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SCRUTINY OF INTEREST STIPULATION ON LOAN TO A FOREIGN WHOLLY-OWNED SUBSIDIARY

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INTRODUCTION

Can an Indian parent company fund its foreign wholly-owned subsidiary interest-free? Contrary to what one might suppose, the question has to be answered negatively as the guidelines issued by the legislature require certain preconditions to be followed before executing or transacting inter-corporate loan. In general, such loans have to be structured following the letter of the law & respecting Section 186 of the Companies Act 2013 (hereinafter also referred to as "**Co. Act**"), which provides an outline or framework for such loans. From a plain reading of the language of clause 186(2)(a) of the Co. Act, which is "give any loan to any person or other body corporate", it can be understood that Section 182 of the co. will take within its domain the inter-corporate even loan provided to any enterprise incorporated outside India and hence includes loan advanced to a foreign wholly-owned subsidiary (hereinafter also referred to as "**WOS**").

Subsection 186(7) restricts a parent company from giving an interest-free loan to its WOS. The abovementioned provision dictates that no loan can be provided unless the interest rate is in accordance with the current yield of respective government security nearest to the loan's maturity. The precise meaning of governmental security cannot be construed if searched for within the confines of the Co. Act, so the search has to be extended to the Securities Contracts Regulations, 1956 (hereinafter also referred to as "**SCRA**") as Section 2(95) of the Co. Act lays down that if a particular term is not defined in the Act or spelt out in the Act, then the definitions provided for in the SCRA can be of assistance and applied herein. As per Section 2(b) of the SCRA, a 'government security' is a "security created and issued whether before or after the commencement of this Act, by the Central Government or a State Government to raise a public loan and have one of the forms specified in clause (2) of Section 2 of the Public Debt Act, 1944." But it is vital to fully understand that only securities furnished by the Central or State Government (intending to accumulate a public loan) shall fall within the domain of this clause.

No exemption is provided in term of the interest charged when the parent company advances a loan to its WOS, the only exemption offered under Section 186(3) of the Co. Act is that shareholders' approval is not a prerequisite when submitting a loan or guarantee to one's WOS.

To understand what exactly constitutes a subsidiary company, one needs to know Section 2(87) of the Co. Act, which states that a subsidiary company is a company in which the holding company controls the composition of the Board of directors or holds more than one-half of the total share capital either on its own or together with one or more of its subsidiary companies.

COMPARING THE OLD WITH THE NEW

Before the Companies Act, 2013 came into the picture, the Companies Act, 1956 was in force & the provision under the older Act that was analogous in character or form with Section 186(7) was Section 372A(3). The latter provision dealt with intercorporate loans & investment, it governed both private limited & public limited companies & it provided that no loan to any body corporate shall be made at a rate of interest lower than the prevailing bank rate, being the standard rate made public under section 49 of the Reserve Bank of India Act, 1934 (2 of 1934). The provisions of loan and investment by Companies have been captured under Section 186 in the Co. Act, which is stricter than its predecessor Section 372A of the 1956 Act.

Under the previous legislation, i.e. Companies Act, 1956, a special provision existed in the form of Section 372A(8), which provided immunity from meeting all the conditions laid down in Section 372A, when the holding company offered a loan to its WOS. Thus, the interest rate requirement attached with the inter-corporate loan did not apply if the parent company provided the funding to its WOS.

However, the Co. Act offers no such exemption as no immunity is provided to the WOS from meeting the conditions laid down in Section 186 except for Section 186(3), whose application is exempted & so the requirement of obtaining a special resolution before granting of a loan to the wholly-owned subsidiary is dispensed with.

FEMA RULES CONCERNING SUCH LOANS

As per Section 5 sub-clause (1) of the Foreign Exchange Management (Borrowing or lending in foreign exchange) Regulations, 2000(hereinafter also referred to as "**FEMA**"), an Indian entity may lend in foreign exchange to its wholly-owned subsidiary or joint venture abroad constituted following the provisions of Foreign Exchange Management (Transfer or issue of foreign security) Regulations, 2000(hereinafter also referred to as "**FEMA Regulations**"). If the foreign currency loan proposed falls outside the domain of the Schedule, then the resident applicant is supposed to obtain the Central Government's prior permission. Also, if the parent company requires the assistance of the bank in providing loans to its wholly-owned subsidiary, Reserve Bank of India has tightened the norms[i] for

such transaction or advance provided & now, as per the guidelines issued, the Banks can give loans to overseas subsidiaries of Indian companies, but they have to make 2% of the loan amount as provision on such loans. Compared to the standard loans, it is a straight 1.20% jump as in those cases; the bank is supposed to set aside only 0.40% of the loan amount.

ASSOCIATED PROBLEMS

In many scenarios, a wholly-owned subsidiary cannot borrow or raise capital directly from the market & is highly dependent on the holding company's assistance. That's where the problems lie. A subsidiary company should be able to raise capital from its holding company as & when required without any interest hanging over its head which is an additional financial burden for an enterprise that is seeking assistance & might be going through a rough patch.

Additionally, suppose the wholly-owned subsidiary is located or incorporated in a different nation than the holding company. In that case, conflict may arise as to whose law will be applicable; Since it is very much possible that the foreign law might mandate that the rate of interest will not cross a prescribed threshold contrary to the Indian provision. The annualized interest rate[ii] implemented by the RBI in India is notably higher compared to some of the world's other jurisdictions like the United States of America, Japan, Canada or Hong Kong. The foreign WOS also has to follow the guidelines sanctioned by the Agency or authority where it is domiciled & it cannot conveniently ignore such jurisdictions' mandate. So the Indian benchmark comes with a lot of inconvenience & hassle for such subsidiaries. So taking a loan from the holding companies in such cases comes up with a massive pile of legal complications, which might make a subsidiary avoid taking a loan from a parent company in the first place, owing to the uncertainty & confusion it generates. This creates a flawed scenario where the holding company cannot assist its subsidiary in the form of financial support, even in dire situations.

APPROACHES UNDERTAKEN

Because of this provision, companies resort to getting funding through other means, skirting around Section186(7) of the Co. Act.

The first technique used by the holding company is that it acquires redeemable preference shares in its wholly-owned subsidiary, which can be redeemed at a later date & converted to treasury stock.

The second technique used by the subsidiary company is to issue optionally convertible debentures to the holding company to raise the requisite amount, which can be converted into shares at the expiry of a specific period.

Concerning the already undertaken loan, such an advance could be substituted with a particular set of securities like equity or preference shares. However, this mode may reduce the pocket influx of the company, taking into account the cost of sustaining higher authorized capital.

Thirdly, another means that can be resorted to is that the subsidiary company can take capital in regional currency. Then, the holding company can back the loan & provide a guarantee to the lender after duly abiding with the FEMA regulations.

SECURITIES: THE NEW INTEREST-FREE LOAN?

The controversy that arose along with the insertion of Section 186(7) is that the proviso states that the company cannot give interest-free loan, so does this exclude securities which is not precisely a loan from the application of its provision & does it infer that holding company can acquire by way of subscription, purchase or otherwise securities of the body corporate & no requirement of chargeability of interest comes along with it. The question raised is whether the obligation to charge interest imposed by the legislature does not have any application for the parent company's subscription of securities in any other body corporate.

Under Section 2(h) of the Securities Contracts (Regulation)Act,1956, 'securities' are deemed to include shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate. So has the legislature ousted interest-free loans for the interest-free debentures?

The picture that needs to be cleared out is whether debentures are the new preferred mode of intercorporate loan advancement because of its interest-free nature & whether it is to be used as a 'loan' or 'security. From the description of Section 372A under the Old Act, it could be understood that 'loan' encompassed within its domain, debentures or any deposit of money, passed on by non-banking company onto the other. But no such clarification or definition is provided to the term 'loan' in the current Companies Act, 2013. Does it mean that this omission's legislative intent was deliberate, & government intends to consider debentures as securities & not as loans?

Considering the SCRA definition & the liberal approach taken by the Supreme Court in the case of Sahara Real Estate Corporation Limited & Ors. V. Securities Exchange Board of India & Anr[iii], the gateway to construe debentures as securities are open. So it could be argued that the debentures are not awarded the position of a loan under the new Act, thereby opening up the possibility of providing interest-free advances to their subsidiaries through debentures.

Optionally, corporations not interested in picking sides or being a party to the ongoing debate of securities Vs. The loan has an alternative of fusing parent-subsidiary corporates into a single unified corporate, thereby eliminating the need for an intercorporate loan.

CONCLUSION

Thus, the law is not in sync with the ground realities & there is a dire need to alter Section 186(7) of the Companies Act, 2013 to provide relaxation to many wholly-owned subsidiaries from such financial burden who are entirely independent of the parent company for seeking financial assistance. It is noteworthy that while granting a loan to its foreign wholly-owned subsidiary, the parent company also has to follow the letter of the law engraved in the FEMA framework. Even if Section 186(7) is amended & the interest threshold is altered, FEMA guidelines will still be in place to keep a check & to provide sufficient safeguards. The legislature needs to clarify whether debentures are not included under the loans anymore, as per the Companies Act, 2013 & if not, does it opens up the possibility of providing interest-free advances to one's foreign wholly-owned subsidiary in the form of debentures.

In its report, the Company Law Committee, 2016[iv] had scrutinized the proposition of whether the parent company should be exempt from the general rule to provide interest-free loans when it comes to their wholly-owned subsidiary. However, the committee didn't agree with the proposition put forth, stating it is not wise & advisable to allow WOS to receive interest-free loans from their holding enterprise. Even if receiving interest-free loans may not be permitted, for now, Section 186(7) should at least be altered to withdraw the application of the Indian interest rate benchmark when the grant to a foreign wholly-owned subsidiary is concerned to ensure that there is no clash between Indian and foreign provisions.

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[i] Sangita Mehta, RBI tightens norms for banks lending to overseas subsidiary of Indian Companies, THE ECONOMIC TIMES (Jan.01, 2016, 3:19 PM) https://economictimes.indiatimes.com/news/economy/finance/rbi-tightens-norms-for-banks-lending-to-overseas-subsidiary-of-indian-companies/articleshow/50396549.cms

[ii] Interest Rates, Central Bank News, http://www.centralbanknews.info/p/interest-rates.html

[iii] (2012) 174 Comp Cas 154 (India)

[iv] Report of the Company Law Committee, submitted on February 1, 2016, Pg. 61.