

LOAN TO DIRECTORS UNDER SECTION 185 AND LOAN AND INVESTMENT BY COMPANIES UNDER SECTION 186 OF COMPANIES ACT, 2013: DETAILED ANALYSIS

(i) In this Article an attempt has been made by the author to explain the scope and applicability of Section 186 of Companies Act, 2013 read with Companies (Meetings of Board and its Powers) rules, 2014. For the proper understanding of the spirit behind section 186, 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 186 read with Companies (Meeting of Board and its Power) rules, 2014 supported by judicial precedents.

SECTION 186: LOAN AND INVESTMENT BY COMPANY

RESTRICTION ON MAKING INVESTMENT THROUGH MORE THAN TWO LAYERS

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

Provided that the provisions of this sub-section 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.

Explanation: The person does not include any individual who is in employment of the company.

ANALYSIS ON 186(1):

- Section 186 starts with the words 'Without prejudice to the provisions contained in this Act' these words implies that sub-

section (1) of Section 186 is subordinate to other provisions of Companies Act i.e in case of inconsistency between Section 186(1) and any other provision of companies act, the other provision of the act shall override the provisions of sub-section(1) of Section 186.

- This sub-section prohibits any company from making investment through more than two layers of investment companies.

Let's try to explain this with the help of an illustration:

ABC Ltd. invested Rupees 25 lakhs in PQR Ltd. (1st Layer) and PQR Ltd further invested the said amount in XYZ Ltd.(2nd Layer). now XYZ Ltd. cannot further invest the said amount because if it does so the investment will go beyond two layers which is not permitted under Section 186(1).

- The proviso to the said sub-section provides for two situations under which, the provision of 186(1) shall not be attracted, the said situations are reproduced hereunder for ready reference:

(a) Acquisition by a company of any company incorporated outside india which is having investment layers beyond two as per the laws of that country.

(b) 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.

A subsidiary company has been defined under section 2(87) which is for your perusal is reproduced below:

“subsidiary company” or “subsidiary”, in relation to any other company,

means a company in which the holding company—

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital

either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation.—For the purposes of this clause,—

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-

clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

(b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(c) the expression "company" includes any body corporate;

(d) "layer" in relation to a holding company means its subsidiary or subsidiaries;

- The MCA vide Notification No. GSR 8(E) and 9(E), dated 4th January, 2017 has exempted applicability of section 186(1) to specified IFSC Public and Private Companies.

RESTRICTION ON PROVIDING LOANS TO OTHER BODY CORPORATES AND PERSONS : Section 186(2)

(2) 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 per cent. of its paid-up share capital, free reserves and securities premium account or one hundred per cent. of its free reserves and securities premium account, whichever is more.

ANALYSIS OF 186(2)

Sub-section (2) prohibits any company as defined under section 2(20) (again it is imperative to mention that only companies has been prohibited not body corporates) from granting loan or providing security and guarantee to the following:

- person and
- body corporate.

The term person finds no place in Companies Act, 2013 and therefore the same is defined in context of General Clauses Act, 1897. Section 3(42) of the said act defines "person" as under:

“Person” shall include any company or association or body of individuals, whether incorporated or not;

Whereas body corporate has been defined under Section 2(11) of Companies Act, 2013 as under:

“body corporate” or “corporation” includes a company incorporated outside India, but does not include-

- (i) a co-operative society registered under any law relating to co-operative societies; and
- (ii) any other body corporate (not being a company as defined in this Act) which the Central Government may by notification specify in this behalf;

➤ on careful analysis of the Section it can be inferred that the scope of Section 186(2) covers only transactions where the lender must be a company and the borrower may either be a company, body corporate or any other person. In other words, if a body corporate let's say a foreign company provides loan to another body corporate, such body corporate can easily escape from the compliance of Section 186(2).

➤ MEANING OF FREE RESERVES

Free Reserves means reserves which are free for distribution as dividend and shall include balance to credit of securities premium account but shall not include share application money.

➤ The MCA vide Notification No. GSR 8(E) and 9(E), dated 4th January, 2017 has exempted applicability of section 186(1) to specified IFSC Public and Private Companies, if such company passes resolution to this effect either at the meeting of Board of Directors or by circulation.

SPECIAL RESOLUTION IN EVENT OF BEYOND LIMIT

(3) Where the giving of any loan or guarantee or providing any security or the acquisition under sub-section (2) exceeds the limits specified in that sub-section, prior approval by means of a special resolution passed at a general meeting shall be necessary.

NOTE: Section 186(3) provides that a company proposing to go beyond the limit specified under section 186(2) shall pass a special resolution at a general meeting prior to effecting such transaction.

The MCA vide Notification No. GSR 8(E) and 9(E), dated 4th January, 2017 has exempted applicability of section 186(1) to specified IFSC Public and Private Companies, if such company passes resolution either at the meeting of Board of Directors or by circulation.

DISCLOSURE IN FINANCIAL STATEMENT

(4) 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 utilized by the recipient of the loan or guarantee or security.

UNANIMOUS BOARD RESOLUTION AND PFI APPROVAL

(5) 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:

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

ANALYSIS of 186(5)

This provision states that every company proposing to provide a loan, security or guarantee shall prior to effecting such transaction pass a unanimous board resolution and shall also obtain approval of PFI (public financial institution) if any term loan is subsisting as on the date.

NOTE: The said resolution is to be passed only in case of loan, security and guarantee and not in case of acquisitions.

Further, it is pertinent to highlight that the board resolution must be passed at the duly convened Board meeting and not by circulation. However,

MCA vide Notification No. GSR 8(E) and 9(E), dated 4th January, 2017 has provided that in case of specified IFSC public and private Companies, the board can exercise powers under Section 186 by means of resolution passed at the meeting of Board of Directors or through resolutions passed by circulation.

MEANING OF Public Financial Institutions (PFI)

According to section 2(72) of Companies Act, 2013 public financial institution” means—

- (i) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956;
- (ii) the Infrastructure Development Finance Company Limited, referred to in clause (vi) of sub-section (1) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;
- (iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002;
- (iv) institutions notified by the Central Government under sub-section (2) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;
- (v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

Provided that no institution shall be so notified unless—

(A) it has been established or constituted by or under any Central or State Act; or

(B) not less than fifty-one per cent. of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments;

- The MCA vide Notification No. GSR 8(E) and 9(E), dated 4th January, 2017 has provided that in case of specified IFSC public and private company, the board can exercise the powers under 186

by means of resolution passed at the meetings of the Board of Directors or through resolution passed by circulation.

SPECIAL PROVISION OF CERTAIN COMPANIES

(6) No company, which is registered under section 12 of the Securities and Exchange Board of India (SEBI) 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.

ANALYSIS:

This provision absolutely prohibits certain class of companies from granting loan or providing security or guarantee exceeding the prescribed limit. In other words, such companies cannot grant loan or provide security or guarantee exceeding the limits even by passing special resolution, Whereas, section 12 of SEBI Act, 1992 deals with Registration of stock brokers, sub-brokers, share transfer agents, etc.

MINIMUM INTEREST RATE

(7) 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.

Provided that nothing contained in this sub-section shall apply to company in which 26% or more of paid-up share capital is held by Central Government or one or more State Government or both, in respect of loan provided by such company for funding Industrial Research and Development projects in furtherance of its objects, as stated in its memorandum of association. (Inserted by the MCA vide Notification No. 584(E), dated 13th June, 2017)

RESTRICTION ON DEFAULTING COMPANIES

(8) No company which is in default in the repayment of any deposits accepted before or after the commencement of this Act 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.

REGISTER TO BE KEPT

(9) 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.

(The prescribed form is MBP-2, which shall be preserved permanently)

INSPECTION OF REGISTER AND FEES THEREOF

(10) The register referred to in sub-section (9) shall be kept at the registered office of the company and —

(a) shall be open to inspection at such office; and

(b) extracts may be taken there from by any member, and copies thereof may

be furnished to any member of the company on payment of such fees as may be prescribed.

EXEMPTION TO CERTAIN COMPANIES

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

(a) to a loan made, guarantee given or 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 providing infrastructural facilities;

(b) to any investment—

(i) made by investment company;

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

(iii) made in respect of investment and 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.

ANALYSIS:

- This sub-section provides exemptions from whole of section 186 except from sub-section (1) to certain categories of companies in respect of certain transactions.
- MEANING OF BUSINESS OF FINANCING COMPANIES
Rule 11 (2) of Companies (Meeting of Board and its Powers) Rules, 2016 provides that for the purpose of Section 186(11)(a), the expression business of financing of companies shall include, with regard to a NBFC registered with RBI, “business of giving any loan to a person or providing any guarantee or security for due repayment of any loan availed by any person in ordinary course of its business”.
- Companies engaged in business of financing of companies or of providing infrastructural facilities has also been exempt from transactions of loan, security and guarantee, whether it is their ordinary course of business or not.
- MEANING OF INVESTMENT COMPANIES
“Investment company” means a company whose principal business is the acquisition of shares, debentures or other securities; the expression “infrastructure facilities” means the facilities specified in Schedule VI.

MEANING OF SECURITIES

The expression “securities” has been defined by section 2(81) of Companies Act, 2013 as to mean the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.

Whereas, as per Section 2(h) of SCRA “Securities” include:

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

(ia) derivative;

(ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;

(ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

(id) units or any other such instrument issued to the investors under any mutual fund scheme

(ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;

(ii) Government securities;

(iia) such other instruments as may be declared by the Central Government to be securities; and

(iii) rights or interest in securities

MEANING OF FINANCIAL ACTIVITY AS PRINCIPAL BUSINESS

Financial activity as principal business is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of gross income.

MEANING OF NON-BANKING FINANCIAL COMPANY

As per section 45(I)(f) of Reserve Bank of India Act, 1934 “non-banking financial company” means–

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

Whereas, as per Section 45(I)(e) “non-banking institution” means a company, corporation or cooperative society.

And whereas as per section 45(I)(c) “financial institution” means any non-banking institution which carries on as its business or part of its business 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 collected or to any other person,

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;

Let’s peep into section 185 and 186 with help of few tricky yet interesting questions:

Q. Whether a public company can grant loan to its promoter being individual? If yes what compliance shall be made?

A. Yes, a public company can grant loan to its promoter being individual however, in that case, company has to be conscious of the limits of Section 186(2) .since promoter is a person and thereby falls within the ambit of section 186(2). The public company shall in such case pass a unanimous board resolution if the loan amount is within the limits defined under 186(2) and in other case company shall pass special resolution.

Q. whether a company can grant loan to its promoter being a corporate which holds 49% in the lender company?

A. Yes, a company can grant loan to its promoter being corporate, however, in that case company has to be conscious of the limits of section 186(2) .since promoter being a corporate person falls within the

ambit of body corporate and thereby falls within the ambit of Section 186(2).

Q. A company cannot grant loan to its part-time directors under Section 185 as exemption is only given to whole time directors. So whether the loan to part-time directors can be granted under Section 186(2) ?

A. On the harmonious interpretation of Section 185 and 186(2) it can be safely said that, a company cannot grant loan to its part-time directors since loan to directors is specifically covered under Section 185, thereby meaning that loan to directors is not covered under Section 186. Thereby meaning that loan to part-time directors is strictly prohibited.

Q. Whether a foreign company can grant loan to its part-time directors?

A. Yes, a foreign company can grant loan to its part-time directors since section 185(1) prohibits only companies from granting loan not body corporate, a foreign company being a body corporate falls out of the preview of section 185(1).