

5th May, 2014

Frequently asked questions on Section 186 of Companies Act 2013



By P C Agrawal
B.Com., LL.B., CAIIB, FCS

cs.pcagrawal@gmail.com
Aurangabad (Maharashtra)

Q.1. What types of specified transactions are covered under the Section?

Ans.: Section 186 covers 3 types of specified transactions entered into by a company directly or indirectly:

- a) Loans to any person or other body corporate;
- b) Guarantee or security given in connection with a loan to any other body corporate or person; and
- c) Acquisition by way of subscription, purchase or otherwise, the securities of any other body corporate.

Q.2 What is the date of applicability of Section 186?

Ans.: Section 186 is applicable from 1.4.2014. All transactions entered into upto 31.3.2014 will be covered by corresponding Section 372A of Companies Act 1956 which is not in force now.

Q.3. What is the ceiling on the specified transactions that Board of Directors of a company can enter into?

Ans.: Board of Directors of a company can approve transactions as specified above if the aggregate of all such existing and proposed transactions does not exceed higher of the following two limits:

- a) 60% of its paid-up share capital, free reserves and securities premium account; or
- b) 100% of its free reserves and securities premium account.

Q.4. What is the meaning of free reserves for this purpose?

Ans.: Section 2(47) defines "free reserves" as such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that—

- (i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or
 - (ii) any change in carrying amount of an asset or of a liability recognized in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value,
- shall not be treated as free reserves;

Q.5. What if the ceiling of the specified transactions exceeds above limit?

Ans.: Prior approval of shareholders by way of special resolution is required in case the above limit is exceeded. However, as per Rule 11 of Companies (Meetings of Board and its powers) Rules 2014 (yet to be notified) this will not be applicable in case of specified transactions entered into by a holding company with its wholly owned subsidiary company or to a loan or guarantee given or security provided by a company to a joint venture company.

Q.6. Upto what limit shareholders can give approval for such transactions?

Ans.: The Act does not prescribe any limit upto which the shareholders can give approval for such transactions. However, on a query under corresponding Section 372A of Companies Act 1956, the erstwhile Department of Company Affairs vide circular No.8 dated 4.6.1999 had clarified as under:

- “(i) The companies are expected to obtain the approval for making investments into securities or grant of loan to other companies of amounts which are linked with company’s available financial resources and the resolution, for investment much beyond the net worth should not be passed by the companies.*
- (ii) The companies should specifically indicate in the explanatory statement to the resolution, the specific securities in which it is proposed to invest the amount. En bloc approval should normally be avoided (except in the case of guarantee where the resolution can indicate an amount on annual basis).*

2. If the above broad parameters are not complied with, the Government will be constrained to take suitable action against those who contravene these.”

Hence above clarification may be kept in mind while passing special resolutions under Section 186 of Companies Act 2013 also.

Q.7. What types of companies are covered under the Section?

Ans.: Section 186 is applicable to all types of companies including private limited companies irrespective of their size. However, it is not applicable to following transactions (except restriction of investment through not more than two layers of investment companies):

- 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 business or a company engaged in the business of financing of companies or of providing infrastructural facilities as specified in Schedule-VI to the Act;

- b) Any acquisition:
- i. Made by an NBFC registered under Chapter IIIB of the RBI Act and whose principal business is acquisition of securities (exemption 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 on rights basis pursuant to Section 62(1)(a).

Q.8. What is the meaning of 'body corporate' in the Section?

Ans.: Section 2(11) provides that 'body corporate' or 'corporation' includes a company incorporated outside India, but does not include---

- i) A cooperative society registered under any law relating to cooperative societies; and
- ii) Any other body corporate not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf.

General characteristics of body corporate are:

- Incorporated under some law
- Perpetual succession
- Ability to hold property in its own name
- Legal entity apart from the members

Examples of 'body corporates':

1. All companies registered under Indian Companies Act
2. All companies registered under any Act outside India
3. Any Corporation registered under any special law in India or abroad
4. Public financial institutions u/s 2(72) of Companies Act 2013
5. Nationalised banks incorporated under Banking Companies (Acquisition & Transfer of Undertakings) Act 1970
6. LLPs

These are not bodies corporates:

1. Proprietorship concerns
2. Partnership firms (other than LLPs)
3. HUFs
4. Societies registered under Societies Registration Act
5. Mutual funds managed by trustees (UTI is a body corporate)

Q.9. What is the meaning of the word 'Person' used in the Section?

Ans.: The word 'Person' has not been defined in the Act. Section 2(42) of General Clauses Act 1897 provides that 'Person' shall include any company, association or body of individuals, whether incorporated or not.

Q.10. Whether loans to employees are also covered under the Section?

Ans.: Section 186 is applicable to loans to 'any person' or other body corporate. 'Any person' will include employees also. Hence loans to employees will also be covered under the Section. This has created practical difficulty in implementation and MCA is expected to come out with some relief in such cases.

Q.11: Whether various advances and deposits will also be covered under the Section?

Ans.: There is a difference between advance and loan. Loan is lending of money with absolute promise to repay whereas advances is to be adjusted against supply of goods and services. Genuine trade advances given to suppliers against orders for supply of goods will not be considered as loans and hence will be out of purview of Section 186. Similarly, advances given to employees against current month's salary will also not be in the nature of loans.

There is a difference between loan and deposit also. However, in case of Section 295 of Companies Act 1956 courts have held that the difference is immaterial and the Section cannot be evaded by describing monies of a company advanced to a director as deposits. Corresponding Section 372A of 1956 Act specifically provided that loan includes deposits. However, there is no such mention in the 2013 Act.

Sale on credit is also not a loan. [Bombay High Court in *Fredie Ardeshir Mehta v. Union of India* (1991)]

Q.12. Whether book debts will also be considered as loans?

Ans.: Courts have held in various judgements that credit extended beyond normal credit period may be considered in the nature of loans and hence provisions of the Section may get attracted to such book debts also.

Q.13. What is the meaning of 'securities' in the Section?

Ans.: Section 2(81) provides that 'securities' means the securities as defined in Section 2(h) of Securities Contracts (Regulation) Act 1956. As per Section 2(h) of SCRA:

"securities" include—

- (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- (ia) derivative;
- (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (id) units or any other such instrument issued to the investors under any mutual fund scheme.

Explanation.—For the removal of doubts, it is hereby declared that "securities" shall

not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);

- (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- (ii) Government securities;
- (iaa) such other instruments as may be declared by the Central Government to be securities; and
- (iii) rights or interest in securities;

Q.14. Whether investment in mutual funds are also covered under the Section?

Ans.: As per SEBI regulations, most of the mutual funds are managed by trusts which are not body corporates. Hence investment in mutual funds are not covered under the Section. However, Unit Trust of India is an exception since it has been constituted under UTI Act and is a body corporate.

Q.15. Is there any restriction on entering into specified transactions through layers of investment companies?

Ans.: It has been provided that unless otherwise prescribed, investment cannot be made through more than two layers of investment companies. However, this restriction will not be applicable if the applicable law so permits. Further, investment can be made through more than two layers of companies other than investment companies (e.g. manufacturing companies). This provision is prospective in nature and will not apply to existing investments made by companies through more than two layers of investment companies. Giving loan, providing guarantee or security beyond two layers of investment companies is permitted.

Q.16. What is the procedure for entering into specified transactions?

Ans.:

1. Take prior approval of members by special resolution in case the ceiling exceeds specified limits as above.
2. File return with ROC in Form MGT.14 with copy of special resolution.
3. Take prior approval of public financial institutions in case any term loan is subsisting and there is any default in repayment of loans and/or payment of interest or if the total amount of specified transactions is exceeding limit as specified above.
4. Pass Board resolution in a meeting with the approval of all directors present in the meeting.
5. File return with ROC in Form MGT.14 with copy of Board resolution.
6. Disclosure to be made in the financial statements of the full particulars of the loans given, investment made or guarantee given or security provided and 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.

7. Particulars of loans/guarantees/security/investments to be entered into register maintained for this purpose at the registered office, which shall be open for inspection and extracts may be taken by members on payment of prescribed fee.

Q.17. What is the penalty prescribed in case of contravention of provisions of the Section?

Ans.: If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

Q.18. Whether offence under the Section can be compounded?

Ans.: Section 441 of the Act provides for compounding of offences punishable with:

- a) Fine only
- b) Fine or imprisonment
- c) Fine or imprisonment or both.

Offences punishable with imprisonment only or imprisonment and fine both are not compoundable.

However, Section 441 has not yet come into force and hence presently offences under the Act are not compoundable.

Q.19. Whether a company can give interest-free loan?

Ans.: No company can give loans at rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.

Q.20. Whether there is any other restriction on entering into specified transactions by a company?

Ans.: No company which is in default in the repayment of any deposits accepted before or after 1.4.2014 or in payment of interest thereon, can give any loan or give any guarantee or provide any security or make an acquisition till such default is subsisting. Other restrictions to be kept in mind are:

- Company cannot give loan for purchase of its own shares (Section 67).
- Section 2(22)(e) of Income Tax Act 1961 which provides that even loan can be deemed to be dividend in certain cases
- RBI Act (for provisions relating to NBFC)

Q.21. Whether there are any special provisions for various intermediaries associated with securities market?

Ans.: Various intermediaries associated with securities market and registered under Section 12 of SEBI Act, such as stock brokers, sub-brokers, share transfer agents, bankers to issue, trustees of trust deed, registrar to issue, merchant banker, underwriters, portfolio managers, investment advisors etc. and covered under such class of companies as may be notified by the Government in consultation with SEBI, cannot take inter-corporate loans or deposits in excess of the limits specified under regulations applicable to such companies pursuant to which certificate of registration has been obtained from SEBI. Such companies are required to disclose details of loans or deposits in their financial statements.

Q.22. Whether a resolution passed under Section 372A of Companies Act 1956 is still valid?

Ans.: Section 465 of the Act provides that any resolution passed under Companies Act 1956 will be valid under the 2013 Act also. Although this Section is yet to be notified, since the Act is being implemented in phases, it can be presumed that the intention of the law is to give protection to existing actions and hence this Section will be applicable to the extent of provisions of the Act notified. However, in similar situation MCA in its circular has restricted validity of resolutions passed under Section 292 to one year from the date of notification of corresponding Section 180 of the new Act. Hence in order to avoid litigation, it would be advisable to pass fresh resolution under Section 186, although the same is not legally mandatory.

Q.23. Whether the Board can delegate its powers under the Section?

Ans.: Section 179(3) authorizes the Board to delegate its powers to enter into above specified transactions to any committee of directors, the managing director, the manager or any other principal officer of the company or in the case of a branch office of the company, the principal officer of the branch office. However, Section 186 requires consent of all directors present in the meeting for approving such transactions. There seems to be a conflict between Section 186 and Section 173 on this issue. However, applying the principle of harmonious construction it can be said that Board can delegate its powers with the consent of all directors present in the meeting.

Q.24. Is there any cut-off limit on amount of transactions which will not be covered under the Section?

Ans.: The Act has not prescribed any basic exemption limit for the specified transactions. Hence all specified transactions will be covered under the Section even if the same are for nominal amount. This may pose practical difficulty in implementation.

Q.25. Whether specified transactions with parties covered under Section 185 will also be governed by Section 186?

Ans.: Section 186 applies to all specified transactions generally. However, Section 185 of the Act prohibits loans to specific related parties. Since 185 deals with parties where conflict of interest is involved, it will prevail over Section 186. If the clause "Save as otherwise provided in the Act" used in Section 185 is construed in a manner to negative the restriction imposed therein, the very object with which the provision has been enacted will be frustrated. We have, therefore, to construe the expression "save as otherwise provided by or under the Act" in a harmonious manner so that provision of Section 185(1) is not reduced to a nullity. [Based on *State of Rajasthan v. Noor Mohammad* AIR 1973 SC 2729].

Section 67(3)(b) permits giving loans by a company for purchase of its own shares in certain cases. Due to the term “Save as otherwise provided in the Act” used in Section 185, loan under Section 67(3)(b) will not be hit by Section 185.

Accordingly, loans to following parties covered under Section 185 cannot be given:

1. Any director of the lending co. or of a co. which is its holding co.
2. Any partner or relative of any such director
3. Any firm in which any such director or relative is a partner
4. Any private company of which any such director is a director or member
5. Any body corporate at a general meeting of which not less than 25% of total voting power may be exercised or controlled by any such director or by 2 or more such directors together
6. Any body corporate, the Board, MD or Manager whereof is accustomed to act in accordance with the directors or instructions of the Board or of any director(s) of lending company

Exceptions:

Above restriction will not apply to

- a) The giving of any loan to MD or WTD as a part of the conditions of service extended by the company to all its employees, or pursuant to any scheme approved by the members by a special resolution; or
- 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 such loans an interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India.

Section 188 of the Act deals with contracts or arrangements with related parties. Since 188 is specific in nature and aims to control transactions with related parties involving conflict of interest, it appears that Section 188 will prevail over Section 186 in such cases.
