LOANS AND INVESTMENT BY COMPANY

Section 186 of the Companies Act, 2013 ("CA 2013") has replaced the old provision under Section 372A of the erstwhile Companies Act, 1956 ("CA 1956") which provides for loans and investment by companiesin India.

The CA 2013 stipulates inter alia that companies can make investments only through two (2) layers of investment companies subject to exceptions which includes companies incorporated outside India. This article discusses the provisions relating to loans and investments by a company under the CA 2013 vis-a-vis CA 1956.

IMPORTANT CHANGES BROUGHT UNDER THE CA 2013

The provisions relating to loans and investments by a company whether a public or a private are set out in Chapter XII of the CA 2013 read with the Companies (Meetings of the Board and its Powers) Rules, 2014 ("Rules"). The important changes brought about are:

1. Restriction on investment through more than 2 (two) layers of investment subsidiaries

In pursuance to the provisions of Section 186(1) of the CA 2013, a company shall make investment through not more than two (2) layers of investment companies. 'Layer' according to explanation (d) of Section 2(87) of the CA 2013 in relation to a holding company means its subsidiary or subsidiaries.

Further 'Investment Company' means a company whose principal business is acquisition of shares, debentures or other securities. Nevertheless these provisions, shall not affect a company which acquires any other company in a country outside India, if such other company has investment subsidiaries beyond two (2) layers as per the laws of such country; or a subsidiary company which has an investment subsidiary for meeting the requirements under any other law.

Observation

Section 186(1) of the CA 2013 has been incorporated with a view to increase transparency in transactions. The above mentioned restriction is set to significantly affect a variety of corporate transactions in India, especially those companies which operate across numerous sectors with an investment company at the top. The CA 2013 restricts investment through more than two (2) layers of investment companies. It is a subject matter of interpretation that whether Section 186 of the

CA 2013 refers to actual flow of investment money made by an investment company into the third layer of company or whether it speaks about the investment structure between the ultimate holding company and downstream companies.

2. Restriction on loans to directors and other persons

As per the provisions of Section 186(2) of the CA 2013 and as reproduced below, no company shall directly or indirectly:

- *give any loan to any person or other body corporate;*
- *give any guarantee or provide security in connection with a loan to any other body corporate or person; and*
- *acquire by way of subscription, purchase or otherwise, the securities of any other body corporate,*

exceeding sixty (60) percent of its paid-up share capital plus free reserves plus securities premium account or hundred (100) percent of its free reserves plus securities premium account, whichever is more.

Further Section 186 (3) of the CA 2013 states that in case of giving of any loan or guarantee or providing any security or an acquisition exceeding the above prescribed limits, prior approval by means of a special resolution passed at a general meeting shall be necessary.

Observation

It appears from the above provision that it is not essential that the target entity into which investment flows must be a company. It can be any type of body corporate; however, the intermediary company through which investments are made shall be a company. Further as stated earlier this Section mandates a company to make investment only through two (2) layers of investment companies.

A company need not pass a special resolution where loan or guarantee is given, or a security has been provided by a company to its wholly owned subsidiary, or a joint venture company, or an acquisition is made by a holding company, of the securities of its wholly owned subsidiary.

3. DISCLOSURES TO BE MADE

Section 186(4) of CA 2013 stipulates that a disclosure has to be made in the financial statement by a company about the full particulars of loans given, investments made or guarantees or securities given and the purpose for which the recipient is going to utilize the loansorguarantees or securities.

4. APPROVAL OF BOARD AND PUBLIC FINANCIAL INSTITUTION

As per Section 186(5) of the CA 2013, every company shall take consent of all the directors present at the board meeting before making any investment, giving loan and guarantee and providing security to any other body corporate. In case if a company has already taken loan etc., from any Public Financial Institutions, then it is compulsory to take prior approval from such Public Financial Institutions before making any investment, giving loan and guarantee.

As per the proviso of the above Section, in the event where the aggregate loan, investment, guarantee and security proposed is within the limits as specified under Section 186(2) of the CA 2013 and there is no default in repayment of loan installments or interest thereon to the Public Financials Institution, prior approval of Public Financial Institution shall not be required.

5. RATE OF INTEREST ON LOAN

Section 186 (7) of the CA 2013 makes compulsory that no loan shall be given at a rate of interest lower than the prevailing bank rate being the standard rate and which is made public.

6. NO LOAN BY DEFAULTER COMPANY

As per Section 186 (8) of the CA 2013, any company which is in default in the repayment of any deposits or in payment of interest thereon is barred from making loans, investments or giving any guarantee or security till such default is subsisting.

7. REGISTER OF LOAN

Section 186(9 & 10) of the CA 2013 mandates every company to maintain a register which shall contain particulars of the loan or guarantee given or security provided or investment made. Any company giving loan or giving guarantee or providing security or making an acquisition of securities is required to maintain a register from the date of its incorporation and enter therein separately, the particulars of loans and guarantees given, securities provided and acquisitions made, prescribing strict rules for the maintenance of the register.

8. EXEMPTIONS UNDER SECTION 186 OF THE CA 2013

Exemptions under 186 of the CA 2013 are provided to a loan, guarantee or security provided by any banking/insurance/housing finance company in the ordinary course of its business or a company engaged in the business of financing or of providing infrastructural facilities and to any acquisition made by a non-banking financial company and whose principal business is acquisition of securities. However the exemption to non-banking financial company shall be in respect of its investment and lending activities. Further the exemption provision also extends to any acquisition made by a company whose principal business is the acquisition of securities and in acquisition of rights shares.

CONCLUSION

The flexibility specified in Section 372A of the CA 1956 is no longer available under Section 186 of the CA 2013 for loans and investments. The law makers must have kept in mind some fraud cases wherein inter corporate investments and loans are used as a tool for siphoning of funds within group companies or related firms or companies. This apprehension is the reason for bringing in restriction on layers of investment and other new restrictions as discussed above. Nevertheless, the move towards increased regulation of corporate loans and investments under the CA 2013 shall significantly affect the ability of companies (specifically private limited companies) to access funds.

Crackdown on Wilful defaulters

On January 5, 2014, The Securities and Exchange Board of India (“SEBI”) issued a discussion paper proposing amendments in the SEBI Act, 1992 for imposing further restrictions on wilful defaulters.

The term 'Wilful Default' is defined in the Master Circular ("Master Circular") issued by the Reserve Bank of India ("RBI")dated July 12, 2012.

A "wilful default" would be deemed to have occurred if any of the following events is noted :-

(a) The borrower has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
(b) The borrower has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
(c) The borrower has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the borrower in the form of other assets.
(d) The borrower has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

Under the current regulatory framework (Regulation 4 (2) of the SEBI (Issue of

Capital and Disclosure) Regulations, 2009 (“ICDR”)), awilful defaulter may not access capital markets by way of public issue or rights issue of convertible debt instruments. However, the same restriction is not imposed on the issuance of equity shares / debt security / non-convertible redeemable preferenceshares. The SEBI (Issue and Listing of Debt Securities) Regulations, 2008 ("ILDSR") and the SEBI(Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 (“NCRPSR”), do not barwilful defaulters from accessing capital markets through the issuance of non-convertible debt instruments.

The SEBI in its discussion paper refers to the Master Circular, specifically the penal measures that can be initiated by the banks/lenders against wilful defaulters and comes to the conclusion that the intent and object of the RBI is to contain the financial activities of wilful defaulters, by restricting further bank finance to such entities. The SEBI observes that allowing access to capital markets through the issuance of non-convertible debt instruments helps such wilful defaulters to bypass the restriction of access to bank finance as envisaged in the Master Circular.

The natural conclusion is to impose the same set of restrictions on the issuance of non-convertible debt instruments as are imposed on the issuance of convertible debt instruments by wilful defaulters.

The benefits that the SEBI sees out of such a move are that the exposure in the capital markets to such wilful defaulters will be restricted and the wilful defaulters will also be restricted from taking control in other listed companies thereby protecting more listed companies from the promoter/s /management of such wilful defaulters.

That said, the SEBI has also considered the fact that such a restriction may not be in the interests of the shareholders of the listed company. Ideally, the shareholders should infusefunds in a company if it is in trouble. Shutting down financesfrom own shareholders may well be unreasonable and irrational.

Keeping both points of view in mind, the SEBI has sought public comments on the issue. Whatever the conclusion, the intent of the SEBI is pretty clear. A more stringent set of rules with respect to wilful defaulters and their access to capital markets is expected to follow soon.

Two days after the discussion paper was released by SEBI, the RBI also stepped up its efforts to tighten the noose on wilful defaulters. The updated Master Circular, dated 7th January, 2015, includes various modifications that tighten the leash on wilful defaulters.

The first major change is with respect to what constitutes wilful default. Wilful default includes a situation wherein a *unit has siphoned off the funds so that the funds* *have not been utilised for the specific purpose for which finance was availed of, r are the funds available with the unit in the form of other assets.* Transfer of borrowed funds to subsidiaries /group companies or other bodies corporate now falls within the meaning of siphoning off funds. In essence, transfer of borrowed funds to subsidiaries and group companies is now outlawed.

The other significant change is with respect to the penal measures available against wilful defaulters. The promoters and directors of companies classified as wilful defaulters have now been debarred from being a part of corporate boards. Critics believe that this is an extreme step and could have been avoided.

Further, the RBI has come up with an internal process for the identification of wilful defaulters. The process has been reproduced hereinafter:

(a) The evidence of wilful default on the part of the borrowing company and its promoter/whole-time director at the relevant time would be examined by a Committee headed by an Executive Director and consisting of two other senior officers of the rank of GM/DGM.
(b) If the Committee concludes that an event of wilful default has occurred, it shall issue a Show Cause Notice to the concerned borrower and the promoter/whole-time director and call for their submissions and after considering their submissions issue an order recording the fact of wilful default and the reasons for the same. An opportunity would be given to the borrower and the promoter/whole-time director for a personal hearing if the Committee feels such an opportunity is necessary.
(c) The Order of the Committee would be reviewed by another Committee headed by the Chairman / CEO and MD and consisting, in addition, of two independent directors of the Bank and the Order shall become final only after it is confirmed by the said Review Committee.

All in all, it would be safe to conclude that a stricter regulatory and business environment is on the cards for wilful defaulters.

News 10 @ a glance

Preventive measures by RBI to curb cheque related fraud cases

Reserve Bank of India (RBI) has recently notified detailed preventive measures and procedural guidelines to ensure greater security in the cheque presenting/passing and account monitoring processes. The guidelines are to ensure scrutiny of cheques beyond the threshold of Rs. 2 lakhs. For cheques above the threshold of Rs. 5 lakh shall now require greater monitoring of credits and debits in newly opened transaction accounts based on risk categorization and sending an SMS alert to payer/drawer when cheques are received in clearing.

IRDA amends health insurance regulations and removes free look period for policies having tenure of less than one year. NOTIFICATION F.NO.IRDA/REG/7/90/2014, DATED 19-11-2014

Insurance regulatory and Development Authority (IRDA) has notified that health insurance policies having tenure of less than one year will not have free look period. IRDA has extended the cover to all non-allopathic treatment, only if the treatment was undergone in a government hospital or any institute recognized by Government and/or accredited by Quality Council of India/National Accreditation Board on Health.

Review of Foreign Direct Investment in Construction Development Sector (Press Note No. 10 (2014 Series)

The Foreign Direct Investment (FDI) policy in the ‘Construction Development Sector’ has been amended and now it provides for minimum area to be developed under the projects, FDI being reduced to US$ 5 million from US$ 10 million. It provides easy exit routes to investors. In case of completed projects, 100% FDI under the automatic route is allowed for operation and management of townships, malls/shopping complexes and business centres. This would facilitate investment from abroad within India which is much required for a developing economy like ours.

MCA announces extension of CLSS

Ministry of Corporate Affairs has announced the extension of its Company Law Settlement Scheme till 31.12.2014 and has provided a one time opportunity for defaulting companies to file their statutory documents without prosecution.

General Motors (India) Pvt. Ltd. v Ashok Ramnik Lal Tolat & ANR. [Civil Appeal Nos. 8072-8073 of 2009]

The Supreme Court has observed that punitive damages are awarded against a conscious wrong doing unrelated to the actual loss suffered and thereby held that it cannot be awarded unless specifically pleaded. Punitive damages awarded without any such claim made, is contrary to principles of fair procedure and natural justice.

RBI issued Guidelines for Licensing of "Small Finance

Banks" in the Private Sector

The Reserve Bank of India (RBI) came out with a set of guidelines for Licensing of Small Finance Banks in the Private Sector with a view to facilitate supply of credit to micro and small enterprises, marginal farmers, micro and small industries and other unorganized sector entities and to further provide for agriculture and banking services in unbanked and under-banked regions in the country.

SEBI (Prohibition of Insider Trading) Regulations, 2014

SEBI at its board meeting has approved a new regulation in place of the existing insider trading regulations. The new regulations (2014) widen the scope of the 1992 regulations. The new definition of an "insider" is broader, including within its ambit any "connected person" with access to "unpublished price sensitive information" (UPSI). This also includes relatives of directors, employees and of other persons covered as per the definition of an insider under the 1992 regulations. The new regulation brings in clarity to a lot of concepts and definitions and aligns the insider trading norms with international practices.

SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2014

SEBI at its board meeting approved detailed listing regulations to bring in comprehensive norms for various listed securities. The key features of the new listing regulations include overreaching principles for making disclosures and obligations, Mandatory filing on Stock Exchanges through electronic platform, Mandatory appointment of Company Secretary as compliance officer except for units of Mutual Funds listed on stock exchanges etc. The new regulations provide for converged provisions for specified securities (equity segment) listed on Main Board and SME platform with necessary carve-outs for SMEs. It has been clarified that the new norms would be applicable for equity, non- convertible debt securities, non-convertible redeemable preference shares, Indian Depository Receipts, securitized debt instruments and units issued by mutual fund schemes, among others.

5 years experience a must to be a Supreme Court lawyer: BCI

As per the new Certificate of Practice and Renewal Rules issued in 2014, the Bar Council of India (BCI) has stated that to practice in the Supreme Court an advocate must have a minimum of 5 years of practice in the lower court and High court of India. The object behind the new rule is to ensure credibility and make sure that the advocate has experience of the actual court proceedings and also credibility is ensured. It is further clarified by the BAR that Advocates of all the categories can appear before the Supreme Court but Supreme Court advocates on record (AOR), who have cleared the Supreme Court AOR exam, are only eligible to appear and to plead for a party in the Supreme Court. Non AORs cannot file their matter in Supreme Court without the help of AOR.

Delhi Government presents the final draft of the "Delhi Witness Protection Scheme" before Delhi High Court

The Delhi Government presented before the Delhi High Court its final version of the "Delhi Witness Protection Scheme" to ensure safety of witnesses in the wake of the witness manipulation witnessed in the famous Jessica Lal murder case. The government filed an affidavit before a division bench comprising of Justice Manmohan and Justice N Ramana ensuring that it had enumerated all necessary steps to place guidelines that the prosecution, the police and the other concerned executive agencies must follow for the protection of witness. The scheme includes "witness protection cell", "witness protection fund" and other such relevant provisions. All the steps proposed will first be produced before the cabinet for approval and thereafter the scheme will be sent to the Lieutenant Governor for final approval.