Companies Act Series

May 15, 2014

BORROW, LEND OR INVEST: BEWARE OF COMPANIES ACT 2013

- Companies restricted from making investments through more than 2 (two) layers of investment subsidiaries.
- Loans and investments to group companies made difficult.
- Companies are not permitted to issue treasury stock to a trust with the company as a beneficiary in case of amalgamations.

The Government of India has recently notified Companies Act, 2013 ("**CA 2013**"), which replaces the erstwhile Companies Act, 1956 ("**CA 1956**"). In our series of updates on the CA 2013 ("**NDA CA 2013 Series**"), we are analyzing the key changes and their major implications for stakeholders, by setting out the practical impact of the changes introduced by CA 2013. For a quick look at our analysis so far on the changes brought forth by the CA 2013, please refer to our previous hotlines in this series through this link.

In this hotline, we shall analyse the provisions relating to loans, borrowings and investments under the CA 2013.

KEY CHANGES UNDER THE CA 2013

The provisions relating to loans and borrowings 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 key changes brought about are:

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

The CA 1956 did not impose any restrictions on companies which made investments through multiple layers of investment companies. However, Section 186 (1) of the CA 2013 restricts a company from making investment through more than 2 (two) layers of investment companies. An *investment company* has been defined to mean a company whose principal business is the acquisition of shares, debentures or other securities. These provisions, however, would not apply to (i) a company which acquires any other company in a country outside India, if such other company has investment subsidiaries beyond two layers as per the laws of such country; or (ii) a subsidiary company which has any investment subsidiary for meeting the requirements under any law.

Key Takeaways: The decision to impose a limit on number of investment subsidiaries was taken by the Ministry of Corporate Affairs ("MCA") in the wake of the Purti scam, which exposed the lacunae existing in the Indian corporate regime. Section 186(1) has been introduced with a view to increase transparency in corporate transactions. This restriction is set to significantly affect a variety of corporate transactions in India, especially with respect to companies that operate across multiple sectors with an investment company at the top; a structure common in the real estate and infrastructure sectors. However, since the CA 2013 seems to restrict investment through more than 2 layers of investment companies, it may still be possible to structure investments through companies other than investment companies.

An important concern that has arisen, is regarding the applicability of Section 186 (1) to existing investment structures set up under CA 1956. On plain reading of Section 186(1), it does not appear that the provision was intended to have retrospective operation. Since the CA 2013 does not provide any transitory provisions, it seems unlikely that this provision was intended to apply to existing structures.

II. Restriction on loans to directors and other persons: 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:

1. Under CA 1956, loans made to or security provided or guarantee given in connection with loan given to the director of the lending company and certain specified parties required previous approval of the Central Government. However, section 185 of the CA 2013 which has by far been the most debated section of CA 2013, imposes a total prohibition on companies providing loans, guarantee or security to the director or *any other person in whom the director is interested.*
2. Whilst the restriction contained in the CA 1956 applied only to public companies, CA 2013, has extended this restriction to even private companies.

Key Takeaways: On plain reading of CA 2013, the restriction on providing loans to any other person in whom a director is interested is worded broadly and would apply to subsidiaries and other companies within the same group with common directors. Such restriction would create significant difficulties for companies which provide loans, or guarantee/ security to their subsidiaries or associate companies for operational purposes. The MCA attempted to address this concern by issuing various circulars which complicated the matters further on account of ambiguous language of the circulars. However, with the enactment of the Rules, 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

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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. Further, 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.

III. Loans and borrowings of the company

Inter corporate loans: Section 186 of the CA 2013 restricts a company from providing loans, giving any guarantee or security, or acquiring any securities of a body corporate, exceeding (i) 60% of its paid up share capital, free reserves and securities premium account or (i) 100% of its free reserves and securities premium account, whichever is more. However, a company may overcome such restrictions by passing a *special resolution* at a general meeting. These provisions are substantially the same as contained in Section 372A of the CA 1956. However, the following changes have been made in this regard:

1. Section 372A of the CA 1956 was applicable only to public companies. Section 186 of CA 2013 additionally applies to private companies.
2. While CA 1956 restricted a company from giving any loans to other body corporates, the CA 2013, restricts companies from providing loans to any *person or any other body corporate and hence loans to individuals and other non-corporate entities are also covered.*
3. The CA 2013 requires companies to disclose its loans, investments made, guarantee given or security provided and its purpose, to its members in the financial statement.

The Rules however, prescribe that 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, the company need not pass a special resolution.

Key Takeaways: The restrictions imposed on inter corporate loans is viewed largely as a move to usher in accountability in corporate transactions. The MCA has attempted to bring the Indian corporate legal regime in line with global best practices, by increasing shareholder participation in affairs that directly affect the finances of the company. CA 2013 also mandates increased disclosure norms to increase transparency in commercial dealings.

The CA 2013 does not indicate that the provisions of Section 186 are retrospective. Rule 13 (1) of the Rules, however, provides that a special resolution would have to be passed within 1 (one) year from the date of notification of these provisions. The true intent of Rule 13 (1) seems unclear, since public companies were already required to pass a special resolution before providing any loans in excess of the specified limits. It is possible to interpret Rule 13 (1) to mean that private companies would be required to pass a special resolution within a period of 1 (one) year if the loans advanced by them exceed the specified limits, even if such loan was taken prior to the enactment of CA 2013. A clarification from MCA would be required to clarify the true import of Rule 13 (1).

Deposits: The provisions relating to deposits are set out in Chapter V of the CA 2013 read with the Companies (**Acceptance of Deposits by Companies**) Rules, 2014 ("**Deposits Rules**"). CA 2013, like the CA 1956, provides that a *public company can accept deposits from its members and other persons*, while *private companies can accept deposits only from its members* (it should be noted that CA 1956 permitted a private company to accept deposits from members, directors or their relatives also). The definition of "deposit" as provided under the CA 2013 and the Rules specifically indicate that loans obtained by a company shall also be considered to be a deposit.

While the CA 1956 permitted public companies to accept deposits only in compliance with the Companies (Acceptance of Deposits) Rules, 1975, it did not include elaborate requirements for acceptance of deposits by private companies. However, the CA 2013 now states that a company may accept deposits from its members *only* on fulfillment of certain detailed requirements. Some of the requirements include issuance of a circular to the members of the company, filing of the circular with the Registrar of Companies ("**RoC**"), maintenance of a separate bank account (deposit repayment reserve account) etc. Every loan made by a member to the company shall be subject to the requirements set forth in Chapter V and the Deposit Rules. However, the Deposits Rules specifically exempt loans provided by directors of a company from the definition of "deposit", if such director furnishes a declaration to the effect that the loan is not being given out of borrowed funds. For more details on the provisions relating to deposits under the CA 2013, please refer to our previous hotline through this link.

Key Takeaways: Private companies would be severely restricted in accepting deposits from its members. While the elaborate requirements under the CA 2013 shall ensure greater accountability and ensure more credibility on the company regarding repayment of deposits, it may be counterproductive as private companies may be unable to easily access capital from their members.

Restriction on companies on giving loans for purchase of its shares: The provisions in the CA 2013 restricting a public company from giving any financial assistance for purchase of its own shares are set out in Chapter IV of the CA 2013 and the Companies ("**Share Capital and Debenture**") Rules, 2014 ("**Debenture Rules**"). The following key changes have been made in this regard:

1. CA 1956 permitted public companies to provide loans for the purchase of fully paid up shares by trustees for and on behalf of the company's employees (employee share scheme). The CA 2013 also permits companies to do so, however subject to a *special resolution*, and certain other requirements, including the requirement that shares have to be valued by a registered valuer.
2. Unlike the CA 1956, the CA 2013 does not permit directors holding salaried office or employment to be the beneficiaries of the trust holding the company's shares funded by way of loan from the company.
3. Voting rights not exercised directly by employees in respect of the employees share scheme is required to be disclosed in the report of the board of directors.
4. The penalty for non-compliance with these provisions has been substantially increased. The CA 2013 states that an officer in default shall be liable for imprisonment upto 3 (three) years and shall be subject to a fine ranging

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between INR 100,000 (Rupees one hundred thousand) and INR 2,500,000 (Rupees two million five hundred thousand only);

Key takeaways: The restriction imposed on companies for purchase of its own shares is a basic principle of company law. The object is to prevent a permanent reduction of liquid assets caused due to payment for shares being made from the accumulated assets of the company itself. The CA 2013 has recognized the importance of this provision in protecting the rights of shareholders, and has increased the requirements for transparency in the functioning of the company, by ensuring greater disclosure requirements and enhanced penalties. Further, Section 67 of CA 2013 has also plugged the loophole that existed under Section 77 of CA 1956 on issuance of treasury stock to a trust with the company as a beneficiary in case of amalgamations. Such trusts cannot be created under the CA 2013 since such trusts can only have employees as the beneficiaries.

Debentures: Provisions relating to debentures are set out in Chapter IV of the CA 2013 and the Debenture Rules. CA 2013 has introduced the following key changes to the provisions relating to debentures:

1. Secured debentures may only be issued by a company subject to the conditions set out in the Debenture Rules. Some important conditions that a company is required to fulfill include:
   - The date of redemption of the secured debentures should not exceed 10 (ten) years from the date of its issue; however, with respect to infrastructure companies, secured debentures may be issued for a term of upto 30 (thirty) years;
   - The charge on the assets or properties should have a value sufficient for repayment of amount of debentures and the interest;
   - A debenture trustee must be appointed before issue of prospectus or letter of offer for subscription of debentures;
   - A debenture trust deed must be executed within 60 (sixty) days of the date of allotment;
2. CA 1956 made the appointment of a debenture trustee mandatory in every public offer regardless of the number of persons to whom the offer was made. Under the CA 2013, appointment of debenture trustee is compulsory only when the prospectus is issued to more than 500 persons for subscription of debentures.

Key takeaways: The CA 2013 has consolidated the various provisions under CA 1956 regarding the issue of debentures of a company. Secured debentures have become subject to a variety of rules, indicating the shift towards protecting the rights of debenture holders.

CONCLUSION

CA 2013 demonstrates the systemic move towards greater regulation of corporate transactions in India with a view to facilitate increased accountability. CA 2013 has introduced greater disclosure and compliance requirements in regulating access of capital by companies via loans and borrowings. The enhanced standards aim at protecting the rights of the all stakeholders, specifically by facilitating greater shareholder participation when companies obtain / provide loans. However, the move towards increased regulation of corporate loans and borrowings under CA 2013 shall significantly affect the ability of companies (specifically private companies) to access funds.

– Corporate Team

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