

## LOANS TO DIRECTORS UNDER THE COMPANIES ACT 2013

### Introduction

Section 185 of the Companies Act, 2013 (“**CA 2013**”) has replaced the old provision under Section 295 of the erstwhile Companies Act, 1956 (“**CA 1956**”) which provides for loans to directors of companies in India.

Unlike CA 1956, Section 185 now applies to all companies including private limited companies. Private limited companies were exempted from the ambit of Section 295 of CA 1956. Therefore, it is prohibited for all companies in India to give any loans to its directors or to persons in whom its directors are interested.

CA 2013 has made significant changes to the restrictions relating to provision of loan by a company to its directors. The key changes are as follows:

- Under CA 1956, loans made to or security provided or guarantee given in connection with loan given to the director of the lending public company and certain specified parties required previous approval of the Central Government. However, Section 185 of the CA 2013 imposes a total prohibition on companies providing loans, guarantee or security to a director or *any other person in whom a director is interested*.
- Whilst the restriction contained in the CA 1956 applied only to public companies, CA 2013 has extended this restriction to even private limited companies.
- Banking companies were exempt from the ambit of section 295 of the CA 1956. Exemption is now available from Section 185 of the CA 2013 to company which in ordinary course of business is providing loans, etc and interest is charged at a rate not less than the bank rate provided by the Reserve Bank of India (“**RBI**”). It would be safe to assume that the said phrase is inclined to exempt NBFCs from this provision. However the applicability of the same to investing-cum-operating companies, which often act as the financial muscle for group companies, can also come under one of the exemptions. However, this phrase has not been defined in the Act to provide for appropriate interpretation.
- Loans by holding companies to its subsidiaries and guarantee or security provided by holding companies in respect of loans to its subsidiaries were outside the ambit of CA 1956. However, Rule 10 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides certain exemptions in this regard.

### Person in whom the director is interested

Explanation to Section 185 (1) of CA 2013 provides that the expression “person in whom the director is interested” means-

- Any other director of the lending company, or of the holding company of the lending company;

- Any partner or relative of such director; – definition of relative is spouse, lateral ascendants upto two levels i.e. father & grandfather, mother & grandmother and father includes step father, lateral descendants on the son's side upto two levels i.e son and son's children, daughter (including step daughter), her husband and siblings;
- Any private limited company of which director is a director or member;
- Anybody-corporate at a general meeting of which such director exercises control of at least 25% of its voting power either singly or with other director(s) – which means basically the shareholding of such body corporate because presently in India voting power derives from shareholdings; and
- Anybody-corporate the Board of Directors, managing director or manager of which is accustomed to act in accordance with the instructions or directions of the Board of Directors or director(s) of the lending company.

### **Exemptions**

Proviso to Section 185 (1) of CA 2013 exempts the following:

- Giving any loan to the Managing or Whole-time Director in following manner:–
  - a) As a part of the conditions of service extended by the company to all its employees;
  - b) Pursuant to any scheme approved by members vide special resolution.
- A Company which provides loans in the ordinary course of its business and interest in respect of such loans is charged at a rate not less than Bank rate declared by RBI.

Further, Rule 10 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides the following exemptions to Section 185 of CA 2013 –

- Any loan made by a holding company to its wholly owned subsidiary company for its principal business activities;
- Any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company for its principal business activities; and
- Any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company for its principal business activities.

Thus, on a plain reading of the provision as well as the CA 2013 as a whole, one can come to a conclusion that companies are now permitted to give loans, guarantee or security with respect to a loan taken by a wholly owned subsidiary, if the loan is utilized by such subsidiary for its principal business activities. This has to be contrasted with the position under the CA 1956, which permitted companies to give loans, guarantee or security to any of its subsidiaries which may be utilized by the subsidiary for any purpose.

Moreover, the CA 2013 does not provide any indication as to what activities would

amount to principal business activities of the subsidiary. In view of the above, the ability of associate companies and other subsidiaries to access capital from their parent company shall be restricted. However, CA 2013 permits holding companies to give guarantees or provide security for a loan provided by any bank or financial institution to any of its subsidiaries for its principal business activities.

In ordinary parlance, the 'principal business activity' of a company is understood to be the business as mentioned under the main objects of the Memorandum of Association of a company. It appears that the intention of the legislature is to exempt from the purview of Section 185, such loans and advances which are taken by the subsidiaries from its holding company for the activities relating to its main objects.

### **Conclusion**

Section 185 which was notified in September 2013 has become one of the most debatable sections as far as the interpretation is concerned. The provision deals with guarantees given by the companies, however, such guarantees needs to be distinguished from certain other documents of the same nature like a letter of comfort. Further, the term 'loan' has not been defined which may create confusion while determining transactions which include salary advanced and financial accommodation provided to directors by the companies.

The real test would be of the Judiciary to come to a fair and equitable conclusion in the coming time when applying the test of this provision.

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## **VODAFONE ITAT TAX ISSUE**

Vodafone has been the subject of a number of recent debates concerning the prevailing tax regime in India. The instant case involves the sale of Vodafone's call centre business of Vodafone India to another Indian based company Hutchison Whampoa Properties and an assignment of call options to its group entity Vodafone International in 2007-08. Initially, in 2013, the tax department demanded Rs. 3,700 Crores from Vodafone India. ITAT had directed Vodafone India to deposit 200 Crores till the plea is decided. The primary issue that arose in the present case was that the Arm's Length Principle applicable to international transactions were not followed in this transaction.

In this case, the Bombay High Court had refused to intervene in the matter and directed the Tribunal to hear the case on a day to day basis. In a landmark decision, the Supreme Court reversed the decision of the Bombay High Court and held that the Indian tax authorities did not have territorial jurisdiction to tax the offshore transaction, and therefore, Vodafone was not liable to withhold Indian taxes.

Subsequently, ITAT had directed the Indian tax authority to re-assess the taxable income and the tax to be paid by Vodafone India in the impugned international transaction under dispute. Pursuant to this, the Bombay High Court, in October 2014 ruled in favour of Vodafone India stating that it is not liable to pay the said additional tax demanded by the Income Tax Department. In a recent judgment in December 2014, ITAT has passed a judgment in the 2012 plea by Vodafone India challenging the jurisdiction of the tax department in issuing a draft transfer pricing order adding Rs 8,500 Crores to Vodafone's taxable income for the fiscal year 2007-2008 which comes as a major blow to Vodafone India's ongoing battle with tax authorities in India. In the impugned case, ITAT has held in favour of the Income Tax department stating that assigning Call Options to Vodafone is an international transaction. It upheld the sale of Vodafone's call centre business and added that income out of the sale of call centre business is taxable.

Consequently, ITAT has held that it has the right to exercise its jurisdiction over the Vodafone transfer pricing case. However, Vodafone India is now entitled to appeal from the said order of ITAT before the Bombay High Court hoping for some respite in the continuous tax struggle in India.

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## Investment by Alternative Investment Funds

The Reserve Bank of India has issued a Circular dated December 9, 2014, allowing Securities and Exchange Board of India ("**SEBI**") enlisted Alternative Investment Funds ("**AIF**") to make investments overseas. Prior to the said Circular, domestic Venture Capital Funds ("**VCF**") enlisted under the SEBI Regulations, 1996, were only permitted to invest in equity and equity-linked instruments of off-shore venture capital undertakings ("**VCU**"), subject to an overall limit of USD 500 million for all VCFs aggregately. This position was under Circular No. 49 dated April 30, 2007 and Circular No. 50, dated May 4, 2007 (the 2007 Circulars). Enrolled VCFs looking to invest in equity and equity linked instruments of off-shore VCUs were required to obtain prior approval of SEBI, however no prior approval of RBI was required.

However the SEBI VCF Regulations were repealed under Regulation 39 of the SEBI AIF Regulations, 2012. In view of this, new VCFs shall now be required to register with SEBI as "Category I Alternative Investment Fund – Venture Capital Fund", under the AIF Regulations.

Further, it is pertinent to note that the 2007 Circulars allow investments only in equity and equity-linked instruments of off-shore VCUs and pertain specifically to domestic VCFs, registered with SEBI, under the erstwhile VCF Regulations. However, the AIF Regulations now cover not just VCFs but other investment funds, social sector funds, infrastructure funds, private equity funds, hedge funds, etc. The

reason behind limiting investment opportunities for such AIFs only to equity and equity linked instruments of off-shore VCUs is not clear and the Circular also does not provide any reasons for such a limitation.

A few other negatives have been found in the said Circular. The overall limit of US\$500 million can be considered to be a very small limit. On logical terms, around a 100 AIFs have been already registered with SEBI. Considering the same, if all of them were to invest in off-shore entities, it would only fetch them an investment of about US\$ 5 million.

Prior to the issuance of the Circular, there was no provision in the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (FEMA ODI Regulations) and its circulars, which specifically enabled AIFs to invest in instruments or securities issued by overseas entities. In that sense, the Circular has now fully enabled AIFs to invest overseas without any further amendments required to be carried out to the AIF Regulations. Considering all factors mentioned above, it seems that the Circular has many loopholes and has attempted a narrow approach.

## 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 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 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 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.