
LOANS TO DIRECTORS: AN ANALYSIS UNDER THE COMPANIES LAW

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ABSTRACT

Under the companies act of 2013, loans granted to directors is one of those provisions which, although, under the law has been provided as a restrictive measure in the concerned provision of section 185, yet, the provision itself provides for certain exceptions which makes the facility available, subject to certain conditions. Since the directors of a company hold the power to run the business in their preferred direction, such a restriction is provided to prevent the misuse of any company funds and the arbitrary abuse of the power. The provision can be seen to loosen its restrictions as it proceeds. The stringency of the law does not follow up to obstruct the ordinary running of a business, so there are reasonable relaxations that are also provided as exceptions under the conditions of provision which altogether acts as a system of check so that the relaxation provided is not exploited to their self-interest. The provision can be seen to have missed out on mentioning some of the aspects under the prohibition or the exception. With the enforcement of section 185, the intention of the legislation can be seen to provide a security shield to the rights of the shareholders and protect the company's best interest at the same time. This article aims at shedding some light on the provision of loan to directors.

Keywords: Loan, directors, Subsidiary, Partially-owned.

INTRODUCTION

In the regular course of a business, financial transactions constitute a big part of it. Granting loans, and providing guarantees or securities are those financial aspects of business that are important in the day-to-day affairs of a company. The directors should not be encouraged to avail the facility of securing any loans, or any guarantees from their companies, and so they should be allowed only to seek the considerable remuneration or sitting fees only¹. The Companies Act of 2013 has been incorporated with section 185² which deals with the provision related to these advances or guarantees given to a director of a company and other person in whom the director of the lending company may be interested in, and thus, it ensures that an insulation exists between the company and the directors in case of any potential conflict of interest to protect the best interest of the company.³

WHAT IS A LOAN?

The term “**Loan**” has not been defined under the Companies Act of 2013. According to the Black’s Law Dictionary, the term “loan” has been defined as “**an act of lending or a grant of something for temporary use**”⁴. The judicial pronouncement by the Hon’ble Bombay High Court in the case of *Dr. Freddie Ardeshir Mehta v Union of India*⁵ has provided the following definition of a loan: “*It is a thing lent, something the use of which is allowed for a time, on the understanding that it shall be returned or an equivalent amount especially a sum of money lent on these conditions and usually with interest. The essential requirement of a loan is the advance of money or some other article upon the understanding that it shall be returned and may or may not carry interest.*”⁶

Section 185 applies to both types of loans, that is, direct loans and indirect loans. A direct loan is provided to either a director or his relative or a firm of which he is a partner. Due to the absence of a definition of the term “indirect loan” in both, the Companies Act, 2013 and the

¹ MINISTRY OF CORPORATE AFFAIRS,

<https://www.mca.gov.in/Ministry/reportonexpertcommitte/chapter5.html> (last visited July 3, 2023).

² The Companies Act, 2013, § 185, No. 18, Acts of Parliament, 2013 (India).

³ Ramaswami Kalidas, *Loans to Directors under Section 185 of the Companies Act, 2013- Some perspectives*, TAXMANN (Aug. 18, 2021) <https://www.taxmann.com/research/company-and-sebi/top-story/10501000000020820/loans-to-directors-under-section-185-of-the-companies-act-2013-some-perspectives-experts-opinion?amp=1>.

⁴ *Black’s Law Dictionary*, (9th ed. 2009).

⁵ [1991] 70 Comp Cas 210 (Bom.).

⁶ *Supra* note, 4.

General Clauses Act, 1897, it can be seen that an indirect loan is one in which the beneficiary of the loan is either the director or the relative but there exists someone who fronts for them instead of that person, therefore, there exists no direct nexus in-between the lender and the borrower.⁷

CAN A LOAN BE GRANTED UNDER SECTION 185?

According to Sub-section (1) of Section 185, no company **shall** provide any loan, irrespective of it being directly or indirectly, to any of its directors of the company, or of a company which is its holding company, or to any partner, or to a relative of such a director, or any firm in which such director or his relative is a partner.⁸ Loans that are provided to the directors of the holding company are also covered under section 185 as a prohibition, but the provision does not mention anything concerning the directors of the subsidiary of the lender company, and also, section 185(3)(c)⁹ allows the company to grant any loan made by a holding company to its wholly-owned subsidiary company, but the provision cannot be seen to mention anything concerning the partially owned subsidiary company.¹⁰

Not only under the Companies Act, but also as per the notification of the **Reserve Bank of India (RBI), The Banking Regulation Act, 1949** has also been amended concerning the loans granted to directors. Subject to exceptions, according to the concerned notification, the Primary (Urban) Co-operative Banks (UCBs) are not allowed to grant or even renew any loans or advances or surety of any guarantee to or on behalf of their directors, or their relatives, or to the concerned companies in which the directors or their relatives have a vested interest. The term ‘**advances**’ mentioned above, as per the same notification, shall include all types of funded or working capital limits such as cash credits, overdrafts, credit cards, etc.¹¹

Section 185(1)¹² of the Companies Act is a restrictive provision but sub-section 2¹³ of the same permits the grant of loans to “**any person in whom any of the directors of the company is interested**”. The term, as per the respective clause includes a private company in which a

⁷ Supra note, 3.

⁸ The Companies Act 2013, § 185(1), No. 18, Acts of Parliament, 2013 (India).

⁹ The Companies Act, 2013, § 185(3)(c), No. 18, Acts of Parliament, 2013 (India).

¹⁰ Supra note, 3.

¹¹ RESERVE BANK OF INDIA, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12019&Mode=0>, (last visited July 3, 2023).

¹² The Companies Act, 2013, § 185(1), No. 18, Acts of Parliament, 2013 (India).

¹³ The Companies Act, 2013, § 185(2), No. 18, Acts of Parliament, 2013 (India).

director is a member or a director, or any body corporate in which at least twenty-five percent of voting power is in the hands of the concerned director. However, this grant is subject to certain compliance with two requirements. Firstly, a special resolution shall be passed in the general meeting. As per *section 118(10) of the Companies Act*¹⁴, every company shall observe the secretarial standards with respect to general and board meetings, thus as per the Secretarial Standards-1, i.e., Secretarial Standards on Meetings of the Board of Directors, issued by **The Institute of the Companies Secretaries of India** is enforceable, according to which the *Annexure-A* provides a list of items which are required be placed before the Board at its Meeting, and not be passed just by a circulation. In that list, one of the items is provided as “**Granting loans or giving guarantee or providing security in respect of loans**”. Therefore, a resolution is mandatory by the Board of Directors. As per *section 102 of the Companies Act*¹⁵, an explanatory statement shall be annexed to the notice of the general meeting, and so, that statement shall contain all the information which is related and material to the concerned loan. Secondly, the concerned loan shall be made to use by the borrowing company for its principal business activities, that is, in the ordinary course of business only. Since the above two requirements are not mutually exclusive to each other as the word “**and**” has been used in section 185(2)¹⁶, therefore, both of them shall be satisfied.

With respect to the second requirement. the term “ordinary course of business”, as per in the case of *Unisys corporation v. Hercules Incorporated et al.*¹⁷, the Appellant Division of the Supreme Court of the State of New York held that “*Something which is done as a matter of corporate historical practice is, as a matter of law, done in the ordinary course of business*”. What constitutes “**Principal Business**” are the activities that are in nexus with the company’s objective as per its Memorandum of Association, and there should be the motive of profit generation¹⁸. In the case of *The sole trustee, Lok Shikshana Trust v. The Commissioner of Income Tax, Mysore*¹⁹, the Hon’ble Supreme Court of India held that in a business, “profit motive” should be there. Profit motive does not mean that profit must in fact be earned, nor it means a mere desire to earn monetary gains. “*It predicates a motive which pervades the whole*

¹⁴ The Companies Act, 2013, § 118(10), No. 18, Acts of Parliament, 2013 (India).

¹⁵ The Companies Act, 2013, § 102, No. 18, Acts of Parliament, 2013 (India).

¹⁶ The Companies Act, 2013, § 185(2), No. 18, Acts of Parliament, 2013 (India).

¹⁷ 24 A.D. 2d 365 (1996) : 638 N.Y.S 2d 461.

¹⁸ C.R DUTTA, Company Law 2.1729 (7th ed. 2017).

¹⁹ AIR 1976 SC 10.

series of transactions effected by the person in the course of activity.”²⁰

Clause (c) of sub-section 2 of section 185 includes a body corporate, or a board of directors, the managing director, or the manager, who is accustomed to act in accordance with the instructions or directions of the board, or any director of the lending company²¹ under the category of any person in whom director is interested. The term “***accustomed to act according to the directions or instructions of***” has not been defined in any of the acts, neither in the 1956 one, nor in the 2013 one. One of the interpretations of the term has been provided by the English Court in the case of “***Secretary of State for Trade and Industry v. Laing and others***”²² in which the hon’ble court emphasized the term and held that, in relation to a company, a “**shadow director**” means *a person in accordance with whose directions or instructions the directors of the company are accustomed to act*. To satisfy whom all may fall under the category of a “shadow director”, some tests were set in the case of ***Re Hydrodam (Corby) Ltd***²³,

1. Who are the directors of the company, irrespective of them being *de facto* or *de jure*;
2. Directors were directed to act in relation to the company by such person;
3. The directors act in accordance with the directions given;
4. The director of the borrower is accustomed to act. The court stated that what is needed is first, a board of directors claiming to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgement of its own, but acted in accordance with the directions of others only.

Therefore, to exercise the exemption under section 185(2)(c)²⁴, the lending company’s directors or the board itself can be said that it would be acting as the shadow directors of the borrowing company.

Sub-section 3 of section 185 can be seen to be an exception to the sub-sections (1) and (2) as it clarifies that the restrictive provision does not apply to grant of any loan to a managing director or even a whole-time director who is provided such loan under the conditions of service

²⁰ The sole trustee, Lok Shikshana trust v. The Commissioner of Income Tax, Mysore, AIR 1976 SC 10.

²¹ The Companies Act 2013, § 185(2)(c), No. 18, Acts of Parliament, 2013 (India).

²² (1996) 2 BCLC 324 at 337 and 338.

²³ (1994) 2 BCLC 180 at 183.

²⁴ The Companies Act, 2013, § 185(2)(c), No. 18, Acts of Parliament, 2013 (India).

agreed between them and the company, which is extended by the company to all its employees, or the members have approved the proposal of granting such concerned loans by passing a special resolution. In the case of *M.R. Electronic Components Ltd. v Asstt. Registrar of Companies*²⁵ it was held that an advance salary provided to a director of the company shall not be considered as a loan unless a loan had been provided under the subterfuge of an advance.²⁶

ARE PRIVATE COMPANIES EXEMPTED?

Section 462 of the act²⁷ vests the Central Government with the power to issue notification in the public interest, for the applicability of any provision of the act. The Central Government can, by notification, exempt any class or classes of companies from any provision enforceable under the act. In 2015, the Ministry of Corporate Affairs issued a notification dated **05/06/2015** by exercising their power under section 462²⁸, as per which section 185²⁹ shall not apply to a private company: (a) in whose share capital no other body corporate has invested any money; (b) if the borrowings of such a company from banks or financial institutions or any body corporate is less than twice of its paid-up share capital or fifty crore rupees, whichever is lower; and (c) such a company has no default in repayment of such borrowings subsisting at the time of making transactions under this section³⁰. Therefore, it can be seen that if the mentioned conditions under the notification are satisfied, then a private company, as per the concerned notification, is allowed to provide a loan to its directors, **provided** that the private company does not fall under any other restrictive provision in section 185³¹.

PENALTY UNDER SECTION 185 OF THE COMPANIES ACT, 2013

Penal actions against the offenders can be taken for non-compliance with the provisions as per section 185(4)³². The company is held liable to pay the fine, and the director or the person in

²⁵ [1987] 61 Comp Cas 8 (Mad).

²⁶ Ramaswami Kalidas, *Loans to Directors under Section 185 of the Companies Act, 2013- Some perspectives*, TAXMANN (Aug. 18. 2021) <https://www.taxmann.com/research/company-and-sebi/top-story/10501000000020820/loans-to-directors-under-section-185-of-the-companies-act-2013-some-perspectives-experts-opinion?amp=1>.

²⁷ The Companies Act 2013, § 462, No. 18, Acts of Parliament, 2013 (India).

²⁸ The Companies Act 2013, § 462, No. 18, Acts of Parliament, 2013 (India).

²⁹ The Companies Act 2013, § 185, No. 18, Acts of Parliament, 2013 (India).

³⁰ MINISTRY OF CORPORATE AFFAIRS,

<https://www.mca.gov.in/bin/ebook/dms/getdocument?doc=NzY1Mg==&docCategory=Notifications&type=open> (last visited Aug. 04, 2023).

³¹ The Companies Act 2013, § 185, No. 18, Acts of Parliament, 2013 (India).

³² The Companies Act 2013, § 185(4), No. 18, Acts of Parliament, 2013 (India).

whom the director is interested to whom such loan is advanced or guarantee or security is provided, that person or director is liable to imprisonment which may be with or without fine, and by the 2017 amendment to the companies act, 2013, the provision can be seen to have been evolved as the ambit of the penalties has been widened as the obligation of “*every officer*” of the company has been incorporated in the provision, thus it’s not only the directors or the other person to whom the loan is advanced holds the liabilities, rather “*every officer*” having nexus with the concerned transaction which invites the penalties can be seen to be held liable under the section 185.³³

CONCLUSION

A director appointed by the company holds a duty of care towards the company and the shareholders, which has also been recognized by the act under section 166(2)³⁴ which states that a director shall act in good faith, and in the best interest of the company, its employees, its shareholders. The motive behind such provision can be seen to ensure that these duties are abided by accordingly and thus, to prevent any misuse of the capital belonging to the company by ensuring that the directors of the company, who holds the company’s directional compass do not prioritize their self-interest above the company’s interest in their capacity as the director and thus, their fiduciary duty towards the company is not eclipsed. It is to prevent the directors from acting malafidely. Section 185³⁵ acts as a restrictive provision so that the directors are restricted in arbitrarily siphoning the company’s capital to their own interests, to ensure that the best interest of the company is protected.

³³ The Companies Act 2013, § 185(4), No. 18, Acts of Parliament, 2013 (India).

³⁴ The Companies Act 2013, § 166(2), No. 18, Acts of Parliament, 2013 (India).

³⁵ The Companies Act 2013, § 185, No. 18, Acts of Parliament, 2013 (India).

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