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An e-newsletter from
Lakshmikumaran & Sridharan, New Delhi, India

January 2015 / Issue – 42

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Article

Holding-subsidiary loans prohibition - Respite under company law

By **Dinesh Babu Eedi**

Prelude

On 2nd December, 2014, the Union Cabinet, approved the Companies (Amendment) Bill, 2014 ('Amendment Bill') for introduction in Parliament (Lok Sabha) to make certain amendments in the Companies Act, 2013 ('2013 Act'). The 2013 Act was brought into force partly on 12th September, 2013, and on 1st April, 2014, of 470 Sections of the 2013 Act, 283 Sections and 22 sets of related rules have been brought into force so far. The Amendment Bill was drafted with the intent to improve the "ease of doing business" by correcting certain lacunae, clarifying issues and addressing concerns raised by industry on the 2013 Act.

Proposed amendment

The Amendment Bill seeks to clarify the issues on Section 185 of the 2013 Act, which deals with the issue of loans to the Directors by their companies. For the purpose of easy reference, the proposed amendment to the above referred Section is as follows:

> In section 185 of the principal Act, in sub-section (1), in the proviso, after clause (b), the following clauses and proviso shall be inserted, namely
>
> "(c) any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company; or
>
> (d) 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:
>
> Provided that the loans made under clauses (c) and (d) are utilized by the subsidiary company for its principal business activities".

The existing Section 185 – 2013 Act

Section 185 of 2013 Act, contains a blanket prohibition on companies from giving loans, guarantee or security to its directors or '*any other person in whom the director is interested*'.

The only exception to the above mentioned blanket prohibition is that the restriction contemplated under Section 185 is not applicable to the loans given to a managing director or whole-time director consequent to the conditions of services extended by the company to all its employees or pursuant to any scheme approved by the members through a special resolution. Section 185 also does not apply to companies which provide loans or give guarantees in the ordinary course of its business as long as interest not less than the bank rate declared by the Reserve Bank of India is charged.

The entities/person covered in the ambit of '*any other person in whom the director is interested*' is exhaustive and means:

a) Any director of the lending company, or of a company which is its holding company

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or any partner or relative of any such director;

(b) Any firm in which any such director or relative is a partner;

(c) Any private company of which any such director is a director or member;

(d) Any body corporate at a general meeting of which not less than twenty five per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or

(e) Any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.

Since all subsidiary companies would be required to act on the directions/instructions of the Board of the lending company, Section 185(e) seemed to include in its prohibition the giving of loans, securities and guarantees provided by holding companies to its subsidiaries.

However, related Rule 10 of the Companies (Meetings of Board and its powers) Rules 2014, clearly envisaged and exempted from the restrictions of Section 185:

(a) loans, guarantees or security given by a holding company to its wholly owned subsidiary and

(b) guarantees and securities provided by holding companies to its subsidiaries with respect to loans given by a bank or a financial institution.

The issuance of the rule created more confusion than clarification since a rule cannot override the provisions of the Act and further a distinction, whether intended or not was carved out for loans to wholly owned subsidiaries and guarantees and security for subsidiaries (not necessarily wholly owned). This led to an unusual situation of loans by holding companies to subsidiaries not permitted by allowing guarantees and security.

Further, Section 185 is applicable only when a 'company' gives loan to its director or any person in whom the director is interested. However, the definition of a 'company' under Section 2(20) means only a company incorporated under 2013 Act or any previous company law. So, the restriction in Section 185 will not apply when a holding company incorporated outside India gives a loan, guarantee or security to its Indian subsidiary.

Section 185 & 186 of 2013 Act – The unanswered issues

Previously, Section 295 of the Companies Act, 1956 ("1956 Act") required public companies or private companies which were subsidiaries of public companies to obtain central government's approval for granting loans, guarantee or security. However, the said section was not applicable to private companies or to such transactions provided by a holding company to its subsidiary. Whereas, the corresponding Section 185 of the 2013 Act applies to all companies irrespective of a company being a private or a public company and levies a blanket prohibition on loans to directors by any of such companies, except under the exception cited hereinabove.

Further, Section 295 of 1956 Act in addition

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to the exceptions provided therein, also carved out an exception for the banking companies from the applicability of such Section. Whereas, Section 185 instead of limiting the exception to banking companies, had widened the exception to include the companies giving loans, guarantee or security in their '*ordinary course of businesses*' and had thereby included entities such as non banking financial companies into the small bracket of exceptions.

The most important difference is that, Section 295 had in itself contemplated an exception to the loans given, guarantee or security provided for a loan, to subsidiary company by the holding company. Whereas, Section 185 prohibits such transaction merely if a director of the holding company is a director of the subsidiary as well.

It is relevant to note that Section 2(87) of 2013 Act defines the term 'subsidiary/Subsidiary Company' to mean 'a company in which the holding company control the composition of the Board of Director or exercises/controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies'.

Section 185 was brought into force through notification on 12th September 2013[1] and Section 186 which corresponds to Section 372A of 1956 Act dealing with Inter-corporate loans and investments was brought into force on 1st April, 2014[2]. Further, as the concept of providing loans, security and guarantees by the holding company to the subsidiary is a common business practice in India, introduction of Section 185 had put the Indian companies in distress. As a temporary fix, clarifications were issued by the Ministry of Corporate Affairs initially in November, 2014[3] and finally on 14th February 2014[4]. The said clarification had addressed the issue of applicability of Section 185 of the 2013 Act by exempting Section 372A of the 1956 Act from its ambit. By way of the said clarification, the Ministry stated that Section 372A would stay in force till Section 186 of the New Act is notified and thereby had harmonized the provisions of Section 185 and 372A.

On principle grounds this blanket prohibition under Section 185 received quite a negative response from the industry. Understanding the nature and intent of Section 185, there seems no reason to justify prohibition of loan, guarantee or security transactions between holding and subsidiary companies merely if a director of the holding company is a director of the subsidiary as well. Section 185 seeks to curb the misuse of powers by the directors, so that they do not siphon away the company's funds. On the contrary, helping out a subsidiary company in general, does not benefit personal interest, unless the subsidiary company itself has been set up as a sham to siphon the funds to personal accounts through such channel. In genuine transactions, if the subsidiary does well, it is ultimately for the benefit of the holding company itself, and this

[1] MCA Published in the Gazette of India, dated 12th September 2014
[2] The Gazette of India, Extraordinary, Regd. No. D.L.-33004/99, dated 26th March 2014
[3] MCA General Circular No.18 of 2013 dated 9th November 2013
[4] MCA General Circular No. 3 of 2014 dated 14th February 2014

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would help in developing the overall business of the company.

In the present situation where Section 185 and 186 both stand notified and by virtue of Section 186 in operation its predecessor Section 372A stands repealed, there is no scope in the present provisions of 2013 Act to provide for such transactions as between the holding and subsidiary company which have a director in common, to be valid. However, the Rules for Chapter XII[5] that came into operation along with Section 186 on 1st April 2014, provided that -

> "(11) Where a loan or guarantee is given or where a security has been provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition is made by a holding company, by way of subscription, purchase or otherwise of, the securities of its wholly owned subsidiary company, the requirement of sub-section (3) of section 186 shall not apply. Provided that the company shall disclose the details of such loans or guarantee or security or acquisition in the financial statement as provided under sub-section (4) of section 186"[6]

It is relevant to note that the said rules and the exemption contemplated therein had added to the woes of the industry. On one hand, the principal provisions of the 2013 Act i.e. both 185 and 186 do not per se allow loans, guarantee or security for subsidiary companies in cases where i) the directors are interested and ii) beyond 60% of the paid-up of share capital of the holding company respectively. However, as against the bar contemplated by the above sections, the above extracted Rule had carved out an exemption for such loans if Sub-Section (4) of Section 186 is complied with.

Thus, the legislature seems to have realized that such an intricate issue is to be resolved and had proposed to insert the amendment extracted herein above into Section 185.

Issues in relation to the proposed amendment

The Amendment Bill provides exemption for loans made by holding company to its wholly owned subsidiaries and guarantees/securities provided by the holding company in respect of loans made to its wholly owned subsidiary company. The Amendment Bill also states that the guarantees/securities provided by a holding company in respect of loan made by bank or financial institution to its subsidiary company are exempted.

It is relevant to note that 2013 Act did not provide any specific definition defining the term 'wholly owned subsidiary'. It is a natural proposition that all wholly owned subsidiaries are subsidiaries but all subsidiaries may not be wholly owned subsidiaries. Therefore, in accordance with the aforesaid proposed amendment, it is clear that the exemption is only for the loans made by the holding company to its wholly owned subsidiaries and not to include the 'subsidiaries' as defined in 2013 Act. It is also relevant to note that the proposed exemption is not covering the subsidiaries incorporated outside India.

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[5] The Gazette of India, Extraordinary, Regd.No. D. L.-33004/99, dated 31st March 2014

[6] *Ibid.*

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It may be noted that the purpose mentioned for the aforesaid amendment of Section 185 in the Amendment Bill approved by the Cabinet is 'as a matter of abundant caution'. The Hon'ble Supreme Court had categorically held in *Addl. District Magistrate (Rev.) Delhi Administration* v. *Shri Siri Ram*[7] that the exemption should come under the Act itself and Rules should not provide what is not provided in the Act. Therefore, in order to avoid judicial review of constitutional validity of the Rules, the said amendment is necessary rather than being merely cited as 'as an abundant caution'.

The Draft Amendment Bill ought to have covered above issues to overcome the problems faced by India inc. and put the uncertain issues under Sections 185 and 186 to rest.

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Notifications & Circulars

Cost audit provisions amended: Companies, including foreign companies, engaged in the production of specified goods or in provision of specified services, and having overall turnover of Rs. 35 crore or more during the preceding financial year have to now include cost records in their books of accounts. The new Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 as substituted by Notification dated 31-12-2014 of the Ministry of Corporate Affairs, also gives a table listing 6 regulated industry sectors and 33 non-regulated sectors required to have cost records of their production and services. The erstwhile Rule 3 had a different threshold limit for every industry. According to the new rules, these provisions will however not be applicable in respect of companies classified as micro or small enterprises.

Further, in respect of regulated sectors, such cost records are to be mandatorily audited if overall turnover from all products and services is more than Rs. 50 crore and the aggregate turnover of specified products and services is more than Rs. 25 crore. The limit is Rs. 100 crore and Rs. 35 crore respectively in respect of non-regulated sectors according to newly substituted Rule 4. This requirement of audit of cost records is however not applicable for companies operating in SEZs or whose revenue from exports exceeds 75% of total revenue. Forms CRA-1 and CRA-3 relating to items of costs to be included in the books of accounts and that relating to cost audit report, have also been substituted by Companies (Cost Records and Audit) Amendment Rules, 2014.

SEZ – Dual use of infrastructure permitted in non-processing area in SEZ: Ministry of Commerce and Industry has allowed dual use of non-processing area in the Special Economic Zones with effect from 2-1-2015. According to the newly inserted Rule 11A in the Special Economic Zones Rules, 2006, the non-processing area can be divided into two parts, wherein social or commercial infrastructure and facilities in one part can be used both by SEZ entities and entities present in the domestic tariff area, while facilities in the other area are to be used only by SEZ entities.

In respect of facilities where dual use is permitted,

[7] AIR 2000 SC 2143

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the new provisions disallow exemptions, concessions, or drawback for creation of such infrastructure and states that customs duty, central excise duty and service tax and such other tax benefits already availed for creation of such infrastructure have to be refunded by the developer along with interest. The new provisions, inserted by Notification No. G.S.R. 5(E), dated 2-1-2015, further provide norms with respect to areas earmarked for residential, commercial and other social facilities for the purpose of dual use. It may be noted that now schools, colleges, socio-cultural centres, training institutes, banks, post office, etc., are also allowed in such SEZ non-processing areas.

SEBI (Prohibition of Insider Trading) Regulations, 2015, notified: Securities and Exchange Board of India has notified new set of regulations, to put in place a framework for prohibition of insider trading in securities. As per the new Regulations, 'insider' means a connected person or a person having access or possession of unpublished price sensitive information. It may be noted that according to the note below the definition of 'insider', anyone in possession of or having access to unpublished price sensitive information should be considered an 'insider' regardless of how one came in possession of or had access to such information. A long definition of 'Connected person' is also provided in the new Regulations to cover any person directly or indirectly associated with the company on basis of contractual, fiduciary or employment relationship. Frequent communication with the officers of the company by any person can also make that person connected with the company. The new Regulations notified on 15-1-2015, and coming into force after 120 days, also contain 'note' after number of provisions, explaining the intent and objectives of the particular clause, etc.

Wilful defaulters not to include non-promoter/non-whole time directors: Reserve Bank of India has modified its Master Circular relating to willful defaulters. RBI Circular as updated on 7-1-2015 in this regard states that in view of the limited role of non-promoter/non-whole time directors (Nominee and Independent Directors) in the management of a company's debt contracts, their names shall be excluded from the list of willful defaulters. This exclusion however will not be applicable in rarest circumstances where it is conclusively established that the director was aware of the fact of wilful default or when the wilful default had taken place with his consent or connivance. The circular also prescribes detailed procedure for identification of non-promoter/non-whole time director as a wilful defaulter.

ECBs – Security can be provided by creating charge on immoveable assets: Reserve Bank of India has relaxed conditions for External Commercial Borrowings. According to RBI A.P. (DIR Series) Circular No. 55, dated 1-1-2015 issued for the purpose, creation of charge on immovable assets, movable assets, financial securities and issue of corporate and / or personal guarantees in favour of overseas lender / security trustee, may be allowed by the AD Category-I banks subject to satisfaction of certain conditions in this regard. This circular also specifies separate conditions for creation of charge on immovable assets, movable assets, financial securities and for issuance of corporate or personal guarantee.

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Ratio Decidendi

Director's liability – 'Alter ego' and attribution of acts of companies: The Supreme Court of India has held that when the company is the offender, vicarious liability of the Directors cannot be imputed automatically, in the absence of any statutory provision to this effect. The Court in this regard set aside the Order of the special magistrate which had treated Managing Directors of specified companies as "alter ego" of their respective companies and had held that the acts of the companies are "to be attributed and imputed to them". The court in the order impugned before the Apex Court had found that the appellants (Directors) were prima facie, controlling the affairs of the said three companies and, therefore, represented the directing mind and will of each company. Noting that the principle of 'alter ego' was applied in number of earlier judgements to impute the criminal content to the body corporate and not *vice versa*, the court held that otherwise there has to be a specific act attributed to the Director or any other person allegedly in control and management of the company, to the effect that such a person was responsible for the acts committed by or on behalf of the company. It was observed that the impugned order had not recorded satisfaction of the magistrate, by mentioning the role played by the Directors which would bring them within criminal net.

Further, noting the importance of the words 'sufficient grounds for proceeding' appearing in the provisions, the court held that the order is liable to be set aside if no reasons, not necessarily detailed, are given therein while coming to the conclusion that there is *prima facie* case against the accused. It was observed that these words amply suggest that an opinion is to be formed only after due application of mind that there is sufficient basis for proceeding against the said accused, and formation of such an opinion is to be stated in the order itself. The court in this regard also observed that a person ought not to be dragged into court merely because a complaint has been filed. [*Sunil Bharti Mittal* v. *Central Bureau of Investigation* –Criminal Appeal 34/2015, Judgement dated 9-1-2015, Supreme Court]

Status of secured creditor not altered unless charge explicitly extinguished: The Supreme Court of India has held that a charge created under Section 125 of Companies Act, 1956 shall not be extinguished unless the arbitration award explicitly says so. It was held that the consent award in an arbitral proceeding would not bar a suit for enforcement of the charge and it would not be hit by Order II, Rule 2 Code of Civil Procedure, and that in the absence of proceedings for satisfaction or release of charge under Section 138 and 139 of Companies Act, 1956, the status of the company as a secured creditor continues. The respondent company here had availed a short term loan facility from the petitioner. The respondent company offered security in the form of first and exclusive charge on certain receivables. A deed of hypothecation was accordingly executed by the parties and relevant documents for creation of charge were filed with the Registrar of Companies. When the respondent company failed to repay the loan, the parties referred the matter to arbitration.

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The arbitration award decreed that the award was passed on consent and provided for settlement of money claim by issue of post dated cheques. The respondent company further filed for scheme under Section 391-394 of Companies Act, 1956. The petitioner filed various objections to the scheme. The respondent company had contended that based on the arbitration award, the petitioner was only an unsecured creditor since the deed of hypothecation was extinguished based on the arbitration award and hence, the consent of the petitioner was not required for the scheme. [*Infrastructure Leasing & Financial Services Limited* v. *B.P.L. Limited* - Civil Appeal No. 2701 of 2006, decided on 9-1-2015, Supreme Court]

Sick company – Power of Registrar/ Secretary to adjudicate application before BIFR: Setting aside the order of the Registrar, Secretary and that of the Chairman, Board for Industrial and Financial Reconstruction (BIFR), the Delhi High Court has held that when the Registrar or the Secretary, is of the opinion or view that the company making the reference is not a sick industrial company and therefore reference should not be registered, they need not register the reference but refer the matter to the Board. It was further held that in case the Chairman finds that there is a dispute on registration of reference requiring adjudication on merits, the matter should be referred to the Board for appropriate decision. It noted that the Act recognises the Board as the adjudicating authority for all disputes and the office of the Registrar or the Secretary are not regarded as adjudicating authorities. [*Zenith Infotech Ltd.* v. *Union of India* - W.P.(C) 3437/2014, decided on 23-12-2014, Delhi High Court]

Arbitration – Jurisdiction of foreign court: Calcutta High Court has held that *prima facie*, a dispute if arbitrated upon, can never be called 'settlement' of a dispute in the sense used in the clauses of the agreement in the dispute. The agreement here stated that 'in case the parties do not settle the dispute by mutual agreement, then it will be settled under the competence of the Law Court of Rome, Italy'. The court in this regard held that reference of arbitration cannot be called "settlement of disputes" in terms of this clause and hence the Courts of Rome could only be utilized for "settlement process" here. Further, noting that proceedings in India as well as in Italy were pending at the same point of time, the court directed the Italian company to take no steps to execute the decree, in case any order is passed by the Italian court, till a decision is made by the Calcutta High Court. [*Modern Malleables Ltd.* v. *Nuova Elettromeccanica Sud. S.P.A.* – Judgement dated 11-12-2014 in AP No. 855 of 2013, Calcutta High Court]

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