

ANALYSIS OF SECTION 185 & 186 OF THE COMPANIES ACT, 2013

by

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ABSTRACT

This Research Paper focuses on the detailed analysis of Section 185 and Section 186 of Companies Act, 2013, which are falls under Chapter XII – Meetings of the Board and its Powers.

Section 185 provides for Loans to Directors, etc. while Section 186 provides for Loan and Investment by Company. The paper discusses the provisions lying within the said sections.

The paper, further, analyses all provisions in detail, and even discusses the amendment brought about in Section 185 and Section 186, by way of the Companies (Amendment) Act, 2017.

Keywords: Analysis, Section 185 & 186, Company

ANALYSIS OF SECTION 185 OF THE COMPANIES ACT, 2013

Section 185, Loans to Directors, etc. deals with some prohibitions, some relaxations and some exemptions relating to lending of loan and providing guarantee and security. It also deals with the penalty for contravention of the provisions of the section. The rationale behind this section, is to prevent:

1. Siphoning off of Public funds lent by Financial Institutions and Banks
2. Public issue proceeds
3. Misuse by transferring funds to private businesses owned by the Director
4. Providing corporate guarantees and securities to financial institutions to secure personal gains for the Director.

The section 185(1) primarily deals with the subject of person to whom company cannot give loan.¹ It states that, no Company shall, directly or indirectly, advance any loan (including book debt) or give any guarantee or provide any security in connection with any loan taken by:

Prohibits providing of loan or guarantee or security to the below mentioned individuals and firms -

- Any Director of the Company or
- Any Relative of such Director or
- Any Partner of such Director or
- Any Director of its Holding Company or
- Any Relative of the Director of its Holding Company or
- Any Partner of the Director of its Holding Company or
- Any Firm in which any of the above mentioned Director is a Partner or
- Any Firm in which Relative of the above mentioned Director is a Partner

Provisions as under Section 185(2), state that a Company can advance any loan (including book debt) or give any guarantee or provide any security in connection with

¹ K.S Prabhakar, *Introduction to section 185*, SSRN ELECTRONIC JOURNAL (Aug 17, 2019) <https://dx.doi.org/10.2139/ssrn.3438691>

any loan taken by any person in whom any of Director of the Company is interested subject to the conditions:

“Any person in whom any of Director of the Company is interested” means following list of persons:

- any private company of which any such director is a director or member
- anybody 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
- anybody 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.

And subject to fulfilment of conditions such as:

- I. Pass Special Resolution in General Meeting and
- II. Loan must be utilised by the borrowing Company for its Principal business activities.

Provisions as under Section 185(3), state the exemptions from complying of sub-section 1 and 2 of Section 185 for following below mentioned individuals and entities, subject to conditions:

- Giving of any loan to a managing or whole-time director; or

Conditions: Service extended by the company to all its employees or pursuant to any scheme approved by way of special resolution.

- Company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan; or

Conditions: Interest charged on such loan at a rate not less than the rate of prevailing yield of 1 year, 3 years, 5 years or 10 years Government security closest to the tenor of the loan.²

² John C. Coates, *CONDITIONS FOR A LOAN*, OXFORD HANDBOOK ON COMPANY LAW, 2013(July, 2014) http://www.law.harvard.edu/programs/olin_center/papers/pdf/Coates_781.pdf

- 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

Conditions: Loan must be utilised by the subsidiary Company for its principal business activities.

- Any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company

Conditions: Loan must be utilised by the subsidiary Company for its principal business activities.

Thus, as per Sec 185 (3), above mentioned individuals and entities are not required to comply with sub-section 1 and 2 of Section 185, if they are fulfilling the conditions mentioned for them.

Provisions under Section 185(4), state the punishment and penal provisions for the contravention of any of the provisions of the Section 185:

- For Company:

Fine: Minimum- 5 Lakhs & Maximum- 25 Lakhs

- For Every officer of the Company who is in default:

Imprisonment for a term which may extend to six months or

Fine: Minimum- 5 Lakhs & Maximum- 25 Lakhs

- For Borrower (Person who has taken loan):

Imprisonment for a term which may extend to six months or

Fine: Minimum- 5 Lakhs & Maximum- 25 Lakhs or Both (Fine & Imprisonment)

Section 185 of Companies (Amendment) Act, 2017

The intent of the rigidity of Section 185 of the 2013 Act was to ensure that directors do not surpass their fiduciary duty towards the company for personal benefit. Keeping that in mind, the 2017 Act still restricts the advancement of loan, *inter alia*, to (a) the director of a company; (b) the director of the holding company; (c) any partner or relative of such director; and (d) any firm in which any such director or relative is a partner.

Section 185 of the 2013 Act, being a restrictive section, had a significant impact on structured lending transactions which were backed by credit support, collateral or guarantee from a parent company or a group company. the provisions of this section created major hurdles for market players for fund raising, intra-group credit support and collateral and in order to address these issues and promote flexible business opportunities, the entire section had been substituted under the 2017 Act.

Therefore, with the amendments introduced by the 2017 Act, the intention of the legislature is clear, that where the shareholders of the company, being the ultimate owners, themselves approve the utilization of the funds of the company, the law need not create a bar on the same. Thus, the provision under the Section 185 of the 2013 Act, has been amended to remove the prohibition to an extent by providing for a way out in the form of a shareholders' resolution for granting of loans/guarantees/securities to entities in which directors are interested or for group companies under common control. While the amended sub-section (2) is an enabling provision for companies to undertake financial exposures towards any 'person' in whom its director is interested, the working of condition (b) under sub-section (2) of Section 185, to which this right is subject to, appears to apply specifically to a borrower which is a 'company' and not any other entity or person that may be a borrower. The resulting construct of the amended section begs a question as to the exact legislative intent behind the condition (b) being applicable to a borrower which is a company or any other entity or person.

Under the amended provisions, the ambit of the penalties³ has been largely widened and as a result, the obligations of every 'officer' of a company has been increased to ensure that all loans, securities and guarantees are in compliance with the provisions of the 2017 Act. This step creates a balance between the liberalisation of the regime under Section 185 and corporate governance as it imposes onerous responsibility on the management of the company to clearly distinguish the transactions entered into with persons in whom its directors are interested.

³ Ambika Sangwan, Penalties discussed under section 185, (Aug, 2014)
https://www.ijaem.net/?gclid=Cj0KCQjwmcWDBhCOARIsALgJ2QebwwH3gah3608tnD7KqwFyrKNiTrAZRWgrE1342LN2Bvt_-R6HQC4aAvZdEALw_wcB

ANALYSIS OF SECTION 186 OF THE COMPANIES ACT, 2013

The Companies Act, 2013 (Act) has come up with a change in the concept of ‘Loan and Investment by Company. The new Act provides that inter-corporate investments not to be made through more than two layers of investment companies.

The 2013 Act states that companies can make investments only through two layers of investment companies subject to exceptions which includes company incorporated outside India.

In pursuance to the provisions of Section 186(1) of the Act, a Company shall make investment through not more than two layers of investment companies.

‘Layer’ according to explanation (d) of Section 2(87) of the Act in relation to a holding Company means its subsidiary or subsidiaries.

The provisions of Section 186(1) shall not have effect in the following cases:

- If a company acquires any company which is incorporated outside India and such company has investment subsidiaries beyond two layers as per the laws of such country.
- A subsidiary company from having any investment subsidiary for the purposes of meeting the requirement under any law/ rule/ regulation framed under any law for the time being in force.

LIMITS FOR LOANS /GUARANTEE/SECURITY/INVESTMENT

In pursuant to provisions of Section 186(2) of the Act, no company shall directly or indirectly

- give any loan to any person or other body corporate,
- give any guarantee or provide 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 exceeding 60% of its paid-up share capital plus free reserves plus securities premium account or 100% of its free reserves plus securities premium account, whichever is more.

APPROVAL FROM MEMBERS

Though the Section 186(2) makes restriction as above, Section 186(3), empowers a Company to give loan, guarantee or provide any security or acquisition beyond the limit but subject to prior approval of members by a special resolution passed at a general meeting.⁴

DISCLOSURE OF PARTICULARS OF LOAN, GUARANTEE GIVEN AND SECURITY PROVIDED

Section 186(4) of the Act provides that the Company shall disclose following details to the members in the financial statement.

- The full particulars of the loans given investment made or guarantee given or security provided.
- 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.

The notice of the general meeting for passing resolution shall indicate that:

- (a) The limits that will be required in excess of the prescribed limits involved in the proposal;
- (b) The particulars of the body corporate in which the investment is proposed to be made or to which the loan or guarantee or security proposed to be given.
- (c) The purpose of the investment, loan, guarantee or security;
- (d) The source of funding for meeting the proposal; and
- (e) Other details as may be specified.

APPROVAL OF BOARD AND PUBLIC FINANCIAL INSTITUTION

In pursuant to provisions of Section 186(5) of the Act, every company shall take consent of all the directors present at the board meeting before making any investment, giving loan and guarantee and providing security.

⁴ AVTAR SINGH, INTRODUCTION TO COMPANY LAW (12th ed., Eastern Book Company 2019).

In case of company has already taken loan etc., from any Public Financial Institutions, then it is mandatory to take prior approval from such Public Financial Institution.

Exception: Provided that prior approval of Public Financial Institution shall not be required where the aggregate loan, investment, guarantee and security proposed is within the limits as specified under section 186(2) and there is no default in repayment of loan instalments or interest thereon to the Public Financials Institution.

COMPANIES REGISTERED UNDER SECURITIES EXCHANGE BOARD OF INDIA

Section 186(6) of the Act provides that those Companies which are registered under Section 12 of SEBI Act, 1992 and 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 can take inter-corporate loans or deposits exceeding the prescribed limit and shall furnish details of loans or deposit in their financial statements.

RATE OF INTEREST ON LOAN

No loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three years, five year or ten-year Government Security closest to the tenor of the loan.

NO LOAN BY DEFAULTER COMPANY

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 OF LOAN

Section 186(9) of the Act mandates every Company to maintain a register which shall contain particulars of loan or guarantee given or security provided or investment made. 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 entered therein separately, the particulars of loan and guarantee given, securities provided and acquisitions made as aforesaid.⁵

This register shall be kept at registered office of the company and the register shall be preserved permanently and shall be kept in the custody of company secretary of the company or any person authorized by the Board for the purpose.

The entries in the register (either manual or electronic) shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

Section 186(10) of the Act mandates the extracts of the register may be opened for inspection and copies may be furnished to members who demands for the same on payment of prescribed fee as mentioned in the Articles which shall not exceed ten rupees for each page.⁶

NON-APPLICABILITY OF SECTION 186:

The Section 186 (except Sub Section 1) of the Companies Act, 2013 does not apply to the following:

(a) to a loan made, guarantee given or security provided by a banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities;

(b) to any acquisition—

(i) made by a non-banking financial company registered under Chapter IIIB of the Reserve Bank of India Act, 1934 and whose principal business is acquisition of securities;

⁵ Kaushik Ghosh & Mayukh Mukhopadhyay, *Review of Company Law on Section 185 & 186 Using SCP Paradigm*, SSRN ELECTRONIC JOURNAL (Jan, 2020) <https://www.researchgate.net/publication/340171749>

⁶ Priya Bhalla, *A sectoral analysis*, (Sept 9, 2014) <https://ijbed.org/details&cid=58>

Provided that exemption to non-banking financial company shall be in respect of its investment and lending activities;

(ii) made by a company whose principal business is the acquisition of securities;

(iii) of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.

PENALTY IMPOSED FOR CONTRAVENTION OF SECTION 186:

On Company: Every Company which contravenes the provisions of this Section shall be liable to a penalty which shall not be less than Rs. 25000/- but which may extend to Rs. 5.00 lacs.

On Officers: Every officer of the Company who is in default shall be punishable with imprisonment for a term which may extend to two years and fine which shall not be less than Rs. 25000/- but which may extend to Rs. 1.00 lacs.

Amendments to Section 186 of the 2013 Act

Section 186 of the 2013 Act did not include any exemption for loans/guarantee/security provided by a holding company to its wholly owned subsidiary companies. This created hardships for subsidiary companies which are largely dependent upon their parent companies for credit support or collaterals/guarantees for fund raising. To resolve this, the rules notified under the 2013 Act provided that where a loan or guarantee is given or a security is provided by a company to its wholly owned subsidiary or joint venture, the requirement relating to obtaining a special resolution at the general meeting will not be applicable, therefore, the amendments brought under the 2017 Act have included these exemptions in the operative part of the Act itself thereby addressing the ambiguities created under the 2013 Act and its rules.

Sub-section (11) of Section 186⁷ of the 2013 Act exempted, *inter-alia*, a company established with the object of and engaged in the business of financing of 'companies' from the applicability of provisions of Section 186. The 2017 Act has amended this sub-section to substitute the word 'industrial enterprises' for 'companies'. While the section continues to retain the existing exemptions, the 2017 Act has amended this provision to the extent of replacing the word 'acquisition' with 'investment' [sub-section (11) of

⁷ N.R. SRIDHARAN & P.H. ARVIND PANDIAN, GUIDE TO SECTION 186 (4th ed., Lexis Nexis 2020)

Section 186] and extending the scope to rights issue in addition to shares allotted pursuant to clause (a) of sub-section (1) of section 62.

The 2017 Act has amended the Explanation to Section 186 to further clarify the scope of the expression 'company whose principal business is the acquisition of shares, debentures or other securities' in respect of 'investment company' to mean companies whose assets in the form of investment in shares, debentures or other securities constitute not less than 50% of its total assets, or if its income derived from investment business constitutes not less than 50% as a proportion of its gross income. This amendment is a relief to a lot of companies operating as holding companies or core investment companies, which are primarily in the investment business and are pending registration with the Reserve Bank of India as an investment company.

CONCLUSION

To conclude, Section 185 & 186 of the Companies Act, 2013 had been enacted with the intent to secure public financial institutions. Both the sections under 2013 Act were restrictive and prohibitive in nature. Whereas in practicality the same was becoming an obstrucle in the course of business of companies.

Both sections 185 & 186 have a unique co-relation to protect the Shareholders and to limit the powers of the board. The powers of the board with regard to acquiring loan were curved to such an extent that the business would be hampered.⁸

To resolve the above mentioned problem the amendment of 2017 was very much needed. The new amendments broadened the scope of both the Sections by limiting the restrictions and penalties provided therein.

⁸ Subhashish Gupta, *Company Law of 2013: Academic Perspective*, JOURNAL OF INDIAN INSTITUTE OF MANAGEMENT, BANGALORE, (Dec, 2007) <https://www.iimb.ac.in/node/4173>

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