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RELATED ENTITY LENDING: THE SECTION 185/186 CONUNDRUM - FINALLY SETTLED?

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One of the most significant legal reforms of the country in recent times has been the enactment of the Companies Act, 2013 (the 2013 Act) as this was a major step towards aligning Indian company law with the company laws prevalent globally. However, the 2013 Act faced multiple implementation challenges and various concerns were raised by industry stakeholders which led to further review and simplification of a few of the provisions of the 2013 Act.

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). The Government of India considered the suggestions made by the CLC and enacted the Companies (Amendment) Act, 2017 (the 2017 Act) which received the President's assent on 1 January 2018 and was notified in the Official Gazette on 7 May 2018 (You can refer to our newsflash dated 4 January 2018 for a snapshot of the amendments). Among the various modifications, one of the key amendments that was brought about under the 2017 Act were the changes to Sections 185 and 186 of the 2013 Act corresponding to Sections 61 and 62 of the 2017 Act, which deals with loans to directors and loans and investments by companies and their corresponding rules. Even though the entire legal framework on inter-corporate loans have been a matter of much discourse and several clarifications and amendments have been introduced on the provisions under these sections, until the amendments suggested by the 2017 Act, companies struggled with structuring lending transactions due to the restrictions present in the legal provisions under the 2013 Act.

Section 185 of the 2013 Act, prohibited companies from advancing any loan (including loan represented by a book debt) or giving any guarantee or any security in connection with a loan taken by the directors of such company or any other person in whom the directors are interested. Section 185 (1) provided certain exceptions to the applicability of this section on certain persons, however the restrictions continued to be stringent for group companies with common directors. Similarly, 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 such restrictions extended to loans given to employees of the company.

The 2017 Act resolves the issues raised under the 2013 Act and we have summarised below the key changes made to Sections 185 and 186 of the 2013 Act.

Section 185 of the 2013 Act: Amendments Analysis

Section 185 of the 2013 Act, being a prohibitory 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. Given that there was no scope of any carve out or any route to apply for the Central Government's approval for non-applicability of such restrictions (akin to the provisions of Section 295 of the Companies Act, 1956), 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 has now been substituted under the 2017 Act.

Reliefs under Sections 185: Special Resolution of lending/guaranteeing/security providing company

Under the erstwhile provisions of Section 185 of the 2013 Act, a company is prohibited to provide a loan, guarantee or security to any of its directors or *to any other person in whom the director is interested*'. One of the results of the expression 'to any other person in whom the director is interested' was that a company could not even give a loan or guarantee/provide security for any loan taken by its subsidiary, associate or joint venture companies if there were common directors between such companies or had any person which would fall within the ambit of the expression 'any other person in whom the director is interested' as provided in the explanation in Section 185(6) of the 2013 Act. This restriction had created major challenges, particularly in situations where financings and investments were largely dependent on credit support/guarantee or security from group companies.

Although the CLC acknowledged that there are difficulties being faced in genuine transactions due to the complete embargo on providing loans to subsidiaries with common directors, they also observed that intra-group credit support route has been misused in the past for siphoning of funds by controlling shareholders. The CLC noted that limited relaxation has already been provided to private companies not having other body corporates invested in them and therefore any further relaxation should be subject to greater safeguards. The CLC, 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.

Therefore, to address the suggestions set out by the CLC comprehensively, the 2017 Act has further eased this restriction by permitting companies to lend/provide guarantee or security to a person, subject to the fulfilment of the following conditions:

- that the granting of the loan or guarantee or creation of security is agreed in a general meeting by a special majority of the shareholders of the company that is to give such loan or guarantee or create security and the explanatory statement to the notice of the general meeting clearly sets out (a) the full particulars of the loans or guarantee given or security created, (b) the purpose for which such loan or guarantee is given or security is to be utilized by the recipient, and (c) any other relevant facts; and

- that the loans are utilized by the borrowing company for its principal business activities.

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.

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 erstwhile Section 185 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.

Omission of the saving provision under Section 185

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 thereby indicating that if there are any provisions in the 2013 Act which permit loans of similar nature, which is otherwise restricted under Section 185 of the 2013 Act, such provision would prevail. The only other section under the 2013 Act which deals with lending by companies is Section 186. However, Section 186 of the 2013 Act starts with "*without prejudice to the other provisions*" which meant that the provisions of Section 186 would not be impacted by the restrictions under Section 185 of the 2013 Act. The wordings of both these sections were circular and created ambiguity as to which one or other of the provisions will take priority. Therefore, the 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.

Interest rates:

As per the report of the CLC, the rate of interest for loans granted under Section 185 of the 2013 Act was proposed to be aligned with the rates set out under Section 186(7) of the 2013 Act. To address this suggestion from the CLC and to ensure that the intra- group loans granted by companies are at arms' length, a further amendment to Section 185 has been brought about which exempts a company which provides loans or gives guarantees or securities for due repayment of loans in the ordinary course of its business from the provisions of the amended Section 185, where in respect of the loans, an interest 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 the loan is charged.

Extension of penal provisions:

Although the amendments under the 2017 Act have largely relaxed the restrictions set out under Section 185 of the 2013 Act, the penal provisions for non-compliance have been widened under the 2017 Act.

Section 185 of the 2013 Act provided for penalties for non-compliance with the conditions set out under the section and as such the penalties were leviable only to non-compliant companies or any director/any person to whom such loan/security/guarantee is provided. Under the 2017 Act, the penal provisions have been extended to an officer of the company, which includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act.

Therefore, under the amended provisions, the ambit of the penalties have 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.

Section 186 of the 2013 Act: Amendment Analysis

Following the amendments to Section 185 of the 2013 Act, certain relaxations have been introduced under Section 186 of the 2013 Act.

Exemptions to JV and WOS: Aligned to Section 372A of the Companies Act 1956

Section 186 of the 2013 Act requires that a company will not (i) give loans to any person/other body corporate, (ii) give guarantee or provide security in connection with a loan to any person/body corporate and (iii) acquire securities of any other body corporate, exceeding the higher of (a) 60% of its paid-up share capital, free reserves and securities premium or 100% of its free reserves and securities premium. For providing any loan/guarantee or security over and above these prescribed limits, prior approval by means of a special resolution would need to be obtained. However, 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. Although the rules notified under the 2013 Act intended to ease these concerns, there were arguments that the rules were possibly overriding the provisions of the 2013 Act. The amendments brought under the 2017 Act have included these exemptions in the operative part of the Act itself (akin to the provisions of the erstwhile Section 372A of the Companies Act, 1956), thereby addressing the ambiguities created under the 2013 Act and its corresponding rules. Further, the lending or the acquiring company is also required to disclose all details of loans or guarantees given or security provided or the acquisition in the financial statement submitted pursuant to sub-section (4) of Section 186.

'Person' to not include employees

Sub-section (2) of Section 186 restricted a company from giving loan or guarantee or provide security in connection with a loan to any 'person' or body corporate where such loan, guarantee or security in connection with any loan exceeded the thresholds specified therein, subject to the shareholders passing a special resolution permitting such loan, guarantee or security in excess of such threshold. The occurrence of the word 'person' in Section 186(2) of the 2013 Act seemed to cover employees. The CLC was of the view that loans which are given to employees as part of their service conditions or pursuant to an approved scheme for employees by a company should not form a part of the restrictions set out under Section 186 of the 2013 Act as the judicial intention of this section was to extend the restrictions to inter-corporate loans. In order to address this ambiguity, the 2017 Act has clarified that the word 'person' shall not include individuals who are employees of such company. Accordingly, companies can provide loans to their employees based on its policies without any statutory restrictions in its limits.

Other Amendments to Section 186 of the 2013 Act

Sub-section (11) of Section 186 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 (excluding sub-section (1) of Section 186). The 2017 Act has amended this sub-section to substitute the word 'industrial enterprises' for

'companies'. This change may cause some confusion as the meaning of 'industrial enterprises' has not been provided either in the 2013 Act or 2017 Act.

Further, sub-section (11) of Section 186 exempted any 'acquisition' (a) 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 subject in respect of its investment and lending activities; (b) made by a company whose principal business is the acquisition of securities; and (c) of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.; and (d) made by a banking company or an insurance company or a housing finance company, making acquisition of securities in the ordinary course of its business. 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' 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 fifty per cent. of its total assets, or if its income derived from investment business constitutes not less than fifty per cent. 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.

Comment

The amendments under the 2017 Act to Sections 185 and 186 are by far the most important amendments for intra group financings and financings for which intra group collateral is offered and cross collateralisation on assets in case of multiple group companies having common directors or are under common control or are accustomed to upon the instructions of a holding company or a common parent. The amendments open up a plethora of flexibilities in structuring options for companies, possibility for innovative structures and an overall relaxation in intra-group collateralisation. Specifically, this would be helpful for companies which depend on their group companies' credit for fund raising. These amendments have been proposed with a rationale that where the shareholders of the company themselves approve the deployment of the funds of the company in a specified manner, the law need not create a bar on the same and its therefore, a much needed relief since it removes the absolute prohibition, but at the same time includes safeguards which are effective and not onerous.

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