

Analysis of exemptions and relaxations of Related Party Transactions provisions under Companies Act 2013

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Gaurav Pingle

Section 188 of Companies Act, 2013 relates to 'Related Party Transactions' that prescribes certain contracts/arrangements with prescribed parties that requires the consent of the Board of directors at Board meetings. There are certain provisions in the Act, the Amendment Act, 2015 the Amendment Rules, 2010 Circulars of Ministry of Corporate Affairs (MCA) and recent MCA Notification dated 5th June, 2015, which exempt companies from the compliance of RPTs. The article discusses such exemptions, along with analysis and impact on the practicing professionals and corporates.

Transaction in “ordinary course of business” and “on arm’s length basis”

1. A transaction will qualify as “related party transaction” (‘RPT’) if the following conditions are satisfied :

- A company [private company or public company] enters into any prescribed transactions [7 transactions as laid down in section 188 of the Companies 2013 (‘the Act’/‘2013 Act’)] with prescribed related party [in accordance with clause (76) of section 2 of the Act]. Once a transaction is a RPT, then we need to apply the following two more fundamental tests :
- Whether the RPT is in ordinary course of business ?
- Whether the RPT is on arm’s length basis ?

If the answer to the above question is affirmative, then the company is not required to comply with the provisions of sub-section (1) of section 188, vide the third proviso to that sub-section which states that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm’s length basis. Therefore, such transaction needs no approval of the Board of directors and shareholders.

Few parties not “related parties” to private company

2. Vide MCA Notification dated 5th June, 2015, sub-clause (viii) of clause (76) of section 2 is not applicable to private companies, i.e., following parties are not “related parties” for private companies :

- Holding company
- Subsidiary company
- Associate company
- Subsidiary of holding company to which it is also subsidiary company.

By virtue of this amendment vide the MCA Notification, the proposed transactions to be entered by a private company with the above mentioned parties shall not require requisite approval under section 188. This can be explained by following practical examples :

- H (P.) Ltd. (holding company) provides sales and support services to S (P.) Ltd. (subsidiary company). For this transaction, H (P.) Ltd. is exempted from the compliance of section 188.
- H (P.) Ltd. (holding company) provides consulting services to A (P.) Ltd. (associate company). For this transaction, H (P.) Ltd. is exempted from the compliance of section 188.

However, it needs to be noted that if the counter-party to such a transaction is a public company, then such counter-party will be under obligation to comply with the provisions of section 188.

Voting by “related party”

3. MCA Notification dated 5th June, 2015 has provided another exemption to private companies. Vide this notification, the second proviso to sub-section (1) of section 188 has been exempted, i.e., the member of a private company is eligible to vote on such ordinary resolution, approving the contract or arrangement which may be entered into by the private company, if such member is a “related party”. In many closely held private companies, the directors are the members of the company, which lacks disinterested directors as well as members. The said relaxation will make the transactions between closely-held group private companies smoother, without requiring the cumbersome approvals process and non-voting by the interested member. MCA Notification has addressed the practical challenge of obtaining consent of such related parties. However, the exemption for the private companies is applicable only in cases where the proposed transaction is either not in the ordinary course of business or not at arm’s length.

Transactions between holding company and wholly owned subsidiary

4. The shareholders approval need to be sought when the transaction is not in the ordinary course of business or the transaction is not at arm’s length or both. The Companies (Amendment) Act, 2015 exempts the shareholders’ approval where the transactions entered into between holding company and its wholly owned subsidiary. To avail such exemption, it is also mandatory that the accounts of the wholly

owned subsidiary company are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

Corporate restructuring transactions

5. MCA, vide the Circular dated 17th July, 2014, exempts companies from the compliance of section 188, arising out of compromises, arrangements and amalgamations dealt under the specific provisions of the Companies Act, 1956 (1956 Act) / 2013 Act.

Transitory provisions

6. MCA, vide the Circular dated 17th July 2014, has clarified on the requirements of fresh approval of past contracts under section 188. The contracts entered into by the companies (private company and public company), after making necessary compliances under section 297 of the 1956 Act, which have already come into effect before the commencement of section 188 (i.e., 1st April, 2014) will not require fresh approval under section 188 till the expiry of the original term of such contract. However, if there is any modification in such contract made on or after 1st April, 2014, the companies will be under obligation to comply with the provisions of section 188.

Revised thresholds for shareholders' approval

7. MCA amended the Companies (Meetings of Board and its Powers) Rules, 2014 on 14th August, 2014 to increase the thresholds for obtaining the approval of members vide special resolution [to be read as "ordinary resolution" vide Companies (Amendment) Act, 2015]. For the purposes of first proviso to sub-section (1) of section 188, except with the prior approval of the company by a special resolution [to be read as "ordinary resolution" vide Companies (Amendment) Act, 2015], a company shall not enter into transaction(s) where the transaction(s) to be entered into –

(a) as contracts or arrangements with respect to clauses (a) to (e) of sub-section (1) of section 188, with criteria as mentioned below :

(i) sale, purchase or supply of any goods or materials, directly or through appointment of agent, exceeding 10 per cent of the turnover of the company or Rs. 100 crore, whichever is lower, as mentioned in clause (a) and clause (e) respectively of sub-section (1) of section 188 ;

(ii) selling or otherwise disposing of or buying property of any kind, directly or through appointment of agent, exceeding 10 per cent of net worth of the company or Rs. 100 crore, whichever is lower, as mentioned in clause (b) and clause (e). respectively of sub-section (1) of section 188 ;

(iii) leasing of property of any kind exceeding 10 per cent of the net worth of the company or 10 per cent of turnover of the company or Rs. 100 crore, whichever is lower, as mentioned in clause (c) of subsection (1) of section 188 ;

(iv) availing or rendering of any services, directly or through appointment of agent, exceeding 10 per cent of the turnover of the company or Rs. 50 crore, whichever is lower, as mentioned in clause (d) and clause (e) respectively of sub-section (1) of section 188.

(b) with respect to the appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs. 2,50,000 as mentioned in clause (f) of sub-section (1) of section 188 ; or

(c) remuneration for underwriting the subscription of any securities or derivatives thereof, of the company exceeding 1 per cent of the net worth as mentioned in clause (g) of subsection (1) of section 188 ;

With respect to the clause (a), MCA clarifies that the limits specified in sub-clauses (i) to (iv), as mentioned above, shall apply for transaction(s) to be entered into either individually or taken together with the previous transactions during a financial year. Though this is not a complete exemption, there has been some relaxation in obtaining the approval of shareholders for the related party transactions.

Members' approval by passing ordinary resolution

8. For obtaining the approval of the shareholders, the Companies (Amendment) Act, 2015 substitutes the provision of passing ordinary resolution instead of special resolution for certain transactions exceeding the prescribed thresholds (as mentioned above). Though this is not a complete exemption, there has been some relaxation in obtaining the approval of shareholders for the related party transactions.

Conclusion

9. Over the last one year, there has been adequate effort by the Government to overhaul the provisions of the Act with an objective of "ease of doing business" in India. The MCA has addressed some critical issues by exempting private companies from compliance of the RPT provisions by an Amendment Act, amending the applicable Rules, issuing circulars and notifications. There has been substantial change in the provisions relating to "related parties", "prescribed transactions", "shareholders approval". In my personal view, the MCA now needs to provide guidance on the "transactions in ordinary course of business" and "arms length", which is one of the most awaited information by the Indian companies.

FOOTNOTES

* Company Secretary, Pune, acsgauravpingle@gmail.com .

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