

LOANS, GUARANTEES & COMPLIANCE: WHAT EVERY BUSINESS MUST KNOW

Corporate governance and financial discipline are crucial for maintaining transparency and trust within organizations. Sections 185 and 186 of the Companies Act, 2013, play a significant role in regulating loans, guarantees, and investments to prevent misuse of company funds. Here's a breakdown of these critical provisions with relevant case laws for better understanding.

Section 185 – Loans to Directors & Related Entities

Section 185 governs the provision of loans, guarantees, and securities by a company to its directors and entities connected to them, ensuring financial integrity and preventing conflicts of interest.

Key Provisions:

1. Prohibition on Loans to Directors

- A company cannot directly or indirectly give loans, guarantees, or securities to its directors or any person in whom the director has an interest (e.g., relatives, partner firms, private companies in which the director holds a substantial stake).

2. Exceptions & Permitted Transactions

- Loans to **Managing Director (MD) or Whole-Time Director (WTD)** if part of employment terms or approved by a special resolution.
- Loans provided by banks, NBFCs, and financial institutions in the ordinary course of business at a prescribed interest rate.
- Loans or guarantees from a **holding company to its wholly-owned subsidiary**.
- Private companies that meet specific financial and governance criteria (subject to conditions).

3. Penalties for Non-Compliance

- **Company:** Fine of ₹5 lakh to ₹25 lakh.
- **Directors/Officers:** Imprisonment up to 6 months or a fine of ₹5 lakh to ₹25 lakh, or both.

Case Law Example:

In *Jitesh Agarwal v. ROC (2021)*, a private company had extended an unsecured loan to its director without meeting the exemption conditions under Section 185. The company was penalized ₹10 lakh, and the director faced an additional fine. This case highlights the importance of strict compliance with Section 185 to avoid penalties.

Exemptions for Private Companies

As per the **Companies (Amendment) Act, 2017**, private companies are exempt from Section 185(1) restrictions if they fulfill these conditions:

- **No corporate shareholder (i.e., all shareholders must be individuals).**
- **No borrowings from banks/financial institutions or full repayment of borrowings before granting loans.**
- **No default on repayment of loans at the time of giving the loan.**

If a private company meets these criteria, it can grant loans or guarantees to directors and related entities without prior approval under Section 185 but must comply with general corporate governance norms.

Section 186 – Loans, Investments & Guarantees by Companies

Section 186 ensures that companies maintain financial prudence when providing loans, guarantees, securities, or investments.

Key Provisions:

1. Limits on Loans & Investments

- A company cannot invest or provide loans/guarantees exceeding **60% of its paid-up share capital, free reserves, and securities premium OR 100% of its free reserves and securities premium**, whichever is higher.
- If exceeding this limit, a **special resolution** must be passed in a general meeting.

2. Board Approval Requirement

- All transactions require Board approval via a resolution.

3. Interest on Loans

- Loans must bear **interest not lower than the prevailing government securities yield of similar maturity.**

4. Restrictions on Subsidiary Loans

- A **holding company cannot give loans or guarantees to its subsidiary** if the subsidiary intends to use these funds for further investment.

5. Reporting to the Registrar of Companies (ROC)

- All loans, guarantees, and securities must be reported to the ROC in **Form MGT-14 within 30 days.**

6. Exemptions from Section 186

- Banking, insurance, and housing finance companies.
- Government companies in infrastructure projects.
- Companies primarily engaged in lending or investment (e.g., NBFCs).

7. Penalties for Non-Compliance

- **Company:** Fine between ₹5 lakh to ₹25 lakh.
- **Officers in Default:** Imprisonment up to 2 years OR a fine between ₹25,000 to ₹1 lakh, or both.

Case Law Example:

In *XYZ Ltd. v. ROC (2019)*, the company had exceeded the prescribed investment limits under Section 186 without obtaining a special resolution. The ROC imposed a fine of ₹15 lakh, and the directors were personally fined ₹50,000 each. This case underlines the importance of adhering to Section 186 limits and obtaining necessary approvals.