

SECTION- 185 LOAN TO DIRECTOR

by CS Divesh Goyal on April, 2014

TERMS ON WHICH WE MUST FOCUS BEFORE START READ THIS SECTION 185



1. With the usage of words '**SAVE AS OTHERWISE PROVIDED UNDER THIS ACT**' in Section 185, whether loans to director and other person in whom Director is interested may also be made after complying with the provisions of such Section 186 of the Act, which has been notified w.e.f. 01st April, 2014?

ANS: If the answer to the aforesaid question is Positive, then the whole purpose of legislation to have Section 185 of the New Law seems Redundant. On the other hand, if the answer to it is Negative, then there seems some drafting error in the legislation or where else do we see the effect of the section in law if not Section 186.

Hence, while the usage of words 'save as otherwise provided in Act'; seems redundant; on application of the Rule of Harmonious Construction, it may be construed that loans to directors or other person in whom director is interested is restricted by virtue of Section 185 and section 186 of the Act is NOT an enabling provision for such transactions.

2. BOOK DEBT?

ANS: Another interesting aspect of this section is its **applicability on book debts**. Provisions of Section 185 of the Companies Act, 2013 **as it straight away include 'any loan represented by a book debt' in its purview**. It remains to be seen now whether undertaking of any related party transaction for

EG: Relating to purchase or sale of goods or services which are otherwise allowed within the purview of Section 188 of the Companies Act, 2013; **For Credit** (not for cash); also **end up in a violation of this section for the Directors** and other person in whom Directors are interested.

So for Section 185 the nature of credit extension to directors and other person wherein directors are interested would **kn**.

Regarding the aspect of this section as to its applicability on book debts; it is pertinent to refer to the case of **Pennwalt India Ltd. v. RoC**, wherein the Hon'ble Bombay High Court 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.

Hence, with reference to each transaction with Directors and other person in whom the Directors are interested; the nature of transactions has to be studied, in case they relates to book debts.



3. ORDINARY COURSE OF BUSINESS:

ANS: Now a significant question here is whether the intent here is to cover just Banking Companies or NBFCs or for that matter, any other entity which undertake such transaction with bonfide intent to achieve its main objects i.e. in ordinary course of its business? The term 'ordinary course of its business' being very subjective in itself leaves lot of scope for different interpretations.

In order to be within the ordinary course of business, a transaction must adhere to the practices and customs that are considered normal for an industry. It would not be unusual for businesses in the same industry.

Determining whether something is within the ordinary course of business or not

- Can involve **evaluating similar types of businesses and industries** to see if they engage in similar types of transactions.
- Other tests can include questioning the parties to the transaction and checking regulations to see if they outline any practices for a given profession or industry. Hence, the provision does not just include Banking Companies or NBFCs in its purview.

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APPLICABILITY:

- *This section now applies to all companies including private companies also.*

- *Save as otherwise provided in this Act



No Company (Private & Public)

Directly or
Indirectly

Advance any
loan, **including**
book debt,

to any of its **directors** or to
any ****other person in whom**
the director is interested

Any **guarantee** or
provide any **security** in
connection with any
loan taken by him or
such other person

EXEMPTIONS

(a) The giving of any loan to a **MANAGING or WHOLE-TIME** director

(1) as a part of the conditions of service extended by the company to **all its employees**; or

(2) pursuant to any scheme approved by the members by a **special resolution**

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

Any loan, Gurantee & security provide by Holding company to its **Wholy Own Subsidiary (WOS)(By Rules)**

Any Gurantee & Security provide by holding company in respect of Loan made **by Bank And Financial Institution to Subsidiary Company**, **Condition:** Subsidiary use such loan for Principle Business Activity.

Thus, the company can give loan or advance to its MANAGING OR WHOLE-TIME DIRECTOR which is according to the terms and conditions of service framed **by the company**

- **For all its employees and not particularly for managing or whole director.**
- **Pursuant to any scheme approved by the members by a special resolution.** Such schemes may include Housing Loan scheme, Education loan scheme, ESOP etc.

LOAN AND GURANTEE GIVEN BY HOLDING TO SUBSIDIARY:

After the notification of Section 185 of Act but prior to notification of Section 186, lot of banks in the country, only on account of narrow and wrong interpretations of Section 185 of the New Companies Act 2013, stopped taking Corporate Guarantee as a security as one of security from holding companies for sanctioning loans to its subsidiary.

Ultimately, this narrow interpretation created speed breaker or bottlenecks in the flow of loaned funds from banks to corporate which affected the economic growth of the resources starved nation like India.

To clarify this ambiguity, the Ministry of Corporate Affairs brought a General Circular No. 03/2014 dated 14th February, 2014 clarifying 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 was, however, applicable for cases where loans so obtained were exclusively utilized by the subsidiary for its principle business activities.

Fortunately, the new notified rules have now Exempted such transactions between the holding company and its subsidiary from the requirements of section 185. The eventual purpose of Section 185 of the New Companies Act, 2013 is to put additional restrictions on loan to directors only and not on giving of Corporate Guarantee by the holding company to its subsidiary company.

To Any Other Person In Whom Director Interested Mean:

Any **other director** of the **lending company**, or of **the holding company** of the lending company

Any **partner** or **relative** of such director

Any **private company** of which director is a **director or member**

Body Corporate in which **25% or more voting power rests with one or more directors**

Body Corporate **whose Board accustomed to act on directions of BOD or Directors** of lending company.

Punishment for violation: According to sub-section 2 of Section 185 of the Act, if any loan is advanced or a guarantee or security is given or provided in contravention of the provisions of sub-section (1):

- (a) The **Company** shall be punishable with fine which shall not be less than 5 lakh rupees but which may extend to 25 lakh rupees, and
- (b) 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 6 months** or with **fine** which **shall not be less than 5 lakh rupees but which may extend to 25 lakh rupees, or with both.**



Conclusion: The Section 185 states that there can be **No Loan** given by the company to any of its directors or Key managerial persons and the people in whom the director is interested. It also cannot give guarantee or security in case of any such person. It can only give loan certain cases mention above.



Thanx & Regards,
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Some options are still available for making the flow of funds available for Group companies having common directorship and membership. Some of them are:

1. Providing loans or giving any guarantee or security for due repayment of any loan in the ordinary course of business and in respect of such loans, an interest is **charged at a rate not less than Bank rate declared by Reserve Bank of India** (presently 9.00%).
2. **Changing the composition of the Board** of Borrowing Company in a manner such that the Directors of the Lending Company are neither the Directors nor the Shareholders in the Borrowing Company, and nor their relatives.
3. **Changing** the composition of group partnership firm in a manner that the Directors of the Lending Company are neither the partners, and nor their relatives.
4. **Making Borrowing Company as a wholly owned subsidiary** of the Lending Company.
5. **Converting group private limited company into public limited company** and **restructuring** the Board in such a manner that the **voting power** of common directors is kept **below 25% in such public limited company**.