

LOANS TO DIRECTORS

SECTION 185 of Companies Act, 2013



Introduction- Loans to Directors and Issues Faced under section 185

Section 185 - Loans to Directors- Notified on 12.09.2013 amended last on 07.05.2018

- ▶ When enacted on 12.09.2013, **it was a complete prohibitory section**, which had significant impact on structured lending transactions which were backed by credit support, collateral or guarantee from a Parent Company or a Group Company.
- ▶ Difficult time initially when **genuine transactions** for providing loans to subsidiaries with common directors was not allowed .
- ▶ **Who can fund subsidiary company** ? Common Directors were required to have corporate governance.

Effect of Notification of this section on 12.09.2013

- ▶ Existing loan/guarantee/security provided before 12/09/2013 was not affected by above provisions.
- ▶ However, it should not be renewed & should be repaid on due date.
- ▶ “Loan repayable on demand” should be repaid on demand.
- ▶ “Loan repayable after fixed period” should be repaid on expiry of Fixed period.

Immediate action upon Notification on 12.09.2013

- Many companies had **converted** lending and borrowing company in **LLP**
- Borrowing companies were **converted in Public Limited** to enjoy 25% limit
- **Shareholding pattern was changed** by gifting shares to relatives
- **Change in Directors** in lending company, new appointment of Director who were neither Director in any company nor holding any share in his/ her personal capacity in other company

Evolution

05th June 2015 exemption to Private Limited Companies

Private Limited Company were exempted to give loan to its Directors, if

- ▶ (a) in whose share capital no other body corporate has invested any money;
- ▶ (b) if the borrowings of such a company from banks or financial institutions or any body corporate is less than twice of its paid up share capital or Rs.50 crore, whichever is lower; and
- ▶ (c) such a company has no default in repayment of such borrowings subsisting at the time of making transactions under this section.

COMPANY LAW COMMITTEE REPORT (CLC)

▶ In the **Report of the CLC, issued in February 2016**, the Committee acknowledged that there are difficulties being faced in genuine transactions due to the complete prohibition on providing loans to subsidiaries with common directors, but at the same time there is no doubt that the route has been **misused in the past for siphoning of funds by controlling shareholders**.

▶ The Committee noted that **limited relaxation** has already been provided to private companies (05th June 2015) **not having other body corporate invested** in them and therefore any further relaxation should be subject to greater safeguards.

COMPANY LAW COMMITTEE REPORT (CLC)

- ▶ The Committee, therefore, recommended, that it may be considered to allow companies **to advance a loan to any other person in whom director is interested subject to prior approval of the company** by a special resolution.
- ▶ Further, loans extended to persons, including subsidiaries, falling within the restrictive purview of Section 185 should be used by the subsidiary for its **principal business activity only**, and not for further investment or grant of loan.

CLC and CAA 2017 (07.05.2018)

CLC---With a view to address the concerns raised in the 2013 Act and improve ease of doing business in the country, the Ministry of Corporate Affairs (MCA) constituted a Companies Law Committee (CLC).

CAA 2017----- The Government of India considered the suggestions made by the CLC and enacted the Companies (Amendment) Act, 2017 which received the President's assent on 1st January 2018 and was notified in the Official Gazette on 7th May 2018.

Until the CAA 2017 -- companies have struggled with structuring lending transactions due to the restrictions of section 185

CAA 2017

1. The shareholders of the company being the ultimate owners and supreme authority may themselves approve the utilization of the funds of the company, the law need not create a bar on the same.
2. This change in section 185 would be helpful for companies which depend on their group companies' credit for fund raising.
3. The opening phrase of sub-section (1) of Section 185 of the 2013 Act states "save as otherwise provided in this Act" which is a non-obstante provision.
4. Deletion of the non-obstante language in the substituted Section 185 under the 2017 Act, clarifies the intent of Section 185 of the 2013 Act.

LOAN BY COMPANY

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graph TD; A["LOAN BY COMPANY"] --> B["TO DIRECTORS / FIRM / RELATIVE  
OR  
IN ANY PERSON IN WHICH  
DIRECTOR IS INTEREST"]; A --> C["TO ANY OTHER PERSON"]; B --> D["SECTION 185"]; C --> E["SECTION 186"];
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**TO DIRECTORS / FIRM / RELATIVE
OR
IN ANY PERSON IN WHICH
DIRECTOR IS INTEREST**

SECTION 185

TO ANY OTHER PERSON

SECTION 186

185 (1)- PROHIBITION TO GRANT LOAN



- ▶ 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.

Loan / Book debt

All loan is book debt but all book debt is loan?

The Hon'ble Bombay High Court in the case of **Pennwalt India Ltd. v. RoC** 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.

Complete Ban to provide loan in section 185 (1)

The intent of the rigidity of complete ban in providing loan to Directors is to ensure that directors **do not surpass their fiduciary duty** towards the company for their personal benefit.

However continuing such ban in spite of the hardship for genuine transaction, the Companies Amendment Act, 2017 **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.

185(2)-Granting of Loans subject to Special Resolution

▶ 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”, subject to the condition that—

a special resolution is passed by the company in general meeting and in the explanatory statement following matters are disclosed :

- (a) full particulars of the loans / guarantee given or security provided ;
- (b) *purpose of its utilization by the recipient
- (c) other relevant fact; and

* Purpose is for its principal business activities only

185(2)-Granting of Loans subject to Special Resolution

"any person in whom any of the director 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 25 % 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.

185(2)-Granting of Loans subject to Special Resolution

Section 2 (27) defines Control as follow

“Control” has been defined as to include

-----the right to appoint majority of the directors or

-----to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly,

-----including by virtue of their shareholding or management rights or shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

185(2)-Granting of Loans subject to Special Resolution

What is the meaning of the term “ordinary course of lending”

- ▶ Whether the company is engaged in lending activities regularly &
- ▶ Lend not only to directors/directors’ entities but also to “arms’ length parties/unrelated parties”

Letter of comfort is not guarantee

185(3)—Exemptions

Nothing contained in sub-sections (1) and (2) shall apply to—

- a) the giving of any loan to a managing or whole-time director as a part of the conditions of service extended by the company to all its employees; or pursuant to any scheme approved by a special resolution; or
- b) a company which in the ordinary course of its business provides it
- c) Loan/ Guarantee or Security given by a Holding Company to its WoS
- d) Guarantee given or security provided by a Holding Company in respect of loan given by any bank or financial institution to its subsidiary company

*Loans made above in (c) & (d) are for the principal business activities.

Section 185 (4) Penalty

Penalty for violation of the provisions of section 185 :

Company shall be punishable with fine which shall not be less than Rs.5 Lakh but which may extend to Rs.25 Lakh

Every officer 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 Rs.5 Lakh but which may extend to Rs.25 Lakh ; and

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 Rs.5 Lakh but which may extend to Rs.25 Lakh , or with both.]

Section 186 to be complied with

- ▶ Section 186 of the 2013 Act dealing with limits on loans and investments by companies, restricted the ability of companies to advance loans or make investments **beyond the certain limits specified therein** and CAA 2017 gave relaxation by excluding loans given to employees of the company.



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