



Upstream guarantee: An unexplored law

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Abstract

With the increase of corporate liabilities in the Indian legal regime, the prevalent question of law that intrigues the norms and provisions of the current regime is whether there are any restrictions on the subsidiary company to guarantee and pledge collateral to secure an obligation of its parent company in India. This question of law deliberates the essence of transaction as if subsidiaries are allowed to provide guarantees for the parent company, can it defeat the purpose of guarantee at the first place as is to provide surety of payment of loans. Thereby, whether upstream guarantee is allowed in India?

Keywords: guarantee, upstream guarantee, company law, FEMA

Introduction

When a subsidiary company guarantees and pledges collateral on behalf of the holding or parent company against a third party, this is called upstream guarantee. In vice a versa case, it is called as downstream guarantee. With the increase of corporate liabilities in the Indian legal regime, the prevalent question of law that intrigues the norms and provisions of the current regime is whether there are any restrictions on the subsidiary company to guarantee and pledge collateral to secure an obligation of its parent company in India.

This question of law deliberates the essence of transaction as if subsidiaries are allowed to provide guarantees for the parent company, can it defeat the purpose of guarantee at the first place as is to provide surety of payment of loans. Thereby, whether upstream guarantee is allowed in India?

the law relating to the issuance of upstream guarantee

The Companies Act of 2013 limits the ability of corporations to guarantee loans taken out by their directors or other parties in which they have an interest.

However, the law allows for practical exceptions to this rule, allowing a holding company to offer a guarantee or security for a loan taken from a bank or financial institution by a wholly owned subsidiary or subsidiary, as long as the loan is used for the subsidiary's or wholly owned subsidiary's primary business purposes. The law has been further liberalized to allow businesses to guarantee loans taken out by anyone in whom a director has an interest with the consent of the company shareholders through a special resolution, so long as the borrower uses the money for their primary business operations. The Companies Act also prescribes limits on the guarantees that can be issued by the holding company.

The contents of the Special resolution shall contain the total amount up to which the Board is authorized to make loans, guarantee, investment or security. No approval by way of SR is required, where ^[1] –

- “The loan is given by a company to its Wholly Owned Subsidiary [WOS] or joint venture company [JVC], or

- The guarantee is given or security is provided by a company to its WOS or JVC.
- Where the acquisition of securities of its wholly owned subsidiary is made by a holding company, by way of subscription or otherwise.”

Therefore, pursuant to provisions of Section 186(5) of the Act, consent of the directors present at the board meeting is required by the company for making any investment, giving loans and guarantee and providing security. It is mandatory to take prior approval from such Public Financial Institutions in case the Company has already taken loan etc ^[2].

Additionally, any credit support provided by Indian corporations for loans obtained by their foreign subsidiaries must be disclosed to an authorized dealer bank. These guarantees must have an expiration date and a ceiling of 400% of the guarantor's net worth. A guarantee that goes beyond the requirements must have the RBI's approval ^[3].

Therefore, under section 182 -186, the holding company can pledge the collateral for the subsidiary company. Thereby allowing the downstream guarantee. However, there is no mention all throughout in the company law for the subsidiary company to guarantee for the holding company. In the absence of any specific restriction under the law and no case law barring the subsidiary company from pledging collateral for the holding company, and as it is a settled law, that unless something is barred by the legislature specifically ^[4], it is deemed to be permitted. Therefore, it will be safe to say that the subsidiary company can be eligible to be a guarantor or pledge collateral for the parent company, for which the company has to pass a special resolution.

Implications if the parent holding company is a foreign entity

Issuance of guarantee is generally governed by the Foreign Exchange Management (Guarantees) Regulations, 2000, in which according to Regulation 5(b), “a company in India promoting or setting up outside India, a joint venture company or a wholly owned subsidiary, may give a

guarantee to or on behalf of the latter in connection with its business:...Provided further that the guarantee under this clause may also be given by an authorised dealer in India”^[5].

Also, as per Para B.1.2(a) of RBI Master Direction on Direct Investment by Residents in Joint Venture (JV)/Wholly Owned Subsidiary (WOS) Abroad, “Indian Parties are permitted to issue corporate guarantees on behalf of their first level step down operating JV/WOS set up by their JV/WOS operating as either an operating unit or as a Special Purpose Vehicle (SPV) under the Automatic Route, subject to the condition that the financial commitment of the Indian Party is within the extant limit. Such guarantees will have to be reported to the Reserve Bank in Form ODI, as hitherto, through the designated AD Category-I bank concerned”^[6].

Only in cases where there is already an existing equity or CCPS involvement via direct investment may an Indian Party issue a loan and guarantee to an overseas firm. The Indian Party may, however, make such a financial commitment with the RBI's approval and without making an equity investment in the JV or WOS, subject to the business and regulatory conditions of the host nation. Except for purposes expressly permitted by the Foreign Exchange Management (Guarantees) Regulations, 2000, Indian companies are not permitted to issue any direct or indirect guarantees, create contingent liabilities, or offer any security in any form for such borrowings by their overseas holding, associate, or subsidiary group companies.

The issuance of guarantee by the subsidiary to the foreign holding company will be governed by the Foreign Exchange Management (Overseas Investment) Regulations, 2022, instead of the (Guarantees) regulations. Under regulation 5 of the Foreign Exchange Management (Overseas Investment) Regulations, 2022, it provides:

“Financial commitment by way of guarantee.– (1) The following guarantees may be issued to or on behalf of the foreign entity or any of its step down subsidiary in which the Indian entity has acquired control through the foreign entity, namely:–

corporate or performance guarantee by such Indian entity;...”^[7]

Therefore, the present case of issuance of a guarantee by the subsidiary for the foreign holding company will be governed by clause (1) read with sub-clause (i) of the regulation as it will be termed as a financial commitment by way of guarantee.

In the case of *Great Pacific Navigation (Holdings) Corporation Ltd. v. M.V. Tongli Yantai*^[8], *Rainbow is a subsidiary of Tongli China*. “The Rainbow Success issued corporate guarantee on behalf of Eastshine to Halcyon under the BBC along with personal guarantee of WWD on behalf of Tongli China which guaranteed the payment of Eastshine to Halcyon”. In the case of *Deputy Commissioner of Income Tax, Central Cricle-2(1), Kolkata-107 and others v. Paharpur Cooling Towers Ltd. and others*^[9], a mention of the situation in which an Indian company, provided a guarantee to a third-party bank on behalf of its foreign subsidiary for which it did not charge a fee.

Compliance requirements in case of foreign guarantee transaction.

As, the ODI regulations, 2022 are applicable in the present scenario, therefore, all the compliances will be met in accordance to the ODI regulations.

- All guarantees (including performance guarantees and Bank Guarantees / SBLC) shall be reported to RBI in Form ODI-Part I. Submission of Form A2 of respective AD Bank along with above mentioned form ODI Part I.
- Any Indian Party which intends to make an ODI shall approach a designated AD- 1 for making the remittance/investment along with duly filled form ODI Part I along with the supporting documents like Board Resolution, Statutory Auditor Certificate, etc. Once the AD Bank scrutinizes and approves the documents as per the regulatory guidelines, the remittance/investment will be processed.
- Any guarantee, to the extent of the amount invoked, shall cease to be a part of the non-fund based financial commitment but will be considered as financial commitment by way of debt. Such invocation shall be reported in Form FC.

Further, other requirements of compliance under the Foreign Exchange Management (Overseas Investment) Regulations, 2022 are provided by the RBI vide Foreign Exchange Management (Overseas Investment) Directions, 2022 in which different compliance requirements are provided depending upon the nature of the transaction.

Conclusion

In view of the aforesaid research, it can be concluded that a subsidiary company can issue a guarantee in favour of the parent company as there is no law prohibiting the said transaction, further the law also does not restrict the issue of a guarantee in favour of the foreign holding company if it is in accordance with the Foreign Exchange Management (Overseas Investment) Regulations, 2022 as an ODI for which, it is to be reported to the RBI. Additionally, the Companies Act, 2013, and Foreign Exchange Management (Guarantees) Regulations, 2000 (the prevailing law on the subject) are silent on such transactions.

References

1. Section 186, The Companies Act, 2013.
2. Section 186 (5), The Companies Act, 2013.
3. RBI/2015-16/41, Master Circular No. 11/2015-16.
4. Justice K. S. Puttaswamy & Anr. vs Union of India & Ors. AIR 2017 SC 4161; Kesavananda Bharati Sripadagalvaru & Ors. v. State of Kerala & Anr. (1973) 4 SCC 225.
5. Regulation 5(b), Foreign Exchange Management (Guarantees) Regulations, 2000.
6. Para B.1.2(a), RBI Master Direction on Direct Investment by Residents in Joint Venture (JV)/Wholly Owned Subsidiary (WOS) Abroad.
7. Regulation 5, Foreign Exchange Management (Overseas Investment) Regulations, 2022.
8. *Great Pacific Navigation (Holdings) Corporation Ltd. v. M.V. Tongli Yantai* 2014 SCC OnLine Bom 71.
9. *Deputy Commissioner of Income Tax, Central Cricle-2(1), Kolkata-107 and others v. Paharpur Cooling Towers Ltd. and others* 2020 SCC OnLine ITAT 2680; 2020 SCC OnLine ITAT 3131.