
INTER CORPORATE INVESTMENTS

Case study on section 372A - Calculation of Limits for Investment by a Public Limited Company

Under section 372A of the Companies Act, 1956, directors of companies are empowered to make investments and loans, give security and guarantees to other bodies corporate, up to specified percentage limits only, and if these percentages are exceeded, the board of directors should obtain the consent of the members by means of a special resolution. Sub-section (8) of this section exempts certain transactions from the operation of this section. In this article, presented in the form of a case study, the author illustrates the operation of these provisions by taking the factual details of a hypothetical case - EDITOR

I. FACTS OF THE CASE AND THE QUERY

1. Large Ltd. ('Large') has a proposal for investment in another company, Black Ltd. ('Black'). 'Black' is making a rights issue in the ratio of 1:1. As per the managing director of 'Large', 'Large' would like to subscribe to its entire entitlement and also subscribe for additional shares in case of renunciations or under-subscription to the extent of Rs. 20 crores. Develop Ltd. ('Develop'), is one of the wholly-owned subsidiaries of 'Large'. 'Develop' is also making a debenture issue to the extent of Rs. 20 crores, 'Large' would like to take up up to 50 per cent. As per the last audited balance sheet, paid-up share capital of 'Large' is Rs. 50 crores and its free reserves are at Rs. 70 crores.

2. Investments already made by 'Large' are as follows:

- (a) In the equity of 'Black' - Rs. 35 crores; of the said amount, a sum of Rs. 15 crores was allotted pursuant to a rights issue made in the year 2000 with an additional allotment of shares for Rs. 5 crores, which was also made consequent to renunciations in favour of 'Large'.
- (b) In the equity of Close Ltd. ('Close'), another wholly-owned subsidiary of 'Large' - Rs. 10 crores.
- (c) In the equity of 'Develop' - Rs. 10 crores.
- (d) By way of corporate guarantee on behalf of 'Close' - Rs. 50 crores.

3. The managing director of 'Large' wants to know whether it would be possible for 'Large' to make the proposed investment in 'Black' of additional Rs. 20 crores through renunciations and by applications for issue of additional shares in the event of under-subscription in the rights issue of 'Black'.

II. APPLICABLE PROVISIONS OF LAW

1. Section 372A of the Companies Act, 1956 ('the Act') lays down the limits up to which the directors of a company are empowered to make investments and loans, give security and guarantees to other bodies corporate, and also the procedure to be followed by the company in this regard. It also lays down the procedure with regard to making investments and loans and to give security and guarantees in excess of these specified percentages.

2. Subject to satisfying other conditions, 'Large' could invest up to 60 per cent of its paid-up capital and free reserves or 100 per cent of its free reserves, whichever is more. However, this limit must be checked after taking into account all existing inter-corporate loans and investments. If the said ceiling had to be exceeded, the Board should obtain the consent of the members by means of a special resolution.

3. However, it is necessary to check if there are any exceptions to the above general rule. Clause (a) of sub-section (8) of section 372A specifies the nature of the companies to which the section is not applicable, and clauses (b) to (e) of the said sub-section exempt certain transactions by companies to which the section would otherwise be applicable.

4. The said sub-section starts with the clause "Nothing contained in this section shall apply...", and transactions which are exempt in this sub-section are as follows:

- (a) Investment made in shares allotted in pursuance of section 81(1)(a) of the Act;
- (b) Investment made in wholly-owned subsidiaries;
- (c) Any guarantee given or security provided by a holding company in respect of loan made to its wholly-owned subsidiary; and
- (d) Acquisition by a holding company, by way of subscription, purchase or otherwise, the securities of its wholly-owned subsidiary.

5. Shares allotted pursuant to section 81(1)(a) are those shares that are offered to the existing shareholders of a company in a proportion of their shareholding in the company, which in common parlance is known as 'rights shares'. Thus, 'Large' can subscribe to the extent of its rights entitlement and such investment would be altogether outside the purview of the provisions of section 372A.

6. As per section 81(1), the entitlement for the rights shares is a statutory right and it carries with it the right of renunciation also. However, the said right does not include the right to apply for additional shares in the event of the rights issue failing to receive a full subscription. The only silver lining is that the board of directors has the power to issue the available shares, in the event of under-subscription, to such persons and in such manner as it may think fit. Hence, whereas any investment by 'Large' in shares of 'Black' to the extent of rights entitlement would be outside the purview of section 372A, it would not be the case when 'Large' would like to invest in additional shares in the event of under-subscription in the rights issue of 'Black'. Therefore, it appears that the managing director of 'Large' had raised the said query!

III. EXEMPTIONS AND ELIGIBILITY TO AVAIL EXEMPTIONS

1. In order to arrive at the percentages for determining the nature of approval that is required, whether that of Board of Directors or of the members of the company, the amounts which are of the nature specified in sub-section (8) of section 372A have to be excluded. They are as follows:

- (a) Investments made by a holding company in the shares or other securities of its wholly-owned subsidiary. The exemption is available only if the invested company is already a wholly-owned subsidiary.
- (b) Investment made in the shares pursuant to section 81(1)(a). This exemption, as already discussed, is not available for any investment beyond the rights entitlement.

(c) Loan made by a holding company to its wholly-owned subsidiary and the value of guarantees given or security provided by the holding company in respect of a loan made to its wholly-owned subsidiary. Any guarantee or security furnished by the holding company otherwise than in connection with a loan made to a subsidiary company would not fall under this exemption.

2. A question would arise whether the language used in sub-section (8) of section 372A clearly suggested that not only it removes altogether from the purview of the Act the above exempt categories of investments/loans and other exposures to the extent of the such investment/other exposure proposed to be made/taken up but also intends to omit from the purview of the Act the quantum of such investment/other exposure already made/taken up. In other words, does it suggest that all the existing as well as proposed investments or other exposure falling under the above exempt category would be totally outside the purview of the entire Act?

3. In this respect, it is worthwhile to read the provisions under the provisos to sub-section (4) of the erstwhile section 372 of the Act.

4. The said proviso reads :

“Provided that the investing company may at any time invest up to any amount in shares offered to it under clause (a) of sub-section (1) of section 81 (hereinafter in this section referred to as rights shares) irrespective of the aforesaid percentages:

Provided further that when at any time the investing company intends to make any investments in shares other than rights shares, then, in computing at that time any of the aforesaid percentages, *all existing investments, if any, made in rights shares up to that time* shall be included in the aggregate of the investments of the company.”

[Emphasis supplied]

5. The erstwhile section, which dealt with investments, specifically stated that any investment that the company has so far made in rights shares invested under the provisions of section 81(1)(a) ought to be included for the purpose of arriving at the limits up to which the company can make investments.

6. In contradistinction with the above provision, the present law contained in section 372A(1) does not provide so. No doubt, the first proviso under section 372A(1) states that the *aggregate of the loans and investments so far made*, the amounts for which the guarantee or security *so far provided* should be reckoned for determining whether the Board’s approval would be sufficient or would the authorization by a special resolution of the members be required while proposing to make any investment or take up any exposure. But when sub-section (8) of section 372A accords an absolute (unqualified) exemption for certain categories of investments/other exposures, it is not necessary to restrict the scope of the exemption. Rather the intention of the Legislature has been very clear that such exempt investments and other exposures are totally outside the purview of the Act. If it had been in any other way, a provision similar to the proviso that existed under the erstwhile, section 372 would have been inserted.

7. In the absence of such a provision in the present section 372A, it is a clear indication that the lawmakers have specifically intended to exclude all investments made under section 81(1)(a) and also the investments, loans, guarantees and securities made/provided under the other clauses in sub-section (8) of section 372A.

8. Also under the erstwhile section 372, the department had opined *vide* Circular Letter No. 48(50)-CL VI/61 dated 12-2-1962, that in calculating the amount that a company is eligible to invest, the amount invested by the company under the provisions of sub-section (14) is to be excluded.

9. Despite the above clear position of law, a question would persist in the minds of people whether the exemption under sub-section (8) of section 372A should be construed to apply only in respect of proposed investments/other exposures or whether it should also be construed to exempt all investments/other exposures (of the categories falling under the said sub-section) which have *already been made/taken up*.

10. The Act contains many provisions where a separate treatment has been envisaged for certain provisions contained in different sub-sections of the same section. An illustration would serve the purpose. Consider section 274 of the Act. Clause (g) was added to sub-section (1) of section 274 by the Companies (Amendment) Act, 2000. A proviso has also been added under the said clause. If the proviso had not been added, it would make the said clause apply to all companies, irrespective of whether they are private or public companies. Similarly, a proviso was added to sub-section (2) of section 77A of the Act in order to give a separate treatment to any proposal for buyback which falls within a prescribed limit. Thus, *if the legislative intention had been to make the exemption under section 372A apply only to fresh proposals without making it available for existing investments already made which would have been made within the said exemption, the Legislature would have provided for the same.*

IV. CONCLUSION

Thus, on a harmonious reading of section 372A(8), the provisions contained in the erstwhile section 372(4) in the light of the intention of the Legislature obtainable from the illustrative provisions of the Act cited, 'Large' can make the proposed additional Rs. 20 crores investment in 'Black' through renunciations and by applications for issue of additional shares by availing the exemption contained in section 372A(8). For the exemption under sub-section (8) of section 372A is total in all respects and it enables 'Large' to enjoy complete exemption from the operation of section 372A. Thus, any amount which would fall within the exemptions specified in clauses (b) to (e) of sub-section (8) of section 372A need not be taken into account for computing the limits specified in sub-section (1) of the section. Therefore, the existing investment of Rs. 15 crores already made in the rights issue of 'Black' being the extent of entitlement of 'Large', the existing exposure of Rs. 50 crores taken up by way of corporate guarantee, the existing investment of Rs. 10 crores in the equity capital of 'Close', the existing investment of Rs. 10 crores in 'Develop', the proposed investment to the extent of Rs. 10 crores in the debenture issue of 'Develop' and the proposed investment of Rs. 35 crores in the rights issue of 'Black', being its entitlement, will fall under the exempt category. Thus, investment/exposure aggregating to Rs. 130 crores will be outside the ambit of section 372A and, therefore, 'Large' can go ahead in its proposal to invest up to Rs. 20 crores by way of an application for issue of additional shares, which will be within the limit prescribed under sub-section (1) of section 372A. Sub-section (1) requires a mere resolution of the board of directors subject to compliance with other requirements under section 372A.