduct provisions made for non-recovery of loans/investments while calculating the monetary limit for the purposes of section 186(2) of the Act? If the company has written off these loans/investments in its books, can the same be deducted for the purposes of calculating the limit under section 186(2) of the Act?

View: Provisions are created where the company is reasonably certain that the money owed may not be recovered from the borrower. However, such provisions should not be deducted while calculating the monetary limit of loans/ investments for the purpose of section 186(2) of the Act. However, when a company writes-off these loans/investments in the books after arriving at a conclusion that the money will not be recovered or it has no value, the same may be deducted while calculating the limits under section 186(2) of the Act.

Query 28: Whether rent unpaid by one company to another company would be considered as 'Loan' and shall fall under section 186(2) of the Act?

View: It may be noted that section 186(2) of the Act specifically refers to specific financial transactions viz.; providing loan, giving guarantee, or providing security, or making investment into the securities of body corporate. However, unpaid rent typically arises from a contractual agreement for the use of property or services and does not necessarily fall under the category of a loan. Therefore, unpaid rent should not be considered as 'loan' for the purpose of section 186(2) of the Act.

However, if the unpaid rent is structured (in its essence) as financial advance, resembling a loan, in that case it might fall under section 186(2) of the Act. Thus, the classification would largely depend on the specific terms and nature of the arrangement between the two companies.

Query 29: Does the term 'Loan' under section 186 of the Act include loan in the form of money only?

View: Section 186 of the Act deals with, *inter alia*, giving of loan by companies. The term "loan" as used in this section is not explicitly restricted to loans in the form of money only, and it may encompass other form of financial assistance provided by a company depending upon the exact nature of such assistance.

As regards the distinction between a loan and advance, one needs to clearly differentiate between the two. While, loan is lending of money with an absolute promise to repay, however, advances are to be adjusted against the supply of goods and services.

Similarly, genuine trade advances given to suppliers against orders for the supply of goods should not be considered as loan and hence will be out of the purview of section 186 of the Act.

It may also be noted that the section 372A of the Companies Act, 1956 specifically provided an explanation to the effect that loan includes deposits. However, no such explanation has been provided under the Act.

In re: *Bombay High Court in Freddie Ardeshir Mehta v. Union of India (1991)*, it was upheld that sale on credit is not a loan.

Query 30: Whether the Board can delegate its powers for loan/investment/guarantee under section 186 of the Act?

View: Section 179(3) of the Act authorizes the Board to delegate its powers for certain specified transactions, to any committee of directors, the managing director, the manager or any other principal officer of the company or in the case of a branch office of the company, the principal officer of the branch office.

However, section 186 of the Act requires the consent of all directors present in the meeting for approving such transactions. Applying the principle of harmonious construction, it can be said that once the Board has approved the specified transactions it can delegate its powers with respect to execution of such decision.

Query 31: As per section 186(5) of the Act investment, loan, guarantee, security can be provided only with the unanimous approval of the Board. As per section 179(3) of the Act the Board can pass a general resolution. Is there any difference in the Board resolution passed under section 186(5) of the Act and the Board resolution passed under section 179 of the Act? If general Board resolution under section 179 of the Act is passed, whether specific Board approval under section 186(5) of the Act shall be required?

View: Section 186(5) of the Act, requires that investment, loan, guarantee, or security provided by a company can only be made with the unanimous approval of the Board of Directors accorded at a Board meeting. On the other hand, section 179(3) of the Act provides for certain powers that can be exercised by the Board of Directors by means of resolutions passed at Board meetings.

While there may be similarities in the concept of Board resolutions passed under these sections, there are also distinct differences:

1. **Specificity:** A Board resolution passed under section 186(5) of the Act is specific to the approval of investment, loan, guarantee, or security provided by the company. It addresses the particular transaction or transactions in question, ensuring that the Board is fully aware of and approves these actions. On the other hand, a Board resolution under section 179(3) of the Act may cover a broader range of matters, as it pertains to the exercise of powers by the Board in general, including but not limited to financial matters.
2. **Unanimity:** Section 186(5) of the Act explicitly requires unanimous approval of the directors present in the meeting whilst taking decisions for investment, loan, guarantee, or security. This means that all directors present at the meeting must approve the transaction. In contrast, a resolution passed under section 179(3) of the Act may not necessarily require unanimity unless the company's articles of association stipulate otherwise or if unanimity is explicitly required for certain matters.

In summary, while a general Board resolution passed under section 179(3) of the Act may grant the Board certain powers, including those related to financial transactions, specific approval under section 186(5) of the Act is necessary for investments, loan, guarantee, or security. Therefore, even if there is a general Board resolution under section 179(3) of the Act say for a transaction dealing with loan/investment etc., a specific Board resolution under section 186(5) of the Act would be required for such transaction.

Query 32: Does 'performance guarantee' come under the ambit of section 186 of the Act?

View: Section 186 of the Act only covers guarantees which are in connection with a loan *i.e.*, financial guarantees. It does not cover performance guarantees.

Query 33: Whether a company can provide guarantee to its subsidiaries even if the principal business activity of the company is not providing loan or guarantee, etc.?

View: According to Section 186(1) of the Act, companies are generally restricted from providing loan, giving guarantee, or providing security to any person or body corporate, except as provided under the specific sub-sections of section 186 of the Act. Though making investments, giving loans or guarantees or providing securities may not be covered in the main objects of the company, however, the same must have been covered in the ancillary objects clause and is permitted. The power to make guarantees is also one of the inherent powers of a company.

However, there are certain exceptions and conditions mentioned in the subsequent sub-sections of section 186 of the Act that allow companies to provide loan, give guarantee, or provide security in certain circumstances.

Thus, we can conclude that companies can provide guarantees to its subsidiaries even though the principal business activity is not providing loan or guarantee but ancillary clause provides for such loan or guarantee.

Query 34: Can a foreign wholly owned subsidiary borrow in the local currency at a rate of interest lower than the prescribed Government securities thresholds, and whether the parent company incorporated in India providing guarantee for such borrowing by wholly owned subsidiary will be subject to FEMA regulations? Will this be a non-compliance of Section 186(7) of the Act?

View: A foreign wholly owned subsidiary borrowing in the local currency at a rate of interest lower than the prescribed Government securities thresholds, would not violate section 186(7) of the Act.

A foreign wholly owned subsidiary borrowing in the local currency with the parent company incorporated in India providing a guarantee shall be subject to compliance with FEMA regulations.

Query 35: Whether one can provide a guarantee on a gratuitous basis. This is specifically because the grant of loans below the threshold under section 186(7) of the Act is not allowed?

View: Providing a guarantee on a gratuitous basis is not akin to the grant of a loan. The threshold under section 186(7) of the Act is not applicable to the guarantee. Hence, provision of guarantee could be gratuitous.

Section 186(7) provides restriction on rate of interest chargeable to loans and there is no concept of interest on Guarantee. While providing guarantee, the following are to be considered:

1. Whether it is permissible under MOA of company (otherwise can be treated as ultra vires); and
2. If it is with related party, then check whether the same is at arm's length basis.

Query 36: Is exemption under section 186(11) of the Act absolute unlike the proviso to sub-section (3) of section 186 of the Act where the exemption is limited only to sub-section (3) of section 186 of the Act?

View: Though the investments made or loans or guarantees given are exempted under the provisions of section 186(11) of the Act, such investments or loans or

guarantees shall be included for aggregating of the loans and investment for the purpose of arriving at the limits under this sub-section.

The exemption provided under section 186(11) of the Act except for section 186(1) of the Act is an absolute exemption. This is unlike the exemption provided under section 186(3) of the Act which is only for section 186(3) of the Act. Investments in wholly owned subsidiaries while exempt from the threshold once having been made the same will be counted for arriving at the limits under section 186(2) of the Act while calculating the aggregate of limits.

However, an exemption of investment in the right issue of share under section 62(1)(a) of the Act is an absolute exemption and will neither be counted for the limits provided under section 186(2) of the Act nor post investment will it be part of the limits calculated under section 186(2) of the Act.

Query 37: What is the difference between section 185 and section 186 of the Act? State some examples where either of the two sections will apply and some examples where both the sections will apply?

View: Sections 185 and 186 of the Act, both deal with restrictions on certain financial transactions involving loans, advances, or guarantees by companies, but they differ in their scope and applicability.

Section 185 of the Act (entailing substantive provisions), primarily deals with loans to directors and their connected/related entities. It prohibits companies from advancing any loan, including providing guarantees or providing security, to any of its directors or to any other person in whom the director is interested, subject to certain exceptions.

Section 186 commences with the words “without prejudice to the provisions in the Act” suggesting that the section operates in an independent field and that it will not in any way prejudice the operation of any other section in the Act. The use of the above expression in section 186 is necessary since there are some segments in section 185 which overlap with section 186.

Examples of situations where section 185 applies:

1. A company providing a loan to one of its directors for personal financial needs.
2. A company providing a guarantee for a loan taken by a director from a financial institution.
3. A company providing security for a loan taken by a director for business purposes.

Section 186 of the Act (entailing procedural aspects), imposes restrictions and conditions on various financial transactions, including loans, investments, guarantees, and securities, by a company. It provides regulations for such transactions with respect to other entities, including companies and body corporates.

Examples of situations where section 186 of the Act applies:

1. A company extending a loan to another body corporate.
2. A company providing a guarantee to a bank on behalf of its subsidiary for a loan taken by the subsidiary.
3. A company investing in shares or securities of another body corporate.

Examples where both sections 185 and 186 of the Act may apply:

1. If a company's director is also a shareholder in another company and the first company (*i.e.*, the lending company) gives a loan to the second company where the director holds an interest, both sections 185 and 186 of the Act would apply. Section 185 of the Act applies due to interest of such director, and section 186 of the Act applies because of the loan transaction between the two companies.
2. If a director of a company (*i.e.*, first company) seeks a loan from another company (*i.e.*, second company) for his personal purposes, and the first company provides guarantee to the second company in relation to such loan to director of first company, in that case both sections 185 and 186 of the Act would apply.

The Companies (Restriction on Number of Layers) Rules 2017- Notified on 20.09.2017

Rule 2: Restriction on number of layers for certain classes of holding companies. -

(1) On and from the date of commencement of these rules, no company, other than a company belonging to a class specified in sub-rule (2), shall have more than two layers of subsidiaries.

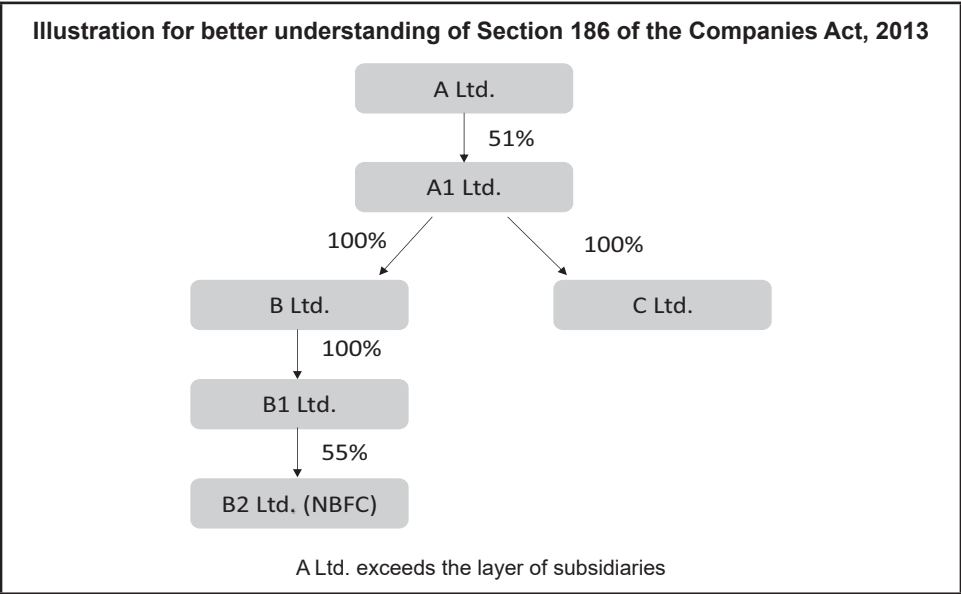
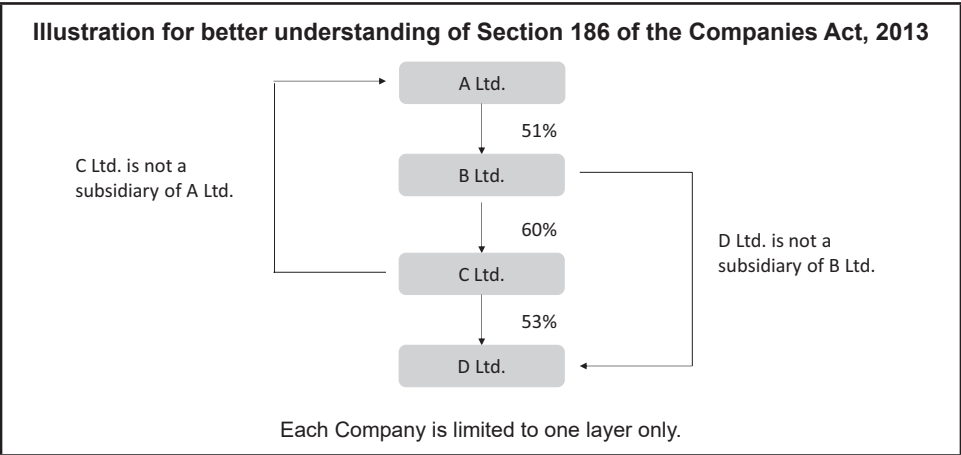
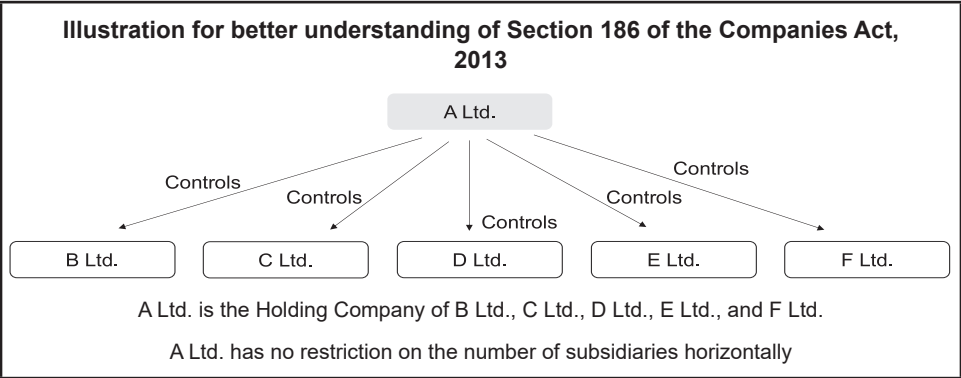
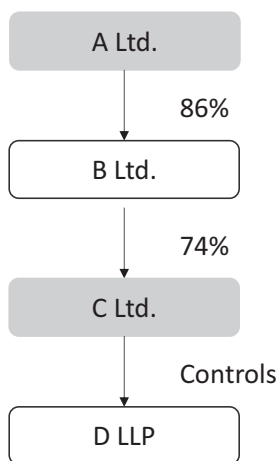
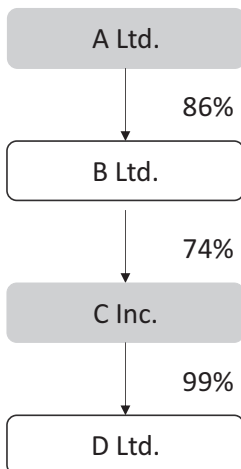


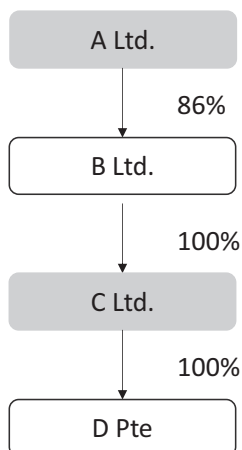
Illustration for better understanding of Section 186 of the Companies Act, 2013

D LLP will not be considered in counting layers of subsidiary

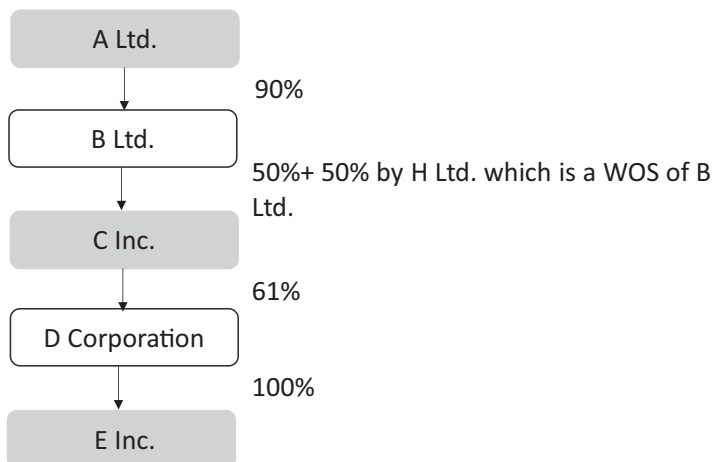
Provided that the provisions of this sub-rule shall not affect a company from acquiring a company incorporated outside India with subsidiaries beyond two layers as per the laws of such country.

Illustration for better understanding of Section 186 of the Companies Act, 2013

A Ltd. is breaching the permitted two layers of subsidiaries as the last layer is a subsidiary incorporated in India

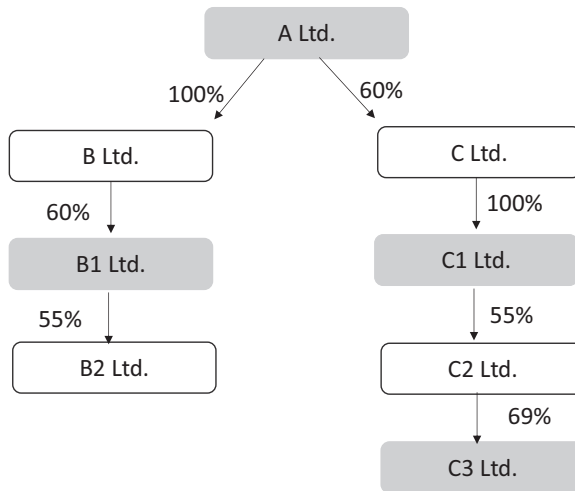
Illustration for better understanding of Section 186 of the Companies Act, 2013

A Ltd. is not breaching the permitted two layers of subsidiaries as the last layer is a subsidiary incorporated outside India

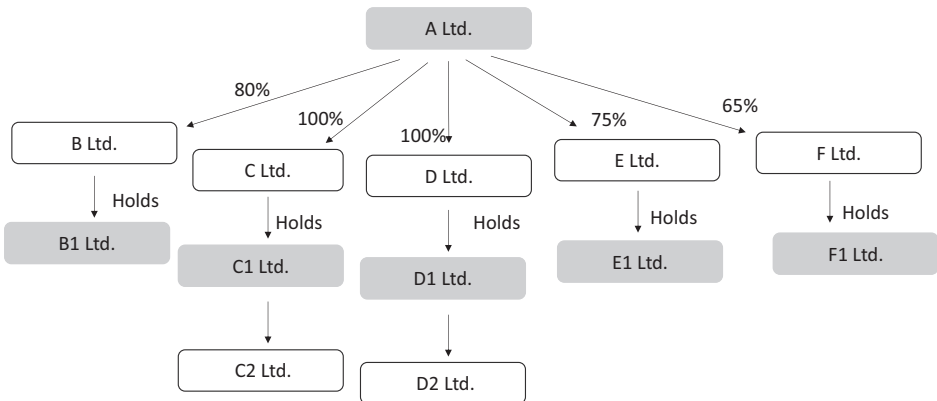
Illustration for better understanding of Section 186 of the Companies Act, 2013

A Ltd. is not breaching the permitted two layers of subsidiaries since C Inc., D Corporation and E Inc. are subsidiaries incorporated outside of India

Provided further that for computing the number of layers under this rule, one layer which consists of one or more wholly owned subsidiary or subsidiaries shall not be taken into account.

Illustration for better understanding of Section 186 of the Companies Act, 2013

B Ltd. being a WOS is exempted; hence, the permitted layer will be until Company B2 Ltd. However, A Ltd. is not the ultimate holding of C1 Ltd. Therefore, for A Ltd., the permitted layer will be till C1 Ltd., and for C Ltd., the permitted layer will be till C3 Ltd.

Illustration for better understanding of Section 186 of the Companies Act, 2013

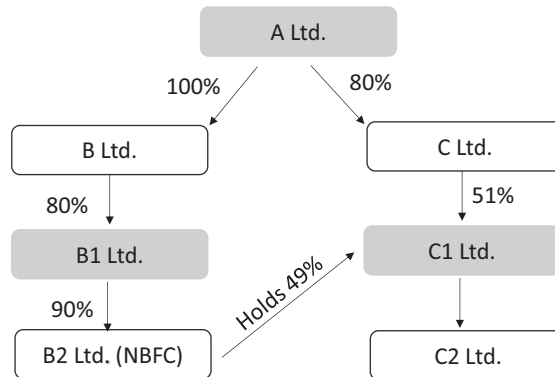
All are permitted structure of layers

(2) The provisions of this rule shall not apply to the following classes of companies, namely: -

- A banking company as defined in clause (c) of section 5 of the Banking Regulation Act 1949 (10 of 1949);
- A non-banking financial company as defined in clause (f) of Section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934) which is registered with the

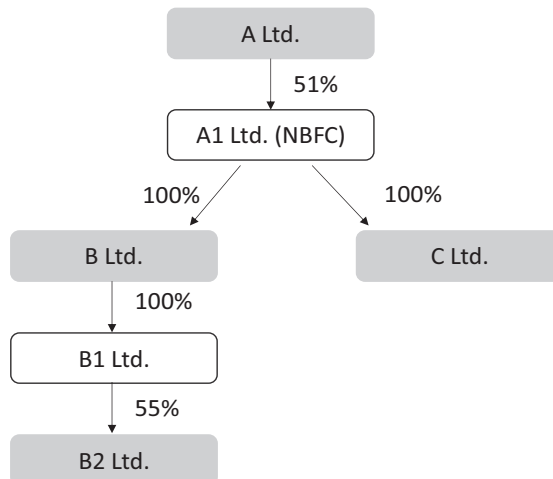
Reserve Bank of India and considered as a systematically important non-banking financial company by the Reserve Bank of India;

**Illustration for better understanding of
Section 186 of the Companies Act, 2013**



C2 Ltd. is not permitted because C1 Ltd. is not a NBFC Company.

**Illustration for better understanding of
Section 186 of the Companies Act, 2013**



A Ltd. exceeds the layer of subsidiaries.

However, for A1 Ltd., the Rule shall not apply since A1 Ltd. is a NBFC Company, and the same is exempted from the layer of subsidiaries.

- (c) An insurance company being a company which carries on the business of insurance in accordance with provisions of the Insurance Act, 1938 (4 of

1938) and the Insurance Regulatory Development Authority Act, 1999 (41 of 1999);

(d) A Government company referred to in clause (45) of section 2 of the Act.

(3) The provisions of this rule shall not be in derogation of the proviso to sub-section (1) of section 186 of the Act.

(4) Every company other than a company referred to in sub-rule (2) existing on or before the commencement of these rules, which has a number of layers of subsidiaries in excess of the layers specified in sub-rule (1) –

- (i) shall file, with the Registrar a return in Form CRL-1 disclosing the details specified therein, within a period of one hundred and fifty days from the date of publication of these rules in the official Gazette;
- (ii) shall not, after the date of commencement of these rules, have any additional layer of subsidiaries over and above the layers existing on such date; and
- (iii) shall not, in case one or more layers are reduced by it subsequent to the commencement of these rules, have the number of layers beyond the number of layers it has after such reduction or maximum layers allowed in sub-rule (1), whichever is more.

(5) If any company contravenes any provision of these rules the company and every officer of the company who is in default shall be punishable with fine which may extend to ten thousand rupees and where the contravention is a continuing one, with a further fine which may extend to one thousand rupees for every day after the first during which such contravention continues.

Query 38: 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. Whether the formation of D Limited as a subsidiary of C Limited will be violation of the provisions of the Act. If C Limited makes D Limited as an associate company instead of subsidiary. 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?

Ans: 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.

Query 39: A Limited is investing company and has a wholly-owned subsidiary B Limited. B Limited has its subsidiary company C Limited, which is also an investing company. C Limited wants to create an SPV

with 51% equity participation in D Limited for the acquisition of Company F Limited in USA. Whether the same is in compliance with the provisions of Section 186 of the Act?

Ans: Yes, the same is in compliance. Rule 2 of the Companies (Restriction on Number of Layers) Rules, 2017 provides that for computing the number of layers under this rule, one layer which consists of one or more wholly-owned subsidiary or subsidiaries shall not be taken into account. Hence B Limited is not counted for the layer of two subsidiaries for A Limited. C Limited becomes the first layer after the exemption of B Limited and then D limited is second layer. F Limited is a foreign company, hence this restriction does not apply and it is in compliance with section 186.

Query 40: 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?

Ans: 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).

Form CRL-1 Return regarding number of layers is placed at Annexure III.

The additional disclosure to be given in the explanatory statements for Inter Corporate Transactions of Loan or Investment for better Governance is given in Annexure IV.

Frequently Asked Questions (FAQs) – Annexure V.

Annexure-I**SCHEDULE VI**

(See Section 55 and Section 186)

The term “infrastructural projects” or “infrastructural facilities” includes the following projects or activities: –

- (1) Transportation (including inter modal transportation), includes the following:
–
 - (a) roads, national highways, state highways, major district roads, other district roads and village roads, including toll roads, bridges, highways, road transport providers and other road-related services;
 - (b) rail system, rail transport providers, metro rail roads and other railway related services;
 - (c) ports (including minor ports and harbours), inland waterways, coastal shipping including shipping lines and other port related services;
 - (d) aviation, including airports, heliports, airlines and other airport related services;
 - (e) logistics services.
- (2) Agriculture, including the following, namely: –
 - (a) infrastructure related to storage facilities;
 - (b) construction relating to projects involving agro-processing and supply of inputs to agriculture;
 - (c) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality.
- (3) Water management, including the following, namely: –
 - (a) water supply or distribution;
 - (b) irrigation;
 - (c) water treatment.
- (4) Telecommunication, including the following, namely: –
 - (a) basic or cellular, including radio paging;
 - (b) domestic satellite service (*i.e.*, satellite owned and operated by an Indian company for providing telecommunication service);

- (c) network of trunking, broadband network and internet services.
- (5) Industrial, commercial and social development and maintenance, including the following, namely: –
- (a) real estate development, including an industrial park or special economic zone;
 - (b) tourism, including hotels, convention centres and entertainment centres;
 - (c) public markets and buildings, trade fair, convention, exhibition, cultural centres, sports and recreation infrastructure, public gardens and parks;
 - (d) construction of educational institutions and hospitals;
 - (e) other urban development, including solid waste management systems, sanitation and sewerage systems.
- (6) Power, including the following: –
- (a) generation of power through thermal, hydro, nuclear, fossil fuel, wind and other renewable sources;
 - (b) transmission, distribution or trading of power by laying a network of new transmission or distribution lines.
- (7) Petroleum and natural gas, including the following: –
- (a) exploration and production;
 - (b) import terminals;
 - (c) liquefaction and re-gasification;
 - (d) storage terminals;
 - (e) transmission networks and distribution networks including city gas infrastructure.
- (8) Housing, including the following: –
- (a) urban and rural housing including public / mass housing, slum rehabilitation, etc.;
 - (b) other allied activities such as drainage, lighting, laying of roads, sanitation and facilities.
- (9) Other miscellaneous facilities/services, including the following: –
- (a) mining and related activities;

- (b) technology related infrastructure;
 - (c) manufacturing of components and materials or any other utilities or facilities required by the infrastructure sector like energy saving devices and metering devices;
 - (d) environment related infrastructure;
 - (e) disaster management services;
 - (f) preservation of monuments and icons;
 - (g) emergency services (including medical, police, fire and rescue).
- (10) such other facility service as may be prescribed.

Annexure-II**FORM MBP.2**

Register of loans, guarantee, security and acquisition made by the company

[Pursuant to section 186(9) & rule 12(1)]

Nature of transaction (whether loan/guarantee/ security/acquisition)	Date of making loan/acquisition/ giving guarantee /providing security	Name and address of the person or body corporate to whom it is made or given or whose securities have been acquired(Listed /Unlisted entities)	Amount of loan/security/acquisition/guarantee	Time period for which it is made/given
(1)	(2)	(3)	(4)	(5)

Purpose of loan/acquisition/guarantee/ security	% of loan/acquisition /exposure on guarantee/security provided to the paid up capital, free reserves and securities premium account and % of free reserves and securities premium	Date of passing Board resolution	Date of passing special resolution, if required	For loans	
				Rate of interest	Date of maturity
(6)	(7)	(8)	(9)	(10)	(11)
For acquisitions					

Number and kind of securities	Nominal value and paid up value	Cost of acquisition (in case of securities how the purchased price was arrived at)	Date of selling of investment	Selling price(how the price was arrived at)	Signatures and Remarks
(12)	(13)	(14)	(15)	(16)	(17)

Signature:

MD/Director/Secretary/Whole time Director

Place:

Date:

Annexure III**Form CRL-1****Return regarding number of layers**

[see clause (i) of sub-rule (4) of rule 2]

1. (a) Name of the company:
- (b) CIN of the company:
2. Number of layers of subsidiaries as on the date of commencement of these rules
3. Layer wise details of subsidiary companies

S.N.	Name of subsidiary	CIN of subsidiary company	Name of holding company	CIN of holding company	Percentage of shares held by holding company
Layer 1					
1	SL1-1				
2	SL1-2				
3	SL1-3				
Layer 2					
..	SL2-1				
..	SL2-2				
..	SL2-3				
Layer 3..					
..	SL3-1				
..	SL3-2				
..	SL3-3				
Layer 4.					
..	SL4-1				
..	SL4-2				
..	SL4-3				
..					
..Upto last layer				...	...

I (*Name of director of the company signing the Form*) am authorised by the Board of Directors of the company *vide* resolution number .. dated (DD/MM/YYYY) to sign this form and declare that –

- (1) the information of the subsidiaries and the layers as contained in the form is true, correct and complete and no information has been suppressed or concealed.
- (2) I have read the provisions of sections 448 and 449 of Companies Act, 2013 which provide for punishment for false statement and punishment for false evidence respectively.

To be digitally signed by

Director DSC

Director Identification Number of the Director

Date:

Place

Annexure IV**Additional disclosures to be made in the explanatory statement for giving Loans or making Investments or providing Guarantees or Securities as a good Governance measure**

1. The company to provide the strategic rationale and not an economic rationale to support its subsidiaries/joint venture.
2. Management's rationale for entering into the said transaction.
3. Details on whether the loans provided will be to the extent of the company's shareholding and if the transactions will be at arm's length pricing.
4. The company to disclose the full terms of transactions including interest and the repayment period.
5. Disclosures on the recipient parties and the nature of their association with the company.
6. Quantum of proposed transaction *vis-à-vis* current financial health of the Company such as Debt-Equity ratio, current ratio and cash flow, fixed assets etc., (to judge whether the Company has the financial capacity to give the loan/guarantee or make investment).
7. Quantum of the outstanding loans/investments/guarantees *vis-à-vis* the size and operations of the Company, prior to and post the proposed loans/guarantees. The financial statements of the recipient Company to be provided.
8. The details of the recipient of the investment/guarantee/security/loan.
9. The specific amount of the proposed transactions.
10. Financial health of the recipient (to judge whether the recipient would be able to repay the amount).
11. How is the Company going to fund the proposed transactions?
12. Is the amount proposed disproportionate to the size of the Company?
13. If the loan is being made to an unlisted company, are other shareholders making a pro-rata contribution to the proposed transaction?
14. Objective and benefits of such transactions.
15. Has the Company written-off any transaction with the entity?
16. Financial health of the Company post-transaction/ impact of transaction on Company's financials such as Debt Equity/interest coverage ratio, profit etc.

17. Whether the Company has defaulted on any of its existing debt obligations?
18. Whether the Company has undergone a debt restructuring in the last 2 years?
19. Disclosure regarding Audit Committee approval for the proposed inter-corporate loans, if required.
20. Whether the entity to which the Company intends to provide loans/ guarantees/ investments is beyond 2 layers of subsidiary (if investment Company)?
21. Whether the approval sought is omnibus in nature?
22. Whether disclosures as required under the Act are made (terms, name(s) of recipient, etc.)?
23. Whether disclosures made regarding particulars as required under section 185 along with the purpose in the Notice?
24. The terms and conditions of the financial assistance (*i.e.*, recipient of such financial assistance and deployment schedule of funds).

Annexure V**Frequently Asked Questions (FAQs)****Q.1: What is the meaning of 'principal business activities' as referred to in the proviso to section 185(3) of the Act?**

Ans: The term, 'principal business activities', is not defined under the Act. Hence, the said expressions would have to be assigned the meaning given to them in common parlance. The term, 'principal business activity', *inter alia* means any business activity which yields the regular and sustainable quantum of revenue to an entity. It also refers to the trade carried on by the entity in substance.

Additionally, it may be noted that section 92 of the Act prescribes the requirement of filing annual return by a company, containing the particulars as they stood on the close of the relevant financial year. One of the particulars, which is required to be reported in annual return is 'principal business activities' of the companies. Accordingly, relevant reporting in the annual return may be taken into consideration while deciding about the company's principal business activities. In addition to this, the main objects mentioned in the Memorandum of Association of the company may be considered as one of the criteria to determine principal business activities.

Furthermore, with reference to term, 'principal business activity', the Hon'ble High Court of Calcutta in the matter of '*Shankar Sales Promotion Private Limited v. Commissioner of Income Tax, Kolkata-II, WB/1042/2019*', held as under:

"Is the principal business of the assessee to be determined on the basis of the businesses mentioned in its memorandum of association? Whether turnover of the assessee is an indication of its principal business? Suppose an assessee makes substantial capital expenditure in a year for promotion of a particular business which it claims to be its principal business but its turnover in that year is much less than the turnover from other business, could the assessee claim the former business to be its principal business? Suppose the assessee carries on more than one business and the turnover of one business is less than the others but the profit of that business is more because the expenses are less. Would that business become the principal business? In my opinion, all the above factors have to be judiciously analysed and assessed to determine the principal business of a Corporate assessee. There may be other factors also."

Therefore, in view above (including the observations made in above judgment), amongst others, the following broad criteria may be considered for determining the principal business activity of a company:

1. Business mentioned in memorandum of association;
2. Turnover (including regularity and sustainability of such turnover) generated from business;

3. Capital expenditure undertaken for the company's business;
4. Relevant reporting about the 'principal business activities', in the company's annual return and financial statements.

Q.2: Can a company grant loans to its subsidiary company for purposes other than the subsidiary's principal business activities?

Ans: No, the proviso under sub-section (3) of section 185 of the Act provides that loans made under clauses (c) and (d) of sub-section (3) of section 185 of the Act shall be utilised by the subsidiary company for its principal business activities.

Q.3: Whether giving of loan by a company to the director of its subsidiary is prohibited under section 185(1)(a) of the Act?

Ans: Section 185(1)(a) of the Act does not prohibit giving of loans by a company to the director of its subsidiary.

Q.4: Whether giving of advance is also covered under section 185 of the Act?

Ans: Giving of advance in a nature of loan is covered under section 185 of the Act.

The Madras High Court in *KM Mohammad Abdul Kadir Routhar v. S Muthich Chettiyar* (2 MAD LJ 13) has held that an advance literally means a payment which has been received beforehand. Hence an advance is not to be considered always as a loan.

Q.5: Can the company have more than two layers of subsidiaries in case they are not investment companies?

Ans: The company can have more than two layers of subsidiaries subject to rule 2(2) of the Companies (Restriction on Number of Layers) Rules, 2017.

Q.6: ABC Pvt. Ltd. gives loan of Rs. 25 lakhs to Mr. X a renowned person in the same industry on 8th December, 2022, subsequently on 11th December, 2022 Mr. X become the Director of ABC Pvt. Ltd. Whether there is any violation of section 185 of the Act?

Ans: The applicability of section 185 of the Act is to be seen at the time of entering into the transaction. In the instant case as the loan has been given on a date before Mr. X became a Director it will not attract the provisions of section 185 of the Act.

Q.7: What is and is not included in free reserves?

Ans: The term free reserve shall carry the meaning given to it under section 2(43) of the Act as amended. Hence, it will essentially cover reserves as per the latest audited balance sheet of the company which are available for distribution as dividend.

It follows therefore that any specific reserve created for specific purposes and which cannot be used for distribution of dividend shall not be included in free reserves.

Further, there is always a pertinent question that whether surplus in the profit and loss account is a free reserve or not. Though surplus in the profit and loss account is not described as a free reserve in the Act, since it is available for the purpose of distribution of dividend, it may be considered as a free reserve for the purpose of limits of section 186 also.

Q.8: Is LLP included in the ambit of section 185 of the Act?

Ans: The term firm under the Act has not been defined specifically for the purposes of section 185 of the Act. However, under the Explanation under sub-section (4) of section 139 of the Act it has been clarified that for the purposes of chapter X of the Act, the word firm shall include a limited liability partnership incorporated under LLP Act, 2008. Further, under rule 2(1)(e) of Limited Liability Partnership (Significant Beneficial Owners) Rules, 2023 a partnership entity means partnership firm registered under the partnership Act 1932 or a limited liability partnership under the LLP Act 2008. Further under sec 2(1)(d) of the LLP Act 2008, an LLP has been considered as a Body Corporate. A body corporate again is defined under section 2(11) of the Act.

Therefore, the conclusion as to whether the LLP is a body corporate or not for the purposes of section 185 of the Act has to be decided in the light of the above. No judicial view in the context of section 185 of the Act which is conclusive is available on the above.

Section 185(1) prohibits giving loan to a firm where its director is a partner. As far as the word 'firm' is concerned, it is not defined in the Act. But, as per ¹explanation appended to section 139, the word firm shall include LLP for the purpose of the said section. Further Rule 2(1)(e) of SBO Rules defines partnership entity. It refers LLP as partnership entity for the purpose of said rules. Definition of firm under Income Tax Act, 1961 also states that firms include LLP. Meaning of Firm under Partnership Act, 1932 refers partnership firm only. Therefore, some of the provisions of the Act defines LLP as firm for the purpose of that relevant sections/rules.

LLP is a body corporate by Section 3(1) of LLP Act, 2008. The term body corporate is defined in Companies Act, 2013 and it will cover LLP. What is a corporation is answered by Supreme court in the case of *Daman Singh and Ors. v. State of Punjab and Ors.* AIR 1985 SC 973. Considering the same LLP may get covered under definition of body corporate under the act.

Section 185(2) states that, a company may give loan/guarantee/Security or loan represented by book debt to certain persons, subject to prescribed conditions. It lists two conditions along with an explanation. Explanation covers two types of body corporate.

1. Explanation. – For the purposes of this Chapter, the word “firm” shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008.

- (1) Body corporate whose Board, Managing Director or manager is accustomed to act as per the instruction of the Board of Directors or Director of lending company; or
- (2) Body corporate at general meeting of which 25% voting power is controlled or exercised by the director or directors of lending company.

The first conditions required to have Board of directors and designated partners are not equivalent to Board and the second condition requires voting power in general meeting. LLP does not have Board of Directors and also does not have concept of general meeting.

No judicial pronouncement is available whether LLP can be covered under Firm for the purpose of Section 185(1) or under body corporate for the purpose of Section 185(2). Therefore, it will depend upon the intention or context of provision. The above mentioned factors need to be considered to decide the same.

Q.9: What is the meaning of the word 'Person' used in section 186 of the Act?

Ans: The term person is not defined under the Act except that explanation contained under sub-section (2) of section 186 of the Act introduced w.e.f. 7th May, 2018 stipulates that the word person does not include any individual who is in the employment of the company. From the above it can be inferred that the term person shall include any individual who is not in the employment of the company.

It is important to note that under section 3(42) of the General Clauses Act 1897, the term person includes any company or association or body of individuals whether incorporated or not. It is important to note that the Supreme Court in its decision in *Dulichand v. CIT* (AIR 1956 SC 354) has cautioned that in any particular statute the meaning of the word "person" may get controlled by the context.

Q.10: Whether investment in mutual funds is covered under section 186 of the Act?

Ans: Section 186 of the Act inter alia seeks to impose a restriction on the quantum of investments that can be made by a company in the securities issued by any other body corporate. Mutual Funds are a creation under the Indian Trust Act, 1881. Since Trusts are not body corporates, investments made by a company into Mutual funds are not covered under section 186 of the Act. However, investment in mutual funds requires the approval of the Board under the provisions of section 179 of the Act.

Q.11: Suppose if the loan, investment, guarantee, and security limit for the purpose of section 186 (2) of the Act has come to Rs. 100 lakhs. Out of this limit company since incorporation has utilised Rs. 60 lakhs. Now the unutilised limit has come down to Rs. 40 lakhs. In next 5-6 months it is expected that loan already made would be repaid. So now the question is whether this limit

be renewed to the original Rs 100 lakhs post repayment of loan or will it stay to Rs 40 lakhs?

Ans: It depends upon how the resolution is passed. In case the resolution permits a revolving limit *i.e.*, limit outstanding at any point of time, then the limit outstanding as on the given date is applicable. If the loan provided to the extent of Rs.40 lacs is repaid as on the date of the audited balance sheet of the lender company pertaining to the immediately preceding financial year, the overall limit under section 186(2) of the Act shall be restored to Rs.100 lacs on the date on which the repayment of Rs. 40 lacs is made. However, if the resolution is passed approving a limit up to a particular sum then the loans repaid cannot be added back to the limit approved.

Q.12: If ABC Ltd. is incorporating XYZ Ltd. as a wholly owned subsidiary (WOS). ABC Ltd. would become member of XYZ Ltd. only when it subscribes to the memorandum of XYZ Ltd. So, can one consider that XYZ Ltd, was WOS of ABC Ltd. even before ABC Ltd. investing funds in XYZ Ltd. So, will that investment get exemption from compliance with section 186(3) of the Act on account it being a wholly owned subsidiary company?

Ans: As per section 186 of the Act where a company *inter alia* makes investment in the securities issued by a wholly owned subsidiary (WOS), company is exempted under sub-section (3) of section 186 of the Act from taking the approval of the shareholders by special resolution. The exemption from sub-section (3) of section 186 of the Act is available only where the investee company is a wholly owned subsidiary.

The essence of section 186 is to exclude the investment in WOS. Though the company is not a WOS until subscribed to the MOA, the Board's intent is clear while passing a resolution to incorporate a WOS. Accordingly, even incorporating a company and investing 100% in it shall be excluded compliance under Section 186(3). Moreover, in case of incorporation of a company once a subscriber subscribes to the Memorandum, on incorporation the subscriber becomes a member. Though subscription money is to be paid no separate allotment of the shares subscribed is required.

Q.13: Can a company give loan to its employee who is a relative of company's MD?

Ans: Section 185(1)(a) of the Act imposes a prohibition on any loan given to a director or to a company which is the holding company of the company or to any partner or relative of such director.

Section 185(3) of the Act exempts any loan given to the Managing Director or whole-time director either as a part of the conditions of service extended by the company to all its employees or pursuant to any scheme approved by the members by special resolution.

The intention of this exemption is that if any loan is provided to all the employees equally with similar terms and conditions, then such loan given to the MD as an employee of the company shall be exempted as well. The restriction is mainly to avoid any special preference to the Director or their relatives. If MD is eligible to obtain such loan as an “employee” of the company, then ideally his relative who is an “employee” shall also be exempted provided the loan is given as a part of the conditions of service extended by the company to all its employees or pursuant to any scheme approved by the members by special resolution. In case the relative is not an employee of the company, then in such case the company cannot give loan to such relative.

Q.14: If company wants to pass Board resolution under section 186(5) of the Act, which has the wordings that the ‘resolution shall be passed by all the directors present at the meeting’, and one of such directors is interested in the resolution. What should be the recourse available in such a situation?

Ans: Section 186(5) of the Act contemplates that no investment shall be made 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.

Considering the above as one of the directors is deemed to be interested in the resolution proposed by the company above, he shall be considered as an interested director and shall not participate in the subject item of the business. Therefore, the approval has to be accorded by all the directors present at the meeting other than the interested directors.

Q.15: What is meant by the term ‘default’ for the purpose of proviso to section 186(5) of the Act?

Ans: The term ‘default’ has not been defined under the Act. Hence, in the context in which the above term is used in section 186(5) of the Act the term ‘default’ may be considered as an act of non-payment of the obligation towards the loan. The term default can also mean the failure to fulfil a contract, agreement or duty such as the failure to meet a financial obligation.

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.