

LOAN TO DIRECTORS - A DIFFERENT ANGLE

BY: PRADEEP KUMAR MITTAL

E-mail : pkmittal171@gmail.com

(i) In this Article an attempt has been made by the author to explain the scope and applicability of Section 185 of Companies Act, 2013 read with Companies (Meetings of Board and its Powers) Rules, 2014. For the proper understanding of the spirit behind section 185, it is pertinent to refer to their bare text along with detailed analysis of each provision.

(ii) The Article elaborates step by step each provision of section 185 read with Companies (Meeting of Board and its Power) rules, 2014 supported by judicial precedents.

SECTION 185: LOAN TO DIRECTORS

RESTRICTION ON PROVIDING LOAN ETC.

(1) 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 a 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.

Analysis of 185(1):

- ✓ The ambit of the section is very wide and it applicable on every company, both private and public companies, it covers all types of companies. The word Company has been defined under

section 2(20) of Companies Act, 2013 as “a company incorporated under this act or under any previous Companies Act”. However, it is pertinent to mention that body corporate are not covered under the section thereby meaning that foreign companies may grant loan or provide security and guarantee to its Directors without attracting any penal consequences of section 185.

Lets understand this with more clarity with the help of following illustration:

- ✓ ABC is a body corporate incorporated under the laws of America and having its branch office in India , ABC wants to grant loan of rupees 20 crores to its Indian director.

Under the present case ABC can grant loan to the proposed Indian director since it is not a company falling within the definition of section 2(20) of Companies Act, 2013(Assumption: ABC is not falling under section 379 of Companies Act,2013)

NOTE: Section 379 provides for the circumstances under which a Foreign Company is deemed to be a company incorporated in India.

- ✓ Further, it is imperative to mention that this section applies only at the time of granting loan and any change in the circumstances thereafter will not make the section applicable. Thus, section 185 will not be attracted in respect of loan given to employee, who does not fall within the ambit of specified persons , but who subsequently becomes director, because at the time of loan , no contravention was invoked.

➤ MEANING OF LOAN:

In view of the importance and significance of this topic, it is absolutely necessary to understand the precise and concise meaning of word “loan” – in view of the serious implications in the event of violation of the provisions of the Act. The Section 2 of Companies Act, 2013, does not define “loan”. Therefore the same has been interpreted in light of judicial pronouncements and dictionary meaning

- ✓ In “**Pennwalt India Ltd. v. RoC**” MANU/MH/0006/1987, the Hon’ble High Court of Bombay has held that to ascertain whether a transaction is a loan or not, **surrounding circumstances, relationship and character of the transaction and the manner in which parties treated the transactions** will have to be considered. Therefore, with reference to each transaction with Directors and other person in whom the Directors are interested, the nature of transactions has to be studied, in case they relates to book debts.

- ✓ In “**Fredie Ardeshir Mehta v. U.O.I.**” MANU/MH/0090/1991, *the Bombay High Court held* that loan by its very nature means advancement of money which is returnable after some time with or without interest.

- ✓ The Calcutta High Court in the case of **Saradindu Sekhar Banerjee Vs. Lalit Mohan** MANU/WB/0045/1941, AIR 1941 Cal. 538 Every loan is a debt but every debt is not a loan.

➤ MEANING OF INDIRECT LOAN

The law maker has used the word directly or indirectly, it is imperative to understand the meaning and scope indirect loan. In the absence of

definition of indirect loan in Companies Act and in General Clause Act, the same has been interpreted in light of dictionary meaning and judicial pronouncements.

Indirect loan can refer to any loan in which the lender does not have a direct relationship with the borrower. Indirect loans can be obtained through a third party with the help of an intermediary (Black's Law Dictionary)

In Dr. Freddie Ardeshir Mehta V. Union of India [1991] 70 Comp. Cas. 210 (Bom.), the term Indirect used in the Section Sec.185(section 295 of Companies Act, 1956) is interpreted as “When Section 185 refers to indirect loan to director, what it means is that the company shall not give a loan to a director through the agency of one or more intermediaries.” **The word “indirectly” used in Sec. 185 cannot be read as converting what is not a loan into a loan.** Therefore, the company shall not lend through intermediary to the persons who are otherwise related with the lending company.

Thus, loan from the funds of company to directors though not given directly by the company but given by some person on behalf of the company is also not permitted. Lets say ABC Ltd granted loan of Rupees 10 crores to its promoter ‘P’ and thereafter ‘P’ granted loan of Rupees 10 crores to ‘D’ director of ABC on same day, this loan is given by ABC Ltd to its Director ‘D’ through an intermediary which is promoter ‘P’ is also prohibited by virtue of section 185(1)

➤ MEANING OF ADVANCE

The Hon'ble Madras High Court in the case of **KM. Mohammed Abdul Kadir Rowther Vs. S. Muthia Chettiar** MANU/TN/0424/1959 held that **advance** means literally a

payment beforehand. In certain cases, it may be a loan but it cannot be said that a sum paid by way of advance is necessarily a loan.

The Hon'ble Privy Council in the case of Raja of **Venkatagiri vs. Krishnaya Rao Bahadur** MANU/PR/0017/1948 : AIR 1948 PC 150 at p. 155, has observed that ordinarily advance does not connote any idea of repayment, hence loan is completely different from an advance as is understood in the common parlance in the sense of payment of money beforehand and which is likely to become due at some future time.

In London Financial Association v. Kelk L.R. (1884) 26 Ch. D. 107, it was observed, that the words-‘advancing’ and ‘lending’ each have a different significance, the **money might be ‘advanced’ without being ‘lent’**.

Thus, it can be safely said that every advance prima facie is not a loan.

➤ PERSONS DEBARRED FROM TAKING LOAN, SECURITY AND GUARANTEE

A Company to its directors (whether whole time or part time) or to his/her partner or relative

A subsidiary company to the directors of its holding company or to his/her partner or relative

Any firm in which **such** director or relative is a partner.

NOTE: The Term “Such” would mean in reference to the director of the lending company and/ or in relation to the director of its holding company.

The term relative has been defined under Section 2(76) relative”, with reference to any person, means any one who is related to another, if—

- (i) they are members of a Hindu Undivided Family;
- (ii) they are husband and wife; or
- (iii) one person is related to the other in such manner as may be prescribed;

Rule 4 of Companies(Specifications and definition details)Rules, 2014 provides that a person shall deemed to be relative of another, if he or she is related to another in the following manner, namely:-

- (1)Father including step-father.
- (2)Mother including step-mother.
- (3)Son including the step-son
- (4)Son’s wife:
- (5)Daughter:
- (6) Daughter’s husband:
- (7)Brother including the step-brother;
- (8)Sister including step-sister.

PERMISSIBLE LOAN

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

- (a) a special resolution is passed by the company in general meeting: provided that the explanatory statement to the notice for the relevant general meeting shall disclose the full particulars of the loan given, or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to

be utilized by the recipient of the loan or guarantee or security and any other relevant fact; and

(b) the loans are utilized by the borrowing company for its principal business activities.

Explanation.—For the purposes of this sub-section, the expression “any other person in whom director 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.

ANALYSIS OF 185(2)

- Unlike sub-section (1), sub-section(2) permits the company to advance loan and to provide security and guarantee to the persons in whom directors is interested subject to passing of:
 - (i) special resolution, and
 - (ii) utilization of loan by the borrowing company in its principal business activities.

- The meaning of person in whom director is interested has been defined under the explanation to sub-section (2) where in the borrower must be either a private company or a body corporate. However if the same is LLP (Limited Liability Partnership) the

provisions of sub-section (2) shall not apply, In other words if such director is a partner or director of LLP then there is no need to pass special resolution and utilize loan by the borrower in its principal business activities but however LLP being a person falls under the ambit of section 186(2) and hence compliance of section 186(2) is mandatory.

- This sub-section is relaxed comparative to the provision prior to Companies (amendment) Act, 2017 where in there was absolute prohibition for giving loan or providing security or guarantee to the persons in whom director is interested.

CERTAIN LOANS EXEMPTED UNDER SECTION 185(3)

(3) Nothing contained in this sub-section (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 loan;

(c) any loan made by 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 to its by a bank or financial institution to its subsidiary company:

Provided that the loan made under clause (c) and (d) are utilized by the subsidiary company for its principal business activities.

ANALYSIS OF 185(3)

- Sub-section (3) provides exemption from the provisions of sub-section (1) and (2).
- It is pertinent to mention that the exemption is given only to managing and whole time directors, thereby meaning that loan to part-time directors is absolutely prohibited. However loan to part-time directors is permissible under section 186(2) upto the limits mentioned therein without approval of members in general meeting.
- Further the exemption is given only if company provides LOAN to its directors, in other words providing guarantee or security is not permitted. Further the exemption is only available when loan is given by company to its directors thereby meaning that loan by subsidiary company to the directors of holding company is not exempted.
- Further the loan must be given as a part of condition of service eg: housing loan, education loan, marriage loan etc. if the loan is not covered under terms of employment then company may pass board resolution , amend the service condition accordingly.
- It is imperative to discuss the term 'ordinary course of business' since the same has not been defined under Companies Act, 2013 reliance is placed on judicial pronouncements and dictionary meaning.

- ✓ In law, the ordinary course of business covers the usual transactions, customs and practices of a certain business and of a certain firm (dictionary meaning).
- ✓ The Division Bench of Allahabad High court in the case of **Kishori Lal Vs. CIT MANU/UP/0904/2014**, while dealing with the issue of giving loan as permitted as a part of Ancillary Object and not as a Main Objects, has held under.

In holding that the advance was not **in the ordinary course of business**, the sole consideration which weighed with the Tribunal was that the main object of the two companies was not to engage in money-lending business, though the ancillary object was to invest and deal with the funds of the company not immediately required

- It is to point out that there is exemption from loan, security and guarantee to wholly owned subsidiary but in case of subsidiary which is not wholly owned, exemption is only for security and guarantee and not for loan, thereby meaning that if holding company wants to grant loan to directors of subsidiary it can not do so because of prohibition under sub-section (1)
- Further the loan given to its subsidiary company must be given by bank or financial institution. Section 2(39) defines "financial institution" includes a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934 (2 of 1934) whereas schedule bank means banks mentioned in Schedule II of RBI Act, 1934. And whereas “financial institution” means any non-banking institution which carries on as its business or part of its business in any of the following activities, namely:–
 - (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own

(ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature

(iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972:

(iv) the carrying on of any class of insurance business;

(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;

(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are 1 Subs. by Act 51 of 1974, s.17, for cl. (c) 64 collected or to any other person, 1[but does not include any institution, which carries on as its principal business,—

(a) agricultural operations; or (aa) industrial activity; or]

(b) the purchase or sale of any goods (other than securities) or the providing of any services; or

(c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;]

Explanation.— For the purposes of this clause, “industrial activity” means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964;

CONCLUSION: To sum up, after Companies (Amendment) Act, 2017 the rigors which were hitherto, have been loosened and is now more in tune with the concept “Ease of doing Business”.