

Notes on Loan to Directors

(Section 185 of Companies Act, 2013) post Companies Amendment Act, 2017

Section 185 of the Companies Act, 2013(hereinafter referred as “CA, 2013”) has been completely re-written under the **Companies Amendment Act, 2017**. Now, Granting of loan, guarantee or security (referred as assistance) has been categorized as **Exempted, Prohibited** and **Conditional**.

A. [EXEMPTED CATEGORY]

1. Private Company, in whose

- a) 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 fifty crore rupees, 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.

Note:The aforementioned exception shall be applicable to the **Private Company** which **has not committed a default in filing its financial statements under Section 137 of the said act or annual return under section 92 of the said act with Registrar**, vide amendment notification no. 583(E) dated 13th June, 2017.

- 2. Nidhi Company** provided that the loan is given to a director or his relative in their capacity as members and **such transaction is disclosed in the annual accounts by a note**.
- 3. Loan to MD/WTD** as a part of the conditions of service extended by the company to all its employees OR pursuant to any scheme approved by special resolution;

Special Issue: Jan, 2018

4. Loan/guarantee/securities provided by company **in the ordinary course of its business** by charging an interest at a rate not less than the rate of prevailing yield of one year, three year, five year or ten year Government security closest to the tenor of the loan;
5. **Loan/guarantee/security by holding company to its WOS subject to the utilization of such loans for its principal business activities;**
6. Guarantee/security provided by holding company in respect of loan made by any bank/financial institution to its subsidiary company subject to the utilization of such loans for its principal business activities.

B. PROHIBITED CATEGORY [Section 185(1)]- OTHER THAN EXEMPTED :

Under the said category, there is total prohibition on ANY CO. OTHER THAN EXEMPTED CO. advancing any loan/guarantee/security **directly or indirectly** to the following persons-

- a) Directors of the Co, or
- b) Directors of the Co. which is its holding Company or
- c) Any partner of such Director, or
- d) Any relative of such Director, or
- e) a firm in which such director or relative is a partner or

Relative

As per section 2(77) of Companies Act 2013 read with Rule 4 of the Companies (Specification of Definitions Details) Rule, 2014 following are relatives:

- 1) Members of a Hindu Undivided Family;
- 2) Husband and wife;
- 3) Father (including step father);
- 4) Mother (including step mother);

- 5) Son (including step son);
- 6) Son's wife;
- 7) Daughter;
- 8) Daughter's Husband;
- 9) Brother (including step brother);
- 10) Sister (including step sister)

Omission of "Save as otherwise provided in this Act"

Earlier Section 185(1) of the 'Act' started with words '**Save as otherwise provided in this Act**'. Thus, the restriction under 185(1) was not applicable where loan or guarantee was permissible under Section 186 of the Act as it started with "**Without prejudice to the provisions contained in this Act**". *Now, in the revised Section 185, these words have been omitted. Thus, the provisions with regards to loan can be only as per provisions of Section 185.*

C. CONDITIONAL CATEGORY [Section 185(2)]:

The conditional assistance is possible to any person in whom the director is interested (other than prohibited categories). Under the said category, advancing any loan/guarantee/security **following parties** is allowed subject to the special resolution and adherence to the disclosure requirements.

- i.** Any private company of which any such director is a director or member;
- ii.** 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;
- iii.** Any body-corporate, the board of directors, managing director, or manager whereof is accustomed to act in accordance with the directions or institutions of the board, or of any director or directors, of the lending company.

Special Issue: Jan, 2018

Limit of loan/guarantee/security given:

The loan/guarantee/security granted under section 185 shall be subject to the provisions of section 186.

Section 185 is applicable on loans/book debts not advances:

This section is applicable only on loans, not on advances. A loan is defined by the Oxford English Dictionary as a thing lent; something the use of which is allowed for a time, on the understanding that it shall be returned or an equivalent given; esp., a sum of money lent on these conditions and usually with interest'. The essential requirement of a loan is the advance of money (or of some article) upon the understanding that it shall be returned and it may or may not carry interest. **[Dr. Freddie Ardeshir Mehta v. Union of India [1991] 70 Comp. Cas. 210 (Bom.)]**

If company provides the book debts where the credit is given for a substantially longer period comparing to other debtors then section 185 will be applicable because in sub-section (1) of section 185 loans includes any loan represented by book debts.

Subscription of debentures Vs. Loan:

The section is applicable **only to loans, and not to subscription of debentures**. If the director's entity issues debentures, **to which the company subscribes, the company is acquiring a security, and not making a loan**. Hence, the section does not apply in such a case.

Letter of comfort Vs. Guarantee:

The section is **applicable to giving of guarantee**. The word guarantee is defined in the Contracts Act to imply the undertaking of the liability of a principal debtor by the guarantor. It will be a case of a guarantee where the guarantor undertakes to pay the debt of the principal debtor. However, where the commitment of the so-called comforting party is merely to the extent of introducing the principal debtor, or prevailing upon the principal debtor to pay, etc., **there may be a moral or reputational obligation, but there is no contractual obligation of the comforting party, and hence, there is no guarantee**. The distinction between guarantee and LoC is not merely one of language – it is language and intent put together. If there is a clear contractual liability being assumed by the contracting party, then it is a guarantee irrespective of the nomenclature.

Penalties [Section 185(4)]:

- **The company** shall be punishable with fine minimum of Rs.5 lacs and maximum of Rs.25 lacs;
- **Every officer of the company who is in default** shall be punishable with imprisonment upto 6 months or fine of Rs.5 lacs and maximum of Rs.25 lacs; and
- **The director or the other persons to whom any loan** is advanced shall be punishable with imprisonment upto 6 months or fine of Rs.5 lacs and maximum of Rs.25 lacs or both.

Note: Now **defaulting officer in** the company shall be penalized along with the company and director or the other person to whom any loan is advanced or guarantee or security is given.

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