INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS

Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed

www.ijlra.com

ISSN: 2582-6433

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 ISSN: 2582-6433

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 ISSN: 2582-6433

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ISSN: 2582-6433

HOW INTER-CORPORATES INVEST?

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Abstract

Loans, Advances, and Investments are essential part for growth in any form of enterprise. From the legislative lens, priorly this aspect was regulated through the instrumentality of section 372A of erstwhile Companies act, 1956, but this law was always seen gullible and raw. Further, section 185 and 186 of Companies act, 2013 was known to be the stringent one with exhaustive rules and regulations, but this was again simplified in amendment act of 2017. Apparently non-stringent inter-corporate loans and investments provisions were the encouraging seeds for mayhem scams like Ketan Parekh scam of 2001, Satyam scam of 2009 or latest Purti scam of 2012. All these mishaps of siphoning funds, cavity investment, and ill-intentioned moves would have been prevented if regulatory machinery were rigorous and scrutiny was exhaustive. Though it brings hardships on the account of companies to align with the regulations, but it provides a sense of security to all minor shareholders (in case of a public listed company), which are ultimately citizens of our nation. In this paper, we have tried to analyse the chronology and comparative legislative interpretations of 'inter-corporate' loans and investments, nitty-gritty of the law, its application, and most importantly, the loopholes and how it is misused by some notorious people. Also, trying to find the answer of, is the law fair to corporates and directors? And what will be the perfect set of legislation to this corporate conundrum.

Keywords – Inter-corporate loans, Section 186 of Companies act 2013, Purti scam, Inter-corporate investments, Section 372A of Companies act 1956, Directors.

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Introduction

After Constitution and Criminal laws, Commercial laws have been the legislation with most prominent importance. The law of enterprises, not only govern them but provide for every essential ranging birth to death of the companies, that is from articles of association to winding up of the entity, between them their every aspect of life is been govern by these company laws, codes, and rules formulated by the legislature. When it comes to any enterprise, ambition is something which we find innate in all of them, the ambition to be on the top, and pursual to this they set up numerous avenues to grow. One of the things which foster this growth is transaction and advancement of money, be it loans, investment, intercorporate securities or guarantees, everything places a stern role in making of a conglomerate. Like the important, aspect of intercorporate loans and investments, the laws regarding to it in company laws too, holds an immense gravity, and due to its sensitive, stimulative, and technical position, the sections regarding to intercorporate loans and investments, have been always in the talks. Some advocates for stringency and other pushes for easement. This section of the law has always been dynamic, due to the constant effects it has on markets. Liberalising reforms invites mishaps and narrowing the provisions hampers the growth, this section has always been the elephant in the room for its non-concreteness to its outcome. Whether it be erstwhile section 372A of 1956 Companies act, 1956 *("CA 1956")* or current section 186 of 2013, companies act *("CA 2013")*. Every provision has been stretching some sides and always called for the change. As complex it is by nature, the purpose it serves is also commendable. Let us see how this provision came in the place, what was it then, what it is now and what is its current scenario.

Legislative history

The concept of intercorporate loans and investments is seen as an evolved concept. Its occurrence was not specifically mentioned till CA 1956. Prior to this act, no exact mention can be found in any legislation about intercorporate loans, but we do find the core principle on which, these further provisions are based on. In the companies act of 1913, the importance of visibility and transparency by directors in the official books of the company was emphasized, and following that core value, section 295 of CA 1953 came into the official texts which mentions a rigid restriction of free loans or security to director or to their relatives. Along with Section 370 was introduced, which regulated intercorporate loans and investments and wedged a cap on the amount along with a prior approval from the government, also section 372 where more restrictions were added in acquiring of shares of company to avoid concentration of

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powers. Though subsequently in the amendment of 1999, Section 372A was introduced which became the concrete pillar for most of the legislative changes on the provisions of intercorporate loans and investments. This section was a unified provision which removed the barrier of prior approval of government to a certain limit of amount. It is to be noted that, post this amendment a lot of numbers of abuses of the section was seen, scams were spawning in the nation and somewhere loose regulations and loopholes played a significant role in this scenario. Taking these issues in account, with the introduction of CA 2013, these sections were given new address which was section 186 of CA 2013. This sections again were known to for its exhaustiveness and sternness of its implementation, the body corporates were seen to in their tight seatbelts. Further in this trajectory after 3 years, again to ease some restrictions in CA 2013 provisions another amendment act of 2017, was introduced which eased substantial restrictions to body corporates, just at the cause of reason which was growth, ease to do business was seen equivalent to growth. In this paper we will zero in the provision 186 of the CA 2013 and amended provisions.

Nitty-Gritty of law

"*As their businesses grow, companies operate through their subsidiaries for various reasons such as flexibility in operation of different units, expansion in different geographies, and the like. While a subsidiary is an entity over which the parent has control (and, in the case of a wholly owned subsidiary, complete control), the Companies Act, 2013 recognises a subsidiary as a separate legal entity".*[1]

The provisions which govern these investments are vested in section 186 of CA 2013, read with some certain given rules. The main substance of this provisions is

Restrictions from making investments through more than 'two layer of investments companies', with exception that

1. A company is permitted to acquire a company which is incorporated outside the India and such acquired company have invested beyond the ambit of two layers of companies as in consonance with the laws of such nation.
2. Subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

In Addition, the above provisions also have additional exceptions is case of Wholly Owned

[1] Bharat Vasani, Miloni Mau *available at:* https://indiacorplaw.in/2024/03/holding-subsidiary-relationship-the-legal-regulatory-architecture.html (Last modified 01/08/2024)

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Subsidiary ("*WOS*"), and Joint Venture Company *("JV")* where the WOS and JV should not be counted, in the computation of such 'Two layers' of investment in the given provision.

The whole section of intercorporate investments is about a company having its control in other company, which is called its subsidiary. The term subsidiary is defined in Section 2 (87) of CA 2013, according to the provision a company is subsidiary of another company when, the holding company either controls the composition of the board or exercise or holds more than 50% of its voting yield. The term Investment Company means "A company whose principal business is the acquisition of shares, debentures or other securities and a company will be deemed to be principally engaged in the business of acquisition of shares, debentures or other securities, if its assets in the form of investment in shares, debentures or other securities constitute not less than fifty per cent of its total assets, or if its income derived from investment business constitutes not less than fifty per cent as a proportion of its gross income"[2]

An addition to the two layers of investment another provision which corporates must take care is its following clause which says that directly or indirectly, any "loan given by the company to a person or a body corporate, or any guarantee of security provided to such person or body corporate or any subscription, purchase or any other of such body corporate must be in the coherence with the following ambit –

- Sixty per cent. of its paid-up share capital, free reserves, and securities premium account or
- one hundred per cent. of its free reserves and securities premium account,

whichever is more."[3]

Again, the above provisions are exceptions in case of WOS and JV, though except them if a company exceeds the said amount, the it should be authorised priorly by a special resolution in the general meeting.[4]

Provided such details of the loans, guarantee, acquisitions, or security provided is shown in the official financial statements. Along with detailed particulars by the recipient of such investments or loan, providing how they will utilise such received funds.

[2] The Companies Act, 2013. (Act 18 of 2013) s.186 ss.(13)(a)
[3] The Companies Act, 2013. (Act 18 of 2013) s. 186 ss (2)
[4] Supra

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Reading the provision, one such query which knocks is what if the primary company itself have some loans existing? Regarding, it is stated that if the amount of proposed transaction exceeds the said amount in sub-section 2 of the act, then a blanket Approval from all the directors in the board meeting, along with a prior nodal from the concerned Public Financial Institutions, where such loans are subsisting, is required. Though it is to be noted that, the nodal is only in the case where amount exceeds the limit provided in SS 2 of 186 and there is no default in the repayment of interest and instalment in ordinary cause, along with no-clash regarding to the terms and conditions agreed in the loan transactions.

If we talk about loans, following, we must take in notice is about interest paid on such loans According to the legislation, "all loans provided under this section where rate of interest should not be lower than prevailing yield of one-, three-, five- or ten-year government security closest to the tenor of loan"[5] It is to be noted that, this provision should not be applicable to companies where state or central government hold more than 26% in the company of someone, whose primary object is Industrial research and Development projects as mentioned in their Memorandum of Association.

Defaulters of loan, also should not be given such loans or such acquisition till such default persists. The above provisions along with, Maintenance of register of such loans and investment, in the registered office, open for inspection.

The provisions of this sections govern every nitty-gritty of the loans, security, and investment of inter-corporates. The above provisions are highly contentious and highly amended, as it gives comprehensive sets of rules about how, why, what and which. Though these rules are highly criticised for being stringent and not in consonance with international markets, which hinders the growth of Indian corporates.[6] Though provisions, which linkage with foreign subsidiary and JV poses a scope for ambiguity and grey areas for the interpretations. The retainment of sections such two-level investments makes it harder of Indian corporates to be more flexible in its operations.

[5]The Companies Act, 2013. (Act 18 of 2013) s. 186 ss (7)
[6] Tapan Ray Committee, 2018

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Key Issues

The exemption provided to WOS and JV as to be computed as a layer of investment provides two interpretations –

a. When Company A invests in Company B (WOS of company A), and then company A invests in company C, further C into D. – This is permitted illustration, as layers of investment formed are only two.
b. When Company A invests in Company B, and further Company B invests in Company C (WOS of Company C) and further C into D – is this permitted into said provision?

When we take literal and natural interpretation of the statute, in case b, when company A invest in B, it forms Layer 1, and when B further invests in company C, (a WOS of B), do form Layer 2, as the matter of the fact that, the primary control of company C vests in B, which has just been invested by A.

So, it sabotages the purpose of rules restricting layers. As authors are of view that, the purpose of making such rules is to prevent the diversion of funds, and if literal interpretation overlooks any layers of investments except of primary investment in WOS, it will bounce back the purpose of the provision and contrary to the very provision. [7]

- So, for the purpose of the section, exemption of WOS is only provided to 1st layer of investment.
- Exemption to non- step-down subsidiary can be a mischievous interpretation of the provision.

Another, issue which arises if about offshore subsidiaries, as foreign subsidiaries are exempted and let to be govern by the jurisdiction of its incorporation and it is allowed to have more than 2 layers as provided in their jurisdiction. But the structuring when it comes to overseas acquisition may be often exhaustive. For example, an Indian company A invests in B which is also an Indian entity (forming 1st layer), further company B invests in X which is a offshore incorporation. Here body corporate X, is at liberty subject to the jurisdiction it is present to invest. Let us suppose the layers permitted in 3 in that state, then will a circular investment again in Indian entity by such 5th layered foreign entity will be permissible, as in this case the primary investment flowed from an Indian company again to an Indian company, though through multiple layers offshore. These complex transactions create rooms for ambiguity and invites room for parallel research in foreign investment rules and section 186.

[7] Prerana P., Jishan D. *available at* https://www.scconline.com/blog/post/2023/05/27/restriction-on-layering-of-companies-should-we-go-back-to-the-drawing-board/ (Last visited 10/08/2024)

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One key issue in the provision in focus is about computing, as sub-section 2, limits a threshold of amount to be given as loans, its computing plays an issue in real-life scenario.

Calculating 60% of paid-up shares, free reserves, and securities premium
Or 100% of free reserves or securities premium[8] whichever is more, as the amount to be calculated is on standalone financial statement basis and not on consolidated statement. The key challenge is computation. The subjective question of investments already made and guarantees already provided along with the unpaid underlying loans are to be calculated in that 60% or 100% threshold. This computation opens grounds for the discrepancies. Though the prima facie answer be the simple calculations, but real-life issues will stand different. Another issue of free reserve and general reserve, and their interpretation in this calculation is one such issue. As free reserve and general reserves are two different provisions appearing in many parts, and being affected by many issues, so its amount is dynamic. For example, inclusion of funds in account of absence of profit, from general reserves, so is this action to be calculated in the process of calculating 'free reserves?'[9]
Another most important factor which triggers is, minimum rate of interest in regards to loans provided, that no loans should be provided at an interest lower than prevailing yield of 1 year, 3 years, 5 years, or 10 year's government security, closest to tenor of the loan[10]. The expression "*Government security*" is not defined in the Companies Act, but it is defined in Section 2(b) of the SCRA, 1956, as the security issued by the Central or State Government for the purpose of raising a public debt. Deeply scrutinising, the loans are to anybody corporate, so it can also be given to foreign entities, which poses the real difficulties.

For example, company A, incorporated in India, acquires a company X, incorporated in UK, a WOS of company A. Company X is depended on A for the funds, and if company A provides loans to X, it is mandated by SS 7 of section 186 to have some certain rate of compulsory interests, i.e. is a threshold amount, but it can be a very possible case where the jurisdiction of UK may have provisions where the rate of interest of such loans can be or should be below certain threshold amount, and its potentially possible that such both threshold amounts are in contradiction, For instance, if UK law mandates rate of interests, not more than 7% and Indian

[8] The Companies Act, 2013. (Act 18 of 2013) s. 186 ss (2)
[9] Bharat Vasani *available at* https://corporate.cyrilamarchandblogs.com/2024/01/key-issues-under-section-186-for-a-corporate-lawyer/ (Last visited 18/08/2024)
[10] The Companies Act, 2013. (Act 18 of 2013) s. 186 ss (7)

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government security rates 9% interest of the prevailing year, than which provision should prevail? If directors of company X in UK takes loans at higher interests than, it contradicts its duty to act in the best manner possible and may attract consequences.

Real-life cases linked to intercorporate loans

a. 2001 Ketan Parekh scam

The scams particularly have 3 main features, 1. Manipulation in share prices, 2. Monopoly in share transaction and blanket control, and most important money laundering and borrowing to trade securities but used money for different unaffiliated notorious reason.[11]

Protégé of Infamous Harshad Mehta, Ketan Parekh was an influential stock broker, who was notorious for manipulating stock prices, he usually focused on small companies, also known as K-10 stocks. Parekh used his influence and connections to artificially inflate the prices of shares, creating a bubble that eventually burst, leading to significant losses for investors.

Parekh often borrowed money from banks by using his influence on inadequate collateral, and then invested in securities, Parekh used his corporate entities to get loans and then diverted to his own use, i.e. to inflate stocks. He heavily borrowed from Madhavpura Mercantile Cooperative Bank *("MMCB")* in veil of corporate loans and diverted funds. He used loopholes in intercorporate provisions and shell owned by his associates to borrow and launder funds. Which not for productive business purposes but for speculative activities in the stock market.[12]

(*Current provisions like of section 186 and their action of stringent and comprehensive rules and regulations would been a better deterrent,*)

b. 2009 Satyam scam

Satyam Computer Services was founded by B. Raju in 1987, and grew to be then largest IT firm of India, even to be listed in New York Stock Exchange, blue-chip Indian IT Firm.

Harshly, a confession in 2009 was released by B. Raju about massive financial fraud by company's board of directors, regulators, and even from substantive shareholders.

[11] "Securities and Exchange Commission: Securities fraud and insider trading", Palgraves' Dictionary of Money and Finance (1994)

[12] The Ketan Parekh Scam, Case code FINC006 *available at* https://www.google.com/url?sa=i&url=https%3A%2F%2Fforce9.files.wordpress.com%2F2009%2F03%2Fketan-parekh *(*last visited 20/08/2024*)*

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The orchestrated company's balance sheet showed substantial cash reserves that did not exist. For example, Satyam's books claimed it had cash and bank balances of over ₹5,000 crores (around $1 billion at the time), while the actual amount was just ₹321 crores.[13]

It was known that scam also involved diverting funds through loans and advances to shell companies that were controlled by Raju and his family, which were used to buy land and other assets. "*It has also found evidence on fund trail abroad. Raju and his associates are understood to have siphoned off money to tax havens and later re-routed it back into the country through the 325 front companies.*"[14]

For the exact same cause, the provisions were stringently drafted in the Companies Act of 2013, the mishap was motivated by the loose provisions of act of 1956, which provided loopholes for such activities. Provisions regarding non-advancement of loans to directors or any related person or entity to directors were restricted. Post-accounting fraud, the resources were siphoned-off through the routes of investments and corporate lending to tax havens, which could be protected through exhaustive sets of rules and regulations.

c. Purti Scam

Most classic and apt example, of internal misleading of borrowed funds by directors or people related to director, is the latest Purti Scam of 2017. With big names, involved this scam or so-called scam was known because of loans took by misrepresentation of facts and not-alignment with provisions of the CA 2013. In crux, it was the Union minister Nitin Gadkari, helping his son to get a loan of 42.83 Crore, by mortgaging a land of a co-operative society, named Polysac Industrial Cooperative Society (PCSL), of which Gadkari was director, without intimation or prior nodal from the members.[15]

The land belonging to (PCSL) was allegedly transferred secretly, to get a loan for GMT Mining and Power Ltd, a company owned by Nikhil and Sarang Gadkari (Gadkari's sons). The accusations first came to light when Ghanshyam Das Rathi, a PCSL shareholder, went to the office of the Maharashtra Industrial Development Corporation (MIDC) in Nagpur and discovered that the land belonging to the cooperative society

[13] Satyam scam of corporate governance, *available at* https://www.researchgate.net/publication/346232108_The_Debacle_of_Satyam_Computers_Ltd_A_Case_Study_from_Management%27s_Perspective (Last visited on 20/08/2024)
[14] Sai Deepak. *Available at* https://economictimes.indiatimes.com/tech/software/cbi-finds-evidence-of-fund-diversion-from-satyam/articleshow/5012544.cms?from=mdr (Last visited on 20/08/2024)
[15] Prateek Goyal. *Available at https://www.newslaundry.com/2018/10/16/nitin-gadkari-rss-land-mortgage* (Last visited 21/08/2024)

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had been taken over by Purti Solar Systems Ltd, a company associated with Kishore Totde, Nitin Gadkari's brother-in-law. Further inquiry unleashed the fact that, PCSL's land was mortgaged to Saraswat Bank for multi-crore loan to GMT Mining. Another, hit was when the fact revealed that "*Anil Lambade, another shareholder of PCSL, said: "Gadkari and his associates have not called for an annual general meeting after 2003 and have transferred the land without taking the permission of its members for their financial gains*."[16]

The Purti scam demonstrate, typical use of power by directors in siphoning off the funds, and not being in the ambit of legislation. Though the matter is not reached to a concluding stage and Gadhkari have, rejected every accusation, but who in this world accepts them.

Conclusion

It is always seen that the balance between liberty to flourish and being in ethical limits is altered and misused by some individuals, but does this mean every individual is a perpetrator? Or each individual plays in social ethics? This dilemma is something which legislation must think of as developing nation we can compromise in hindering the economic growth, and the factor of external scrutiny must be increased by the administration, and the legit enterprises should be encouraged to grow more and more at global levels. Exhaustive research in corporate governance is the need of hour by the law-makers, numerous committees, whose suggestion are really meant to be accepted should formed, as solid corporates is prosperousness to nation, and for that sets of legislation like our constitution (Rigid yet Flexible) should be enacted and penal provisions should be broadened to have a deterrent effect to curb. As the loss is nation's loss, the growth will also be of the nation.

[16] Supra note 3 at Page 9