

Loans, Guarantees and Investments by a Company: Sections 185 and 186 of the Companies Act, 2013

Description

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Quick summary

- Section 185 bars a company from lending to its directors, their relatives, partners and firms, or giving guarantee or security for their loans. A loan to a company in which a director is interested is allowed only with a special resolution and if the money is used for the borrower's principal business.
- Section 186 limits loans, guarantees, security and investments in other bodies corporate to 60% of paid-up capital, free reserves and securities premium, or 100% of free reserves and securities premium, whichever is more. Beyond that, a special resolution is needed.
- Every such loan, investment, guarantee or security must be approved at a Board meeting by all directors present, and the loan interest rate cannot be below the prevailing government security yield for the tenor.
- Penalties are heavy: Rs 5 lakh to Rs 25 lakh under section 185, and up to Rs 5 lakh for the company with up to two years for officers in default under section 186.

When a company lends money, gives a guarantee, or buys shares in another business, it is using funds that belong to its members and creditors. The Companies Act, 2013 therefore regulates two situations strictly: loans to directors and people close to them (section 185), and loans, guarantees, security and investments in other bodies corporate in general (section 186).

Section 185: loans to directors

The rule (section 185(1)). No company shall, directly or indirectly, advance any loan, including a loan represented by a book debt, or give any guarantee or provide any security in connection with any loan taken by:

- any **director** of the company, or of a company that is its **holding company**, or any **partner or relative** of such a director; or
- any **firm** in which such a director or relative is a partner.

Entities in which a director is interested (section 185(2)). A company may advance a loan, or give a

guarantee or security, for any person in whom a director is interested, only if:

1. a **special resolution** is passed in general meeting, with the explanatory statement disclosing the full particulars of the loan, guarantee or security, the purpose for which the recipient will use it, and any other relevant fact; and
2. the loans are **used by the borrowing company for its principal business activities**.

A person "in whom a director is interested" means: a private company of which the director is a director or member; a body corporate in whose general meeting a director, or two or more directors together, can exercise or control at least **25%** of the total voting power; or a body corporate whose Board, managing director or manager is accustomed to act on the directions of the lending company's Board or of any of its directors.

Exceptions (section 185(3)). The prohibition and the special resolution requirement do not apply to:

- a loan to a **managing or whole-time director** as part of the **conditions of service extended to all employees**, or under a **scheme approved by members by special resolution**;
- a company that in the **ordinary course of its business** provides loans or gives guarantees or securities, and charges interest at a rate **not less than the prevailing yield of the one year, three year, five year or ten year Government security** closest to the tenor of the loan;
- a loan by a holding company to its **wholly owned subsidiary**, or a guarantee or security by a holding company for a loan made to its wholly owned subsidiary; and
- a guarantee or security by a holding company for a loan made by a bank or financial institution to its **subsidiary**.

The wholly owned subsidiary and subsidiary exceptions apply only if the subsidiary uses the money for its **principal business activities**.

Penalty (section 185(4)).

Who	Penalty
The company	Fine of Rs 5 lakh to Rs 25 lakh
Every officer in default	Imprisonment up to six months, or fine of Rs 5 lakh to Rs 25 lakh
The director or other person who received the loan, guarantee or security	Imprisonment up to six months, or fine of Rs 5 lakh to Rs 25 lakh, or both

Section 186: loans and investments in other bodies corporate

Layers of investment companies (section 186(1)). Unless otherwise prescribed, a company makes investments through **not more than two layers** of investment companies (with exceptions for acquiring a foreign company that has more layers under its own law, and for a subsidiary that must have an investment subsidiary under a legal requirement).

The ceiling (section 186(2)). No company shall directly or indirectly (a) give any loan to any person or other body corporate, (b) give any guarantee or provide security for a loan to any other body corporate or person, or (c) acquire securities of any other body corporate by subscription, purchase or otherwise, **exceeding the higher of**:

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

“Person” does not include an individual in the employment of the company. The limit is measured on the **aggregate** of loans and investments made, and guarantees and security given, along with those now proposed (section 186(3)).

Going above the ceiling (section 186(3)). A further investment, loan, guarantee or security that takes the total over the limit needs **prior authorisation by a special resolution** in general meeting. The requirement does not apply to a loan, guarantee or security given by a company to its **wholly owned subsidiary or a joint venture company**, or to an acquisition by a holding company of securities of its wholly owned subsidiary; the details must still be disclosed in the financial statements.

Process and conditions.

- **Disclosure:** full particulars of the loans, investments, guarantees and security, and the purpose for which the recipient will use them, must be disclosed in the financial statements (section 186(4)).
- **Board approval:** the resolution must be passed at a meeting of the Board **with the consent of all the directors present**, and with the **prior approval of the public financial institution** concerned where any term loan is subsisting. That approval is not needed if the limit in section 186(2) is not exceeded and there is no default in repaying that institution (section 186(5)).
- **Interest rate floor:** no loan can be given at a rate of interest **lower than the prevailing yield** of the one year, three year, five year or ten year Government Security closest to the tenor of the loan (section 186(7)).
- **Defaulting companies:** a company in default in repaying deposits or interest on them cannot give any loan or guarantee, provide security or make an acquisition while the default continues (section 186(8)).
- **Register:** a register of loans, guarantees, security and acquisitions is kept at the registered office, open to inspection, and members may take extracts (section 186(9) and (10)).
- **Entities registered with SEBI:** a company registered under section 12 of the SEBI Act, 1992 and covered by the prescribed classes cannot take inter-corporate loans or deposits above the prescribed limit, and must give the details in its financial statements (section 186(6)).

Who is outside most of section 186 (section 186(11)). Except for the layer limit, the section does not apply to loans, guarantees, security or investments made by a banking company, an insurance company or a housing finance company in the ordinary course of business, or by a company set up to finance industrial enterprises or provide infrastructure facilities; nor to investments by an investment company, investments in shares allotted under section 62(1)(a) or in rights issues of a body corporate, nor to investment or lending by an NBFC registered with the RBI whose principal business is the acquisition of securities.

Penalty (section 186(13)). The company is punishable with a fine of Rs 25,000 to Rs 5 lakh, and every officer in default with imprisonment up to two years and a fine of Rs 25,000 to Rs 1 lakh.

Investments in own name (section 187). A company’s investments are made and held in its own name, with limited exceptions such as shares held in a nominee’s name to keep a subsidiary above its minimum number of members, securities held through a depository, and securities deposited with bankers for collection or by way of security.

A checklist before the company lends or invests

1. Is the borrower a director, relative, partner or a firm of a director? If yes, section 185 prohibits the loan unless an exception applies.
2. Is the borrower a company in which a director is interested? Pass a special resolution with the full explanatory statement, and confirm the money goes to the borrower's principal business.
3. Compute the 60% and 100% limits on the latest audited figures, including all existing loans, investments, guarantees and security, and the new amount.
4. Pass the Board resolution with the consent of all directors present; get the lender's approval if a term loan is outstanding.
5. Charge interest not below the Government Security yield for the tenor.
6. Update the register and disclose in the financial statements.

Points to check

- This post follows the Companies Act as published on India Code, including its amendments up to the footnotes in that edition. Rules prescribing the register, the inter-corporate loan limit and layer exceptions were not reviewed.
- Exemptions for private companies and start-ups have been notified from time to time; check the current notifications before relying on one.
- The statutory auditor reports on compliance with sections 185 and 186 under clause (iv) of the Companies (Auditor's Report) Order, 2020.

Frequently asked questions

Can a company give a loan to its director?

Not under section 185(1). No company can directly or indirectly advance a loan, including a loan represented by a book debt, or give a guarantee or security for a loan, to any director of the company or of its holding company, any partner or relative of such a director, or any firm in which a director or relative is a partner. Section 185(3) lists exceptions.

What are the exceptions?

A loan to a managing or whole-time director as part of the conditions of service extended to all employees or under a scheme approved by members by special resolution; a company that lends in the ordinary course of its business at not less than the prevailing government security yield; a loan, guarantee or security by a holding company to or for its wholly owned subsidiary; and a guarantee or security by a holding company for a bank or financial institution loan to its subsidiary, where the money is used for the subsidiary's principal business.

Can a company lend to a company in which a director is interested?

Yes, under section 185(2), if a special resolution is passed in general meeting (with full particulars in the

explanatory statement) and the borrower uses the loan for its principal business activities.

What is the investment limit under section 186?

A company cannot give loans, guarantees or security to, or acquire securities of, other bodies corporate beyond 60% of its paid-up share capital, free reserves and securities premium account, or 100% of free reserves and securities premium, whichever is more, unless previously authorised by a special resolution passed in general meeting.

What approval is needed for each loan or investment?

A resolution at a Board meeting with the consent of all directors present, and the prior approval of the public financial institution concerned where a term loan is subsisting, unless the limits are not exceeded and there is no default to that institution.

What is the minimum interest rate on a loan?

Not lower than the prevailing yield of the one year, three year, five year or ten year Government Security closest to the tenor of the loan.

What are the penalties?

Under section 185: Rs 5 lakh to Rs 25 lakh on the company; imprisonment up to six months or Rs 5 lakh to Rs 25 lakh on every officer in default; and imprisonment up to six months or Rs 5 lakh to Rs 25 lakh or both on the borrower. Under section 186: Rs 25,000 to Rs 5 lakh on the company, and imprisonment up to two years and Rs 25,000 to Rs 1 lakh on every officer in default.

Official sources

- India Code: The Companies Act, 2013 (sections 185 to 187)
- Ministry of Corporate Affairs

Related reading

- CARO 2020: Applicability, Exemptions and the 21 Clauses of the Companies (Auditor’s Report) Order

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