IBC & COMPANIES ACT 2013

IP CS ANAGHA ANASINGARAJU
anagha.anasingaraju@kanjcs.com

ASPECTS OF COMPANY LAW THAT IP MUST KNOW WHILE DEALING WITH IBC

SYNOPSIS

1. Charges;
2. Statutory Registers;
3. Related party transactions (RPTs);
4. Consortium Finance
5. Beneficial Holdings
6. Doctrine of ultra vires
7. CARO

Provisions of company law - Charges

- For corporate borrowers, a bank is a secured creditor.
- *Secured creditor* in common parlance means, a person in whose favour security in the form of tangible or intangible property is created against the amount borrowed.
- The Companies Act, 2013 defines charge as:
- "An interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage."

Provisions of company law - Charges

A Charge means –

- A right created by <u>any person including a company</u> referred to as <u>the borrower -</u>
- on its <u>*assets and properties, present and future*</u>;
- in favour of a <u>bank or financial institution</u>, referred to as <u>the lender</u>;
- which has agreed to extend financial assistance.

Provisions of company law - Charges

- As a matter of **safety and surety as to repayment of loans or borrowings and interest on it** -
- banks and financial institutions insist on creating security in their favour.
- It leads to creation of right in the assets of the borrower companies.
- This is called as charge.
- Creation of charge – instruments - <u>loan agreements</u>, <u>hypothecation agreements</u>, <u>mortgage deeds</u> and <u>other similar documents.</u>

Provisions of company law - Charges

- The borrowing company executes agreement/ deed in favour of the lending institutions/ banks.
- In case same assets are charged second or subsequent times in favour of different banks or financial institutions, then –
- question of priority in case of these entities arises.
- In order to avoid complications, companies select same banks for subsequent borrowing.

Provisions of company law - Charges

- Registration / Creation of charge –

❖ Charge shall be <u>created within or outside India</u>.

❖ It can be on the <u>property, assets or undertakings</u> of the company <u>in India or outside.</u>

❖ The <u>property</u> can be <u>tangible or intangible</u>.

❖ The <u>duty of creation</u> of charge is <u>on the company</u>.

Provisions of company law - Charges

- Registration is done by filing **Form CHG 1** with the Registrar of Companies.
- Form must be filed within 30 days of creation of charge.
- The Registrar gives a certificate of registration.
- Once the charge is registered, the details of it will get reflected in the Master Data of the company on the website of Ministry of Corporate Affairs (MCA).

Provisions of company law - Charges

- The borrower company is required to maintain a Register of Charges.
- Following are its details:

1. Charge ID, date of creation of charge, short description of property,
2. Period and amount secured by the charge,
3. Names and addresses of the charge holder, terms and conditions of charge,
4. Date of modification of charge and date of satisfaction of charge etc.

Provisions of company law - Charges

- Companies create charge in case of loans, long term borrowings and Debentures.
- Charge documents concerning creation, modification or satisfaction of charges can be seen by accessing the MCA website.
- However, if full details of the charges are required to be inspected, the bank or financial institution will have to pay the prescribed fee for online inspection of public documents in respect of the concerned borrower company.

Provisions of company law - Charges

- Modification of charge and satisfaction of charge are required to be conveyed to the ROC.
- Modification of charge – Form CHG 1
- Satisfaction of charge – Form CHG 4
- Both the forms are required to filed within 30 days of modification and/ or satisfaction or full payment of charge.

Provisions of company law - Charges

- In case of **delay** in filing prescribed form goes –
- beyond 300 days from the date of creation or modification of charge, or
- beyond 30 days from the date of satisfaction of charge -
- the company has to file application in form CHG -8 for condonation of delay.

Provisions of company law - Charges

- Form CHG 8 – application to the Central government for –
- **Extension of time** -

1. for filing of form for creation, modification or satisfaction of charge; or
2. Rectification; or
3. Omission; or
4. Misstatement - of any particular in respect of creation or modification or satisfaction of charge.

Provisions of company law - Charges

- In case of Debentures following forms are required to filed:

1. Form CHG 9 – Registration of creation or modification of charge for debentures.
2. Form CHG 9 – Rectification of particulars filed in respect of creation or modification of charge for debentures.
3. CHG 4 – Satisfaction of charge created for Debentures.

Consequences of Non Registration of Charges

- If the required charge is not registered, it shall be **void** against the liquidator **and** any other creditor of the company.

- In the case of *ONGC Ltd* v. *Official Liquidators of Ambica Mills Co Ltd* the ONGC had not been able to point out whether the so called charge, on the basis of which it was claiming preference as a secured creditor, was registered or not.

  It was held that, ONCG could not be treated as a secured creditor.

  This does not, however, mean that the charge is altogether void and the debt is not recoverable. So long as the company does not go into liquidation, the charge is good and may be enforced.

POSER

- In case of joint charge holders
- CD is in liquidation
- First chargeholder has not given NOC for creation of second charge
- First chargeholder demands possession of property for realizing security interest u/s 52

Statutory Registers

1. Minutes Book – Minutes of Board Meetings, Committee Meetings & General Meetings;
2. Register of Members;
3. Register of Directors and Register of Directors' Shareholding;
4. Register of Debenture holders;
5. Register of Charges;
6. Register of Loans, guarantees, securities given by the company;
7. Register of Investments;
8. Register of Contracts and arrangements in which Directors are interested.

Minutes Books

- Minutes record meeting decisions, which makes them a useful review document when it comes time to measure progress. They also act as an accountability tool because they make it clear whose duty it was to perform which action.
- Minutes represent the actions of the Board and company leadership, and are considered legal documents by auditors, the IRS, and the courts. Legal experts will maintain that if an action isn't in the minutes, it didn't happen.

Related Party Transactions

- Whether parties are related parties.
- Whether there is a transaction between related parties.
- Whether the transaction comes under the purview of the Companies Act, 2013 (Section 188).
- Whether the transaction is at arm's length basis.
- Whether the transaction is in the ordinary course of business.

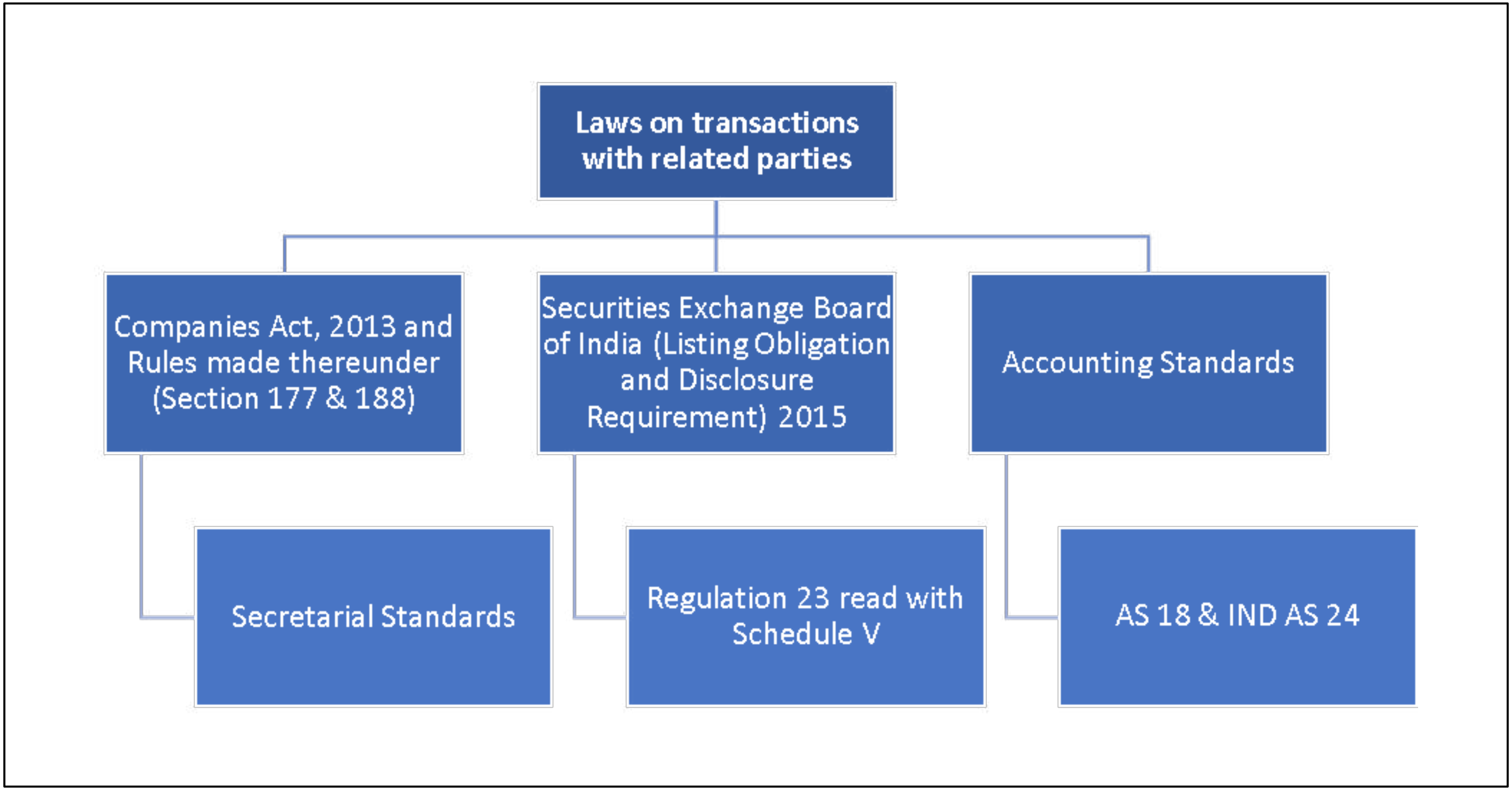
Relevant Provisions

- Section 184 – Disclosure of interest
- Section 185 – Loans to directors
- Section 186 – Loans and investments
- Section 188 – Related party transactions

What Is a Related-Party Transaction?

The term related-party transaction refers to a deal or arrangement made between two parties who are joined by a pre-existing business relationship or common interest. Companies often seek business deals with parties with whom they are familiar or have a common interest. Although related-party transactions are themselves legal, they may create conflicts of interest or lead to other illegal situations when transactions have not taken place on Arm’s Length basis or are not in Ordinary Course of business.

Companies and related parties must disclose these transactions before entering in to related party transaction.



Laws on transactions with related parties
Companies Act, 2013 and Rules made thereunder (Section 177 & 188)
Securities Exchange Board of India (Listing Obligation and Disclosure Requirement) 2015
Accounting Standards
Secretarial Standards
Regulation 23 read with Schedule V
AS 18 & IND AS 24

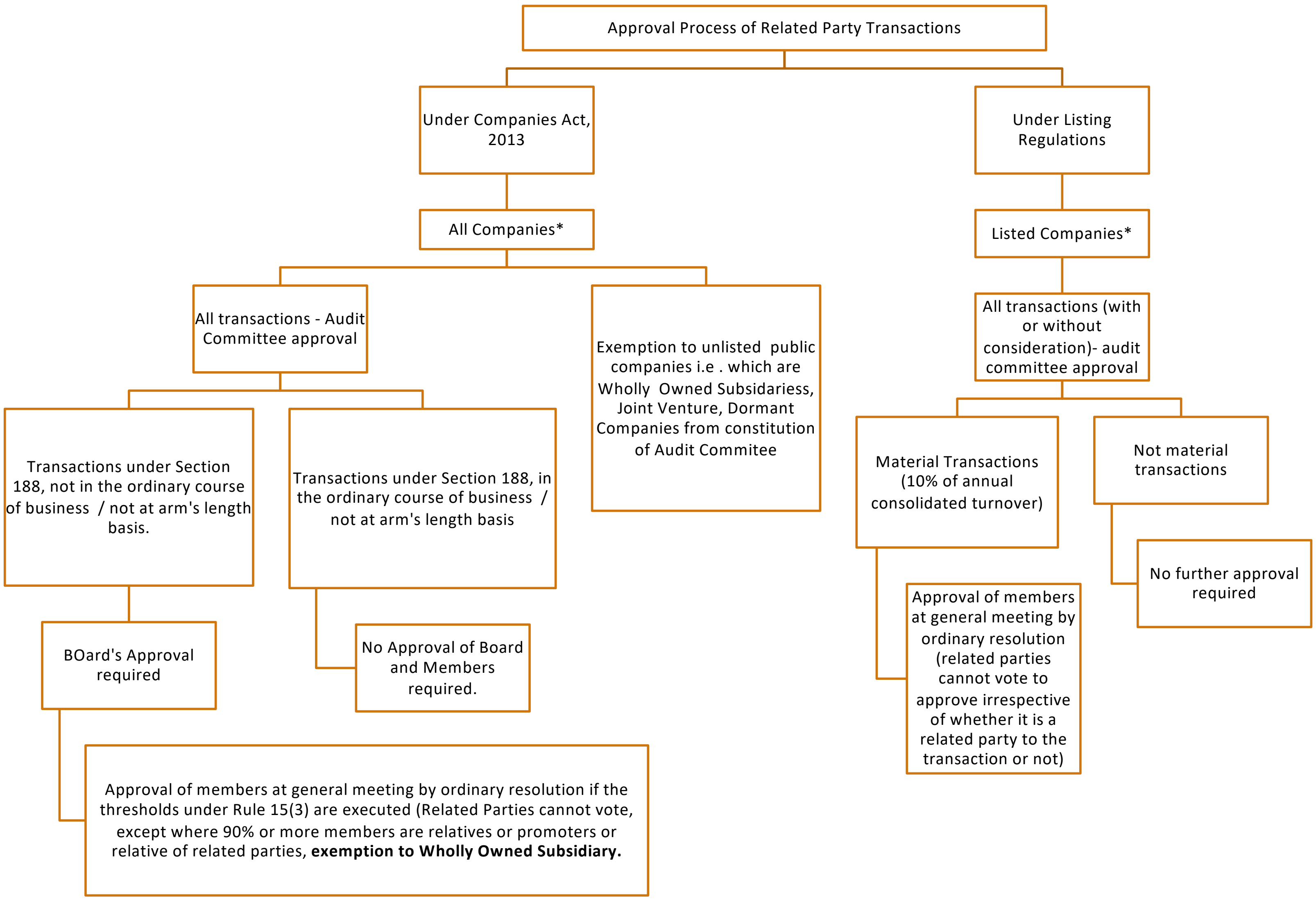
Scope of section 188 of Companies Act, 2013

Section 188 of Act is an amalgam of sections 294, 294A, 294aa and 314 of the 1956 Act.

It leaves the decision on related party transactions to the Board of Directors of the company and the Shareholders of the company. Govt Approval has been done away with

The new act has introduced the concept of 'Interested Shareholder' wherein a member who is a related party has been restrained from voting on the resolution. This Provision also raises the issue of relationship of Shareholder vis-à-vis a company. The Practical issue arising out of this concept is that- by restricting the right to vote of an interested shareholder, majority is left to the mercy of minority .

Constitutional Validity ?



Approval Process of Related Party Transactions
Under Companies Act, 2013
Under Listing Regulations
All Companies*
Listed Companies*
All transactions - Audit Committee approval
Exemption to unlisted public companies i.e . which are Wholly Owned Subsidariess, Joint Venture, Dormant Companies from constitution of Audit Commitee
All transactions (with or without consideration)- audit committee approval
Transactions under Section 188, not in the ordinary course of business / not at arm's length basis.
Transactions under Section 188, in the ordinary course of business / not at arm's length basis
Material Transactions (10% of annual consolidated turnover)
Not material transactions
No further approval required
Approval of members at general meeting by ordinary resolution (related parties cannot vote to approve irrespective of whether it is a related party to the transaction or not)
BOard's Approval required
No Approval of Board and Members required.
Approval of members at general meeting by ordinary resolution if the thresholds under Rule 15(3) are executed (Related Parties cannot vote, except where 90% or more members are relatives or promoters or relative of related parties, exemption to Wholly Owned Subsidiary.

Arm’s length transactions:

The “arm’s length transactions” have been defined as follows: -
According to 'Black's Law Dictionary', 8th Edition, the phrase "arm's length means” of or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power.".

In the 'Advanced Law Lexicon' by Ramanatha Aiyar, the phrase "arm's length" is defined as "a transaction negotiated and entered into by unrelated parties, each of whom acts in his or her own best interest using fair market values", and the phrase "arm's length price" is defined as "the price at which a willing seller and an unrelated willing buyer will freely agree to a transaction".

IndusInd Bank v. Addl. Commissioner of Income Tax [MANU/IU/0262/2012], has defined “arm’s length transaction” in the following words. 'The amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller is an arm's length transaction.’

Judgments under Excise Law may also come Handy.

Illustration

Suppose company A Ltd. sells a product in the market for Rs. 400 per unit and it also sells the same to its associate company B Ltd. for Rs. 400 per unit and on the same terms of contract as with other parties. Here, the price charged from the associate company and others is the same and the transaction between A Ltd. and B Ltd. is governed by market forces and, therefore, is on arm’s length basis.

Issues relating to Arm’s length transactions:

Issue 1:

How do you satisfy the criteria of arm’s length pricing? Should every transaction be accompanied with a certificate from a valuer?

One may check if there are comparable products in the market. If yes, check the terms of sale/purchase, etc. of similar transactions and try obtaining quotes from other sources. Price in isolation cannot be the only criteria. Terms of sale such as credit terms should also be considered. It is not mandatory to obtain a certificate from valuer in every case but this dependent on the policy of the company on transactions with related parties. There are different practices adopted by companies like obtaining certificate from internal auditors, certificate from management etc.

Issue 2:

What are the parameters to be considered by the Audit Committee while considering whether a transaction is on arm’s length basis? How should the Audit Committee decide such an issue?

The Act does not prescribe methodologies and approaches which may be used to determine whether a transaction has been entered into on an arm’s length basis. Audit Committee may consider the parameters given in the company’s policy on transactions with related parties. Transfer Pricing guidelines given under the Income-tax Act, 1961 may also be used. Depending on the nature of individual transaction, any appropriate method may be used by the Audit Committee to arrive at a considered decision to determine arm’s length price.

Issue 3:

Will a preferential allotment of shares to a related party be treated as related party transaction under Section 188 of the Act?

Preferential issue of shares will require approval of the shareholders as provided in Section 42 and Section 62(1)(c) of the Act. Shares should be treated as goods once allotted. In case of preferential allotment although it is a transaction with a related party, the same is not a related party transaction in accordance with the Act.

Issue 4:

Will providing corporate guarantee to the bank by the holding company for a loan availed by its subsidiary company attract the provisions of Section 188 of the Act?

The transaction of providing corporate guarantee is covered specifically under Sections 185 and 186 of the Act, which also covers transaction described above. Ordinarily in such cases, Section 188 is not attracted, however requirements of Section 177 need to be complied.

Ordinary course of business:

The ordinary meaning of the expression ‘in the ordinary course of business’ in dictionaries is ‘part of doing regular business; the regular or customary condition or course of things; as things usually happen’.

To decide whether an activity which is carried on by the business is in the ‘ordinary course of business’, the following factors may be considered:

a. Whether the activity is covered in the objects clause of the Memorandum of Association.

b. Whether the activity is in furtherance of the business.

c. Whether the activity is normal or otherwise routine for the particular business (i.e. activities like advertising, staff training, etc.)

d. Whether the activity is repetitive/frequent.

e. Whether the income, if any, earned from such activity/transaction is treated as business income in the company’s books of account.

f. Whether the transactions are common in the particular industry.

g. Whether there is any historical practice to conduct such activities.

h. The Financial scale of the activity with regard to the operations of the business.

The word “in its ordinary course of business” has not been defined under the Companies Act, 2013 and hence it’s meaning, intent and scope has to be gathered from judgments of various High Courts.

The Division Bench of Orissa High Court in the case of ***Dilip Kumar Swain v. Executive Engineer, Cuttuck Municipal Corporation [MANU/OR/0136/1996]*** has defined “ordinary course of business” Expression "in the ordinary course of business" means " on the ordinary course of a professional avocation or currant routine of business" which was usually followed by the person whose declaration it is sought to be introduced. Expression "in the ordinary course of business" means in the usual course of routine of business. It is used to detect current routine of business. It is trite law that definition or interpretation given in respect of a particular entry has to be judged in the background of that statute itself and cannot always throw a guiding light in respect of other statutes. It has to be judged in the background and context in which it is used in a particular statute.

In the case of ***M/s Bharti Televentures Ltd. v. Addl//Jt. Commissioner of Income Tax [ITA 1395/2006, ITA 1656/2010]*** it was held that the Memorandum and Articles of Association is not conclusive for deciding whether an activity is in the ordinary course of business of the company. Frequency of the activity is sought to be highlighted. It should be a continuous activity carried out in a normal organised manner.

Issue relating to Ordinary course of business:

Who determines that the transaction with related party is in the ordinary course of business? Is it the Board or the Audit Committee?

The Act does not clearly lay down tests for determining whether a transaction is in the ordinary course of business. The Memorandum of Association of the company should be referred to for ascertaining whether the activity is covered in the objects clause therein. This is not a conclusive test but will assist in determining whether a transaction is in the ordinary course of business or not. The Audit Committee may decide whether a particular transaction is in the ordinary course of business and such decision will be based on the policy on transactions with related parties, if any. The company's policy on transactions with related parties should specify the parameters to guide the Audit Committee on whether a transaction is in the ordinary course of business or not. Apart from such a policy, a company may formulate guidelines approved by the Audit Committee and the Board of Directors on transactions with related parties. In such cases, the company can enter into transactions based on the approved guidelines and every transaction need not be placed before the Audit Committee for determining whether the same is in the ordinary course of business or not. In case the company does not have an Audit Committee, the decision as to whether a transaction is in the ordinary course of business or not will be taken by the Board.

Interpretation issues:

1. Where a Board meeting is held prior to the Audit Committee meeting and the Board approves a transaction with a related party. Can the Audit Committee approval be taken subsequently?

Yes. The legal requirement is clear that the transactions referred to in Section 188 require approval of the Audit Committee. Audit Committee approval after Board's approval is not illegal. Further, the approval of the Audit Committee should be obtained before the transaction.

2. Whether approval of the Board is required to be taken by a wholly owned subsidiary which is not required to constitute an Audit Committee, for entering into transactions with related parties in the ordinary course of business and on an arm's length basis?

In such case, it is a good practice to place the item pertaining to related party(ies) before the Board. This is, however, not mandatory.

3. Will easement rights granted to a director's relative be deemed as related party transaction?

This will depend on the facts of the case. For example, if the land was owned by the relative and grant of easementary rights is an integral part of the transaction of sale of land, then although it is a transaction with a related party, it will not be a related party transaction and the same is not covered under Section 188( ) of the Act.

4. Whether issue of “shares and debentures” to a related party, covered under the ambit of Section 188?

No. Shares are treated as goods once allotted. Hence, issue of shares and debentures will not fall under the purview of Section 188. However, transfer of shares to a related party would be considered as a related party transaction. In case of an issue of “shares and debentures” to a related party by way of private placement, the transaction will be treated as one with a related party but would not be regarded as a related party transaction under Section 188 of the Act provided the valuation requirements are met. Further, issue of shares on rights basis, ESOPs, sweat equity, etc. will also not be treated as related party transactions under Section 188 of the Act, if they comply with the provisions of the Act/Listing Regulations.

5. An employee who is also a relative of a director is proposed to be paid a hefty bonus by the company. Whether such payment of bonus will be treated as a related party transaction?

If such employee who is a relative is proposed to be paid any bonus which other employees are not eligible to, the transaction cannot be said to be in the ordinary course of business and on arm’s length basis and would require approval of the Audit Committee and Board.

6. “Leasing of property of any kind” is covered u/s 188. Whether a Leave and Licence agreement will be counted as Leasing of property.

A Leave and Licence agreement is not treated as equivalent to leasing of property. A licence creates limited rights with respect to use of immovable property. However, it will be a transaction with a related party covered under Section 177.

7. X Ltd. has one subsidiary Y Pty Ltd. in South Africa and another subsidiary Z Pte Ltd. in Mauritius. When a transaction takes place between Y Pty Ltd. and Z Pte Ltd., the amount gets consolidated in the accounts of X Ltd. Whether the provisions of Indian law for such transactions between Y Pty Ltd. and Z Pte Ltd. will be applicable?

In accordance with the provisions of Ind AS, the provisions of related party transactions are applicable even to transactions between two foreign subsidiaries situated out of India. However, this applicability of Ind AS will only be for disclosure and not for obtaining approvals. No approval of the Audit Committee or Board of X Ltd. will be required for transactions between the two foreign subsidiaries.

8. If a transaction is covered under two Sections of the Act (example Section 186 and 188) which one would prevail? The problem is more complex when one of the Sections has a non-obstante clause in the said Section.

If there is a specific section in the act which applies , and the transaction is in the ordinary course of business as well as on an arm’s length basis, then ordinarily Section 188 of the Act will not apply.

Investments, Loans and Advances

Applicable Provisions

Section 185

- **Loan to Directors, etc.**

Section 186

- **Loans and Investments by Company**

Section 187

- **Investments of Company to be held in its Own Name**

Origin Of Power To Give Loan, Security Or Guarantee – Section 179 (3)

The Board of Directors may exercise certain powers on behalf of the company by means of resolutions passed at meetings of the Board, which, inter alia, includes:

(e) to invest the funds of the company;

(f) to grant loans or give guarantee or provide security in respect of loans

Restrictions on advancement of loans, guarantee or securities – Section 185(1)

No company shall, directly or indirectly, advance any loan, or give any guarantee or provide any security in connection with any loan taken by,—

(a) any director of company, or of a company which is its holding company or any partner or relative of any such director;

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

Exemption for applicability of section 185

1. To Private Companies

(a) In whose share capital no other body corporate has invested any money

(b) If the borrowings of such 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 not defaulted in repayment of such borrowings subsisting at the time of making transactions under this section.

2. To Nidhi companies - if the loan is given to a director or his relative in their capacity as member and such transaction is disclosed in the annual accounts by a note

3. To Government companies - in case such company obtains approval of the Ministry or Department of the Central Government or State Government, as the case maybe.

Practical Issues and Case Laws

1. Meaning of Loan

Fredie Ardeshir Mehta (Dr.) v Union of India (1989) 2 CLA 244 (Bom): (1991)

“The essential requirement of a loan is the advance of money (or of some article) upon the understanding that it shall be returned, and it may or may not carry interest.

The Word "indirectly" in the section cannot be read as converting what is not a loan into a loan.”

Shree Ram Mills Ltd Vs. Commissioner of Excess Profit Tax, (AIR 1953 SC 485)

“At bottom this is a question of fact. Of course, money so left, could by a proper agreement between the parties, be converted into a loan, but in the absence of an agreement mere inaction on the part of the managing agents cannot convert the money due to them, and not withdrawn, into a loan. A loan imports a positive act of lending coupled with an acceptance by the other side of the money as a loan.”

Practical Issues and Case Laws

2. Section 185 is a prohibitory provision

The words “no company shall” indicate that it is a peremptory and mandatory in character.

Mannalal Khetan and others   vs Kedar Nath Khetan (1977 AIR 536)

“The words "shall not register" are mandatory in character. The mandatory character is strengthened by the negative form of the language.”

3. Meaning of book-debt

Book-debt is a debt connected with the trade of a person, whether or not it has been entered in the books.

Practical Issues and Case Laws

4. Meaning of Advance

'Advance' means literally a payment before hand; in certain cases it may be a loan but it cannot be said that a sum paid by way of advance is necessarily a loan.

In ***London Financial Association v. Kelk L.R. (1884) 26 Ch. D. 107***, it was observed, that the words-'advancing' and 'lending' might each have a different signification, money might be 'advanced' without being 'lent' and that the relation of borrower and lender did not exist in a great variety of the transactions.

In ***Lincolnshire Sugar Company v. Smart L.R. (1937) A.C. 697, 703***, it was observed that the term 'advanced' was ambiguous and might either refer to the prepayments of what would become due in future or be a polite euphemism for loans; but when 'advance' were declared to be 'repayable' (though only conditionally) they certainly would lean to the side of loans."

Practical Issues and Case Laws

5. Leasing / Hire purchase transactions

Section 185 does not apply to these transactions since they do not come under the category of loan.

Performance Guarantees? Also outside the scope

6. Investment in acquiring residential accommodation for director – whether loan?

Where the company has purchased or leased an accommodation for the use of its director and the company has deposited a certain amount with the landlord (in case of lease), such cost of property purchased or amount deposited for lease, is not considered as a loan to director. It is of no concern to the director that on what terms the accommodation has been acquired / leased by the company.

Practical Issues and Case Laws

7. Compounding of offence u/s 185 of Companies Act, 2013

KPR Agrochemicals Ltd. 2016 (135) CLA 226 NCLT.

Where the offence u/s 295 of CA- 1956 (Corresponding to section 185) has been committed but there is no willful default and no malafide intention petitioner is entitled for compounding of offence.

Investment through two layers of companies only - 186(1)

Companies can make investments only through two layers of investment companies subject to exceptions.

Exceptions:

Acquisition of such company which is incorporated outside India and that company has investment subsidiaries beyond two layers as per the laws of that country	Subsidiary company from having any investment subsidiary for the purposes of meeting the requirement under any law/ rule/ regulation

Investment through two layers of companies only - 186(1)

Meaning of Investments:

- Subscription or purchase of shares
- Subscription or purchase of share warrants
- Subscription or purchase of debentures bonds or similar debt securities

Investments do not include:

- Making of loans or advances
- Any other financial transactions such as leases, purchase of receivables, or other credit facilities

Limits For Loans / Guarantee /Security / Investment - Sec 186(2)

Company may, directly or indirectly, enter into given transactions, where the aggregate of all existing and proposed transactions does not exceed higher of the following two limits:-

60% of (PUC + FR + SP)

OR

100% of (FR + SP)

- Give any loan to any person or other body corporate
- Give guarantee / security in connection with a loan to any body corporate or person
- Acquire by way of subscription, purchase or otherwise, the securities of any other body corporate

Limits For Loans / Guarantee /Security / Investment - Sec 186(2)

If the specified transactions exceed above limits:

Prior approval of shareholders by way of special resolution is required.

Exception of obtaining shareholders' approval:

Transactions entered into by a holding company with its wholly owned subsidiary or Joint Venture Company.

Meaning of Free Reserves - Section 2(47)

Section 2(47) defines "free reserves" as such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that—

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognized in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value,

shall not be treated as free reserves.

Other conditions to be fulfilled

- Disclosure of particulars and purpose of loan, guarantee and security provided to be made in financial statements [Section 186(4)]
- Unanimous resolution of directors present [Section 186(5)]
- Prior approval of Financial Institutions (PFI) if company has already taken loan etc.

Exception:

- ✓ If the aggregate amount of transactions is within limits given above, and
- ✓ No default in repayment of loan instalments or interest thereon

Other conditions to be fulfilled

- Rate of interest not to be lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan. [Section 186 (7)]

- No company in default in the repayment of any deposits accepted or interest thereon, shall give any loan or guarantee or security or make an acquisition till such default is subsisting.

- Company to maintain a register which shall contain particulars of loan or guarantee given or security provided or investment made in MBP-2. [Section 186 (9 and 10)]

Non-Applicability of Section 186:

The Section 186 (except Sub Section 1) of the Companies Act, 2013 does not apply to the following:

Loan, guarantee or security provided, **in ordinary course of business**, by:

- Banking companies
- Insurance companies
- Financing companies
- Infrastructure companies

Any acquisition of securities by:

- Registered NBFC whose principal business is acquisition of securities; in respect of its investment and lending activities.
- Company whose principal business is the acquisition of securities
- Rights issue by a company

Practical Issues:

1. Whether loans to employees are also covered under the Section?

Section 186 is applicable to the loans given to 'any person' or other body corporate. 'Any person' shall include employees as well. Hence loans to employees are also be covered under the Section.

2. Whether various advances and deposits will also be covered under the Section?

Loan is lending of money with absolute promise to repay and is different from advances which are to be adjusted against supply of goods and services. Trade advances given to suppliers against orders for supply of goods are not considered as loans and hence are out of the ambit of Section 186.

Practical Issues:

3. Whether advances given to employees against current month's salary are in the nature of loans?

Advance against salary to employees shall be considered as advance against supply of services. Hence, such advances shall not be covered under section 186.

4. Whether book debts will also be considered as loans?

It has been held that credit extended beyond normal credit period may be considered in the nature of loans and hence this Section may be applicable to such book debts as well.

Practical Issues:

5. Whether investment in mutual funds are also covered under the Section?

Majority of the mutual funds are managed by trusts which are not body corporates. Hence investment in mutual funds are not covered under the Section. However, Unit Trust of India (UTI) is an exception since it has been constituted under UTI Act and is a body corporate.

6. Whether a company can give interest-free loan?

A company can give loans at rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan; but not an interest free loan.

Practical Issues:

7. Meaning of body corporate

Vibank Housing Finance Ltd., In re (2006) 130 Comp Cas 705 (Karn)

“The term "body corporate" is wider than the expression "company" and is used in several sections of the Act to denote not only a company incorporated in India but also a foreign company.”

8. No blanket permission by shareholders

[Circular No. 8/99, 4-6-1999]

A blanket permission of the shareholders empowering the Board to make loans or investments or to give guarantee or security up to a certain aggregate limit will not be adequate compliance of the provisions issued by the MCA, stating, inter alia, that en-block approval should be avoided.

Practical Issues:

9. Whether acquisition of shares of a co-operative society is covered under section 186?

Section 2(11) of the Act explicitly excludes a co-operative society from the purview of "body corporate."

Further, as per Section 2(h) of SCRA, "securities", inter alia, include:

(i) shares of any incorporated company or other body corporate;

And, as seen before, limits u/s 186 apply to acquisition of securities of "any other body corporate", which is distinct from the words "any person".

Hence, if a company proposes to invest in the securities of an entity not being a body corporate, like co-operative society, the company may so invest without applicability of limits given u/s 186(2).

Company to hold investments in its own name - Section 187 (1)

All investments made or held by a company in any property, security or other asset shall be made and held by it in its own name.

<u>Exception:</u> The company may hold any shares in its subsidiary company in the name of any nominee or nominees of the company, if it is necessary, to ensure that the number of members of the subsidiary company is not reduced below the statutory limit.

Company to hold investments in its own name - Section 187 (1)

<u>Non-applicability of above provision for certain investments:</u>

- Depositing with the banker, shares or securities for the collection of dividend or interest payable
- Depositing with, or transferring to, or holding in the name of the banker, shares or securities, in order to facilitate the transfer.
- Transferring to, any person any shares or securities, by way of security for the repayment of any loan advanced to the company
- Holding investments in the name of a depository held by the company as a beneficial owner

  (securities in demat form)

Register of Investments not held in own name - Section 197(3)

Where in pursuance of clause (d) of sub-section (2) *(securities in demat form)*, if any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall maintain a register in MBP-3.

Case Law - Presumption as to title where the shares are not held in the name of the company

<u>Commissioner of Income Tax v. Sunaero Limited (2012) 172 Com Cases 562 (Del)</u>

The normal presumption of law is that the registered shareholder holds shares in his own right and for any claim made that the registered shareholder holds the shares as a nominee of another person, the burden of proving the same is on the person so claiming.

The court held that:

"...there is no presumption that the registered shareholder is a nominee of a third person. In case of a dispute, the person who claims to the contrary has

to establish and show that the person mentioned in the register of shareholders was his nominee. The onus is on the person who states and claims that what is apparent is not real.

It was not for the Assessing Officer to establish to the contrary but for the assessee to show and establish that it was a wholly owned subsidiary of the holding company and the shareholders were merely the nominees of the holding company. There is no presumption that the shareholders were nominees."

Register of Contracts and Arrangements in which directors are interested.

- The Register shall contain -

1. Disclosures of Directors' Interest in the transaction of the company;
2. Related party transactions (RPTs).

- It shall be kept at the Registered office of the company.
- It shall be open for inspection during business hours.
- Extracts and copies can be taken from it on payment of prescribed fees.

Register of Contracts and Arrangements in which directors are interested.

- It shall be produced at the commencement of every annual general meeting and shall remain open and accessible during the meeting to any person who has right to attend the meeting.
- In case of non – compliance of this section and other provisions related to it –
- **every director** who fails to comply shall be liable to a penalty of Rs. 25,000/-.

Bank Due Diligence – Consortium Finance

- Lending under Consortium Arrangement/ Multiple Banking Arrangement:
- Transparency and clarity in doing business with corporates.
- Requirement of Lender Banks – Diligence Report -
- Certification by Professionals – CS, CA, CWA etc. -
- Regarding compliance of various statutory provisions.
- In a prescribed format along with Annexures.
- Half yearly and annual report is required.

Due Diligence Certificate – Contents – Reporting Period.

- Incorporation and registration details of the company.
- Examination of Memorandum and Articles of Association of the company – change therein.
- Examination of books, records, registers and documents required to be maintained under various provisions of law.
- Composition of Board of Directors, Shareholding pattern of the company.

Due Diligence Certificate – Contents – Reporting Period.

- Loans advanced, guarantees given, securities provided and investments made by the company to the **directors of the company** or **any other person** – compliance with company law.
- Amounts borrowed by the company from its Directors, Members, financials institutions, banks and others. – borrowing limits.
- Details of Defaults if any, in case of repayment of loans and dues etc.
- Status on existing charges.

Due Diligence Certificate – Contents – Reporting Period.

- Investments in Wholly owned subsidiaries or Joint Ventures aboard.
- Forex exposure and overseas borrowing by the company. – Management's Representation is required.
- Changes in share capital – issue of preference shares, reduction of share capital, buy back of shares.
- Issue of Debentures – whether secured or unsecured.
- Insurance cover for assets offered as security by way of charge or mortgage.
- Management's representation on declaration of dividend.

Due Diligence Certificate – Contents – Reporting Period.

- Management's explanation that name of the company or its directors are not in the defaulters' list of the Reserve Bank of India.
- Management's explanation that name of the company or its directors are not in the Specific Approval List of Export Credit Guarantee Corporation of India ("ECGC").
- Compliance with statutory dues including Provident fund, Employees' State Insurance, Income Tax etc.
- Explanation of the Management that the funds borrowed from the banks/ Financial institutions are utilized for the purpose for which they were borrowed.

Due Diligence Certificate – Contents – Reporting Period.

- Compliance with inter corporate loans and investments.
- Compliance with applicable accounting standards issued by ICAI.
- Statement on credit of amount to Investor Education and Protection Fund.
- Details of prosecutions initiated, show cause notices issued against the company.
- Whether company’s shares are listed on stock exchange or not.

Due Diligence Certificate – Contents – Reporting Period.

- Following are the annexures to the Due Diligence Report:
- Annexure A – Transactions with business entities, in which directors were interested during the reporting period.
- Annexure B – Amounts borrowed by the company during the reporting period.

Beneficial Ownership

As a rule, it is presumed that a person who is registered as a member of a company has both – legal and beneficial interests in the shares registered under his name. However, there are instances when the person, whose name appears in the register of members, may not have beneficial interest in the share. Section 89 of the Companies Act, 2013, provides for declarations by the beneficial and the legal owner of shares.

CARO

CARO 2020 is a new format for issue of audit reports in case of statutory audits of companies under Companies Act, 2013. CARO 2020 has included additional reporting requirements after consultations with the National Financial Reporting Authority (NFRA). NFRA is an independent regulatory body for regulating the audit and accounting profession in India. The aim of CARO 2020 is to enhance the overall quality of reporting by the company auditors.

Detailed Reporting Under Each Clause:

- Details of tangible and intangible assets
- Details of inventory and working capital
- Details of investments, any guarantee or security or advances or loans given
- Compliance in respect of a loan to directors
- Compliance in respect of deposits accepted
- Maintenance of statutory liabilities
- Maintenance of costing records
- Unrecorded income
- Default in repayment of borrowings

Others

Annual compliances during CIRP

Winding up under IBC vs Winding up under Companies Act

Any Questions?

Dhanyawad!