



Members' Section

SECTION 185 of the Companies Act, 2013 – An Analysis

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At the outset, it is pertinent to note that out of the total 98 sections made applicable by the Ministry of Corporate Affairs from the 12th day of September 2013, section 185 is also one of it and since that day, the provisions relating to Loans to Directors etc. has been drawing a huge concern from the corporate sector because prima-facie it emits a sense of challenge to not only loans but also guarantees and securities within group companies. More so, even the private limited companies and subsidiary companies are no more in the exemption list which it seems has added to the already existing ordeal of transiting from the old law to the new regime.

In this write-up, section 185 of the Companies Act, 2013 has been delved upon and to make it comprehensive, the circular dated 14.02.2014 by the Ministry of Corporate Affairs, issued in the nature of clarification and some exemption has been incorporated.

Let us break the section into parts to understand it better:

185(1): Save as otherwise provided in this Act, no company shall:

- ✓ directly or indirectly
- ✓ advance any loan (including any loan represented by a book debt)

To:

- a. any of its directors or
- b. to any other person in whom the director is interested or
- c. give any guarantee or
- d. provide any security in connection with any loan taken by him or such other person

Inputs: The words 'save as otherwise provided in this Act' is to be noticed. To elucidate, this would mean that if anywhere else, i.e. if any other section of the Companies Act, 2013 (and not that of Companies Act, 1956) allows giving of loans etc. to the persons covered in section 185 then that will be permitted. For the information of the readers, there are no such sections that permits the same in the Companies Act, 2013

The phrase 'including any loan represented by a book debt' is a very smart move by the law makers to ensure that the directors and/or any other person in whom the director is interested do not circumvent the law by juggling with the words. To elaborate this with an **example**: Say a Company manufactures air-conditioners. One of the director of the Company is setting up an hotel for which he will also need to buy air-conditioners. The director in the erstwhile situation (when section 185 was not applicable) could have taken a loan from the Company for buying the same. But in the present situation, since he is not able to take that loan, he asks the Company to give him 100 air-conditioners for a long credit period. If the credit period extended by the Company is as per the normal period and in the normal terms and conditions, as extended to its other buyers, then there is no problem but as soon as it is biased and tilted to give undue benefit to the director and/or other person in whom the director is interested, then such transaction will be considered to be loan.

In the proviso to this sub-section, 2 exceptions have been provided:

The first one is:

(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;

Inputs: The exception is extended to a particular class of directors, i.e. to the managing or whole-time directors only. And to be able to enjoy the exception, it further mentions that it should be part of the conditions of service extended by the Company to all its employees or it is as per scheme approved by the members by a special resolution. To elaborate this with a small **example**, the Companies pass a resolution under section 269 of the Companies Act, 1956 for appointment of Managing Director and it approves the terms and conditions of its appointment and if as a part of its terms, there is a loan which can be given to that director, then it falls under the exception given in section 185 of the Act.

The second one is:

(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 loan an interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India

Inputs: The second exception mentions that if a company in its ordinary course of business gives loans or provides guarantees or securities for due repayment of any loan and if that loan is provided at a rate of interest that is not below the bank rate, then that loan will be outside the purview of section 185. Let us understand this with the help of an **example**. There is an NBFC Company which is registered in the category of a loan NBFC. If this Company gives a loan and the rate of interest aspect is taken care of, then the said loan will be falling in the exception clause and hence section 185 will not be applicable.

Will it be applicable for all kinds of NBFC? Clearly not. If suppose this Company in question is a Investment NBFC. Then surely giving of loans for it will not classify in its ordinary course of business. Many a times, a question has been posed that what if the Company includes loans business in its main object clause and hence qualify under the phrase-'ordinary course of business'. This is also not going to help, unless the other special acts e.g. the Nidhi Benefit Companies etc. allows such activities and the Company has all proper registrations for being called so.

Explanation has been provided in the section:

For the purposes of this section, the expression "to any other person in whom director is interested" means—

a) Individual entity:

- i. any director of the lending company; or
- ii. any director of its holding company; or
- iii. any partner of any such director; or
- iv. relative of any such director;

Inputs: The word 'relative' has been defined under the new Act in section 2(77) and has also been notified. According to that definition, members of a HUF, husband and wife or the person as per the prescribed list would be falling under the term, relatives.

It is also important to understand the word, 'such'. 'Such' would mean in reference to the director of the lending company and/ or in relation to the director of its holding company.



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b) Firm:

- i. any firm in which any such director is a partner; or
- ii. any firm in which the relative of any such director is a partner;

Inputs: The firm may be a registered firm under the Indian Partnership Act, 1934 or may be a non-registered one.

c) Company:

- i. any private company of which any such director is a director; or
- ii. any private company of which any such director is a member;

Inputs: This clause is the most challenging clause. If e.g. ABC Private Limited having Mr. R as a Director decides to give loan to XYZ Private Limited also having Mr. R as its Director, then because of hitting point (c)(i) above, it will not be able to give loan to XYZ Private Limited (even if Mr. R is not a promoter director). If XYZ Private Limited is a subsidiary of a Limited Company then the situation will not be the same. In the said case then, the loan can be given.

Let us take another **example:** ABC Private Limited having Mr. R as a Director decides to give loan to XYZ Private Limited in which Mr. R is not a Director but a shareholder, then because of hitting point (c)(ii) above, it will not be able to give loan to XYZ Private Limited (even if Mr. R is holding a single share).

Another situation: ABC Private Limited and XYZ Private Limited do not have a single common director. In ABC Private Limited, Mr. R is a Director and in XYZ Private Limited, the wife of Mr. R is a Director. In such a situation, the loan can be given by ABC Private Limited to XYZ Private Limited. It is neither getting hit by point (c)(i) nor by point (c)(ii). One should not get confused between loan transactions taking place with an individual per-se and between entities. For **example**, one may think in the immediate example given here that section 185 does not permit giving loans to wife of such director. Then how is it that in the said example such loan is permissible. It is true that a company cannot give loan to the wife of such director, because wife falls under the definition of a relative. But in this example, loan is not being given to the wife but to the Company, ABC Private Limited in which the wife is a director.

Another situation: ABC Private Limited and XYZ Private Limited do not have any common directors. ABC Private Limited has Mr. M as a shareholder and even XYZ Private Limited has Mr. M as a shareholder. ABC Private Limited wants to give loan to XYZ Private Limited. Yes, it can.

- d) any body corporate at a general meeting of which not less than 25% of the total voting power may be **exercised** or **controlled** by:
- i. Any such director; or
 - ii. By 2 or more such directors, together; or

Inputs: ABC Limited wants to give loan to XYZ Limited. The loan will not be allowed to be given if the voting power in XYZ Limited is exercised or controlled by a common director between ABC Limited and XYZ Limited and which is not less than 25% of the total voting power. Here it could be one such director or by 2 or more such directors, put together. The definition of 'body corporate' should be understood.

- e) 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:
- i. Board; or of
 - ii. Any director or directors of the lending company

Inputs: 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, in such cases, section 185 will be attracted. Just taking suggestions and views will not tantamount to accustomed to act. The onus to prove this will remain with the party who raises the allegation. This is quite a subjective issue. One should keep in mind that one of the duties of directors is to act with jurisprudence. Just because opinions are sought

and if the action is based on its opinion and stands the tests of justice, then in my opinion it should not be considered as 'accustomed to act'.

Section 185(2)

185(2): If contravention of section 185(1):

- i. The giver and
- ii. The receiver, both are punishable;

The company shall be punishable with:

- a. fine (not less than Rs.5 lakhs but may extend to Rs.25 lakhs)

The director or the other person (receiver) shall be punishable with:

- a. imprisonment which may extend to 6 months; or
- b. with fine (not less than Rs.5 lakhs but may extend to Rs.25 lakhs) or with both

Clarification dated 14.02.2014

General Circular no.03/2014 (produced here-verbatim)

- ✓ This Ministry has received number of representations on the applicability of section 185 of the Companies Act, 2013 with reference to loans made, guarantee given or securities provided under section 372A of the Companies Act, 1956.
- ✓ The issue has been examined with reference to applicability of section 372A of the Companies Act, 1956 vis-à-vis section 185 of the Companies Act, 2013.
- ✓ Section 372A of the Companies Act, 1956 specifically exempts any loans made, any guarantee given or security provided or any investment made by a holding company to its wholly owned subsidiary.
- ✓ Whereas, section 185 of the Companies Act, 2013 prohibits guarantee given or any security provided by a holding company in respect of any loan taken by its subsidiary company except in the ordinary course of business.
- ✓ In order to maintain harmony with regard to applicability of section 372A of the Companies Act, 1956 till the same is repealed and section 185 of the Companies Act, 2013 is notified, it is clarified that any guarantee given or security provided by a holding company in respect of loans made by a bank or financial institution to its subsidiary company, exemption as provided in clause (d) of sub-section (8) of section 372A of the Companies Act, 1956 shall be applicable till section 186 of the Companies Act, 2013 is notified.
- ✓ This clarification will, however, be applicable to cases where loans so obtained are exclusively utilised by the subsidiary for its principal business activities.

----- end of circular -----

Inputs

On the clarificatory General Circular no.03/2014

- ✓ It is to be noted that section 372A is not applicable to private limited companies
- ✓ There is no exemption provided to private limited companies
- ✓ The exemption has been provided only to guarantee given or security provided by a holding company (not for loans given by a holding company to its subsidiary company)
- ✓ The exemption with regard to guarantee or security given by a holding company to its subsidiary company is only available in respect of loans made by a bank or financial institution
- ✓ The other condition is that the loans obtained by the subsidiary company are exclusively utilised by the subsidiary company for its principal business activities
- ✓ There is a typo error (it seems) in the second para - should have been section 186 and not 185
- ✓ In my opinion, even earlier to this circular, the prohibition



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was not relevant to holding-sub subsidiary if there were no common directors and other conditions given in section 185 getting satisfied

- ✓ The point on exercise of not less than 25% voting power was also with regard to directors not the company. It is worthwhile to mention here that in case of holding-sub subsidiary the exercise of voting is done by the company and not the directors
- ✓ The circular draws reference to that subsection of section 372A which mentions about wholly owned subsidiary. On a further reading of the circular, there is mention of holding company to its subsidiary company (not wholly owned subsidiary). One has to take a call on this. In my opinion it will be only for wholly owned subsidiary.

Example:

ABC Private Limited is a wholly owned subsidiary of XYZ Private Limited. The principal business activity of ABC Private Limited is manufacturing of cement. ABC Private Limited borrows money from State Bank of India. It seeks corporate guarantee from XYZ Private Limited. Mr. R is a director of ABC Private Limited and also a director of XYZ Private Limited. Prior to the clarification dated 14.02.2014, this would have attracted the provisions of section 185 because of common directorship.

Post the clarification dated 14.02.2014, the corporate guarantee can be extended by XYZ Private Limited to ABC Private Limited provided the loan amount is utilised solely for its principal business activity.

Another example:

There are 4 private limited companies, all of which are giving corporate guarantee to the 1 company. The 4 companies have directors in common. There is this 1 public limited company which is taking the corporate guarantee. There is no common director between the givers and the taker. In this case, the corporate guarantee can be given.

SECTION IS NOT APPLICABLE IF LOANS OR GUARANTEE OR SECURITY ARE GIVEN BEFORE 12th SEPTEMBER 2013

Section 185 is not applicable if loan is given or guarantee or security provide for the loan is taken before 12th September 2013. However if

such loan was for a specific term and it is renewed after 12th September 2013, where the term is expired then section 185 will be applicable. In case of working loans or other loans which are repayable on demand and are subject to renewal, if is renewed after 12th September and company continues its corporate guarantee, section 185 will be applicable.

IF A COMPANY LENDS THROUGH INTERMEDIARY TO THE PERSONS WHO ARE OTHERWISE RELATED WITH THE LENDING COMPANY.

Under sub-section (1) of section 185 a company does not advance a loan directly or indirectly.

Indirect is interpreted in case of Dr. Freddie Ardeshir Mehta v. Union of India [1991] 70 Comp. Cas. 210 (Bom.) as under:

“When section 295 refers to an indirect loan to a 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’ in section 295 cannot be read as converting what is not a loan into a loan.”

For example if a company (A) borrow the fund from company (B) and lend the money to Company (C) and loan from (B) to (C) is covered by section 185. In this case section 185 also applicable in case of lending from company (A) to (C) because it also included directly or indirectly.

We have come to an end of this article. There are many more situations based on which analysis could be done. Just to mention, one should not confuse between section 185 and section 186. Section 185 is a directional section and section 186 is a quantum section. Section 186 is yet to be notified and hence for quantum and its procedure section 372A needs to be referred to. Since the quantum section 372A is not applicable to private limited companies, there is no restriction of quantum for private limited companies.

It is also to be noted that section 135, Schedule VII and Corporate Social Responsibility Rules, 2013 has been notified by the Ministry of Corporate Affairs on 27/02/2014 and will be effective from 01.04.2014.

It seems that all the rules, sections and schedules will be notified within March, 2014 and the entire Act will be up and running from the beginning of the new financial year.