

COMPANY LAW

[2015] 128 CLA (Mag.) 47

Demystifying ‘ordinary course of business’ in the context of related party transaction**Gaurav Pingle***

In this article, the author makes an attempt to demystify the expression ‘ordinary course of business’ used in the third proviso to sub-section (1) of section 188 of the Companies Act, 2013 which relates to related party transaction wherein the approval process and compliance regime are prescribed for certain prescribed contracts/arrangements with prescribed parties. He feels that the expression ‘ordinary course of business’ is a relative term and cannot be applied as thumb rule for all companies. ❖❖EFW❖❖

Introduction

1. Section 188 of the Companies Act, 2013 (‘the Act’) relates to ‘related party transactions’ (‘RPTs’) wherein the approval process and compliance regime is prescribed for certain prescribed contracts/arrangements with prescribed parties. A transaction will qualify as ‘RPT’, if a company enters into any prescribed transaction [7 transactions as prescribed in section 188] with prescribed related party [as prescribed in section 2(76)]. Once a transaction is a ‘RPT’, then it is necessary 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?

Depending on the answer to the questions, the compliance and approval process is defined *i.e.*, board approval or shareholders approval and requisite disclosures in the Board’s report. One of the fundamental tests is : whether RPT is in ordinary course of business ? This article contains detailed discussion on the concept of ‘transactions entered in the ordinary course of business’.

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Ordinary course of business

2. The Act has neither defined the phrase ‘transactions entered in the ordinary course of business’ nor provided any guidance in the Act/Rules. *Black’s Law Dictionary* (8th edn.) defines ‘ordinary course of business’ as ‘the normal routine in managing a trade or business’ and terms it as ‘regular course of business’, ‘ordinary course’, ‘regular course’. *Ramanatha’s Aiyer’s Advanced Law Lexicon* (3rd edn.) defines ‘ordinary course of trade’, as in anti-dumping law, to mean that “sales are considered to be in the ordinary course of trade when the sales are not affected by any relationship between the buyer and the sellers are based on commercial considerations and are at arm’s length”, “this phrase indicates the current routine of business which was usually followed by the person ... and does not apply to any particular transaction of an exceptional kind such as the execution of a deed of mortgage but to the business ... in which the declarant was ordinarily or habitually engaged.” *Considering these definitions of ‘ordinary course of business’, it can be said that a transaction entered into by the company which is not in an extra-ordinary course or in an unusual or abnormal nature, but in the regular routine of the business, then it can be said that the transaction is entered by company is in the ordinary course of business.*

Guidance on ordinary course of business through tax laws

3. For the first time, the phrase ‘ordinary course of business’ has been introduced in the company law; therefore there is no readily available case law on such phrase. However, in tax laws, there are provisions which define whether transaction with related party is ‘business transaction’, for which it takes into consideration transaction history, provisions in memorandum of association, articles of association, etc. Below cases will assist in understanding phrase ‘ordinary course of business’ from the perspective of tax laws, which may be applied for compliance of the Act (depending on facts of case):

- In *A. Ebrahim & Co. v. State of Bombay* [1962] 13 STC 877 (Bom), [relating to Bombay Sales Tax (Procedure) Rules, 1954 - Rule 3(1) and Sales Tax Act], one of the business activities of the applicant was selling separated parts of the ship. The applicant purchased a ship and reserved an option of either using the ship for trading purposes or to break it up. The Bombay High Court noted that the breaking-up and selling separated parts of the ship was appellant’s ‘normal business activity’ and also acknowledged the facts that applicant has neither used ship for trading purposes nor has broken the ship and sold separated parts thereof. The appellant entered into an agreement of sale with Costa Rica Co. and gave an option to either use the ship for trading purposes or to break it up. The Bombay High Court observed that these circumstances clearly indicate that the applicant had purchased the ship in the course of his usual business activity of purchasing ship,

breaking it up and selling separated parts thereof, though no doubt an option was also reserved by the appellant to use the ship for trading purposes. It observed that it is true that the 'normal business activity' of breaking up the ship and selling separated parts had not been followed by the applicant, but he has sold the ship leaving an option to the purchaser to break it up. The circumstances show that soon after the purchase of the ship, the applicant found a purchaser who possibly was in need of separated parts of the ship, and therefore instead of breaking up the ship and selling separated parts, he had sold the entire ship to the Costa Rica Co. giving it an option to break it up. The High Court held that under these circumstances, the activity of the applicant selling the ship to Costa Rica Co. has a 'very close connection with and akin to the normal course of business' of the company, and was, therefore, in the course of his business activity. The sale proceeds relating to the sale of the ship were therefore included in applicant's 'turnover'.

• In *Commissioner of Sales Tax v. Hindustan Spinning & Weaving Co. Ltd.* [1964] 15 STC 69, the Bombay High Court noted that the respondent-company carried on the business of manufacture of cloth. In 1953-54, 1954-55, 1955-56 and 1956-57, it sold some of its old machinery and replaced it by new machinery. In August, 1956, it sold one roto coner and high speed warping machine for Rs. 35,700. The moot question was whether the respondent-company can be held to be 'dealer' as regards sale of certain old machinery of its mill. The High Court held that although the sale of roto coner and high speed warping machine has been an item of several such transactions of sale of old machinery of considerable volume which have been effected by the respondent-company during 1953-54 to 1956-57, the sale could not be said to have been done in the course of its business activity and, therefore, the respondent-company would not be 'dealer'. The business of the respondent-company was the manufacture of cloth. For the said business the company had from time to time replaced its old and unserviceable machinery by new machinery although such replacements of the old machinery by new machinery may have been necessitated for the business purposes of the company. The disposal of the old machinery for the purposes of replacing it by new machinery cannot be said to be a part of business of the respondent-company.

• In *Gosri Dairy v. State of Kerala* [AIR 1962 Ker 4, 1961 KLJ 860, [1961] 12 STC 683, the Kerala High Court noted that the firm was dealing in dairy products, wherein the business necessitated keeping of productive live-stock and was required to sell away a part of the live-stock annually, to be replaced by fresh yielding stock. The moot question was whether the proceeds of such sales are to be counted as part of 'turnover' which is liable to sales-tax. The High Court noted that the firm is a registered dealer only for dairy product and has been regularly selling its unserviceable cows, in such numbers that the annual proceeds were in the range of Rs. 11,000 – Rs. 16,000. The High

Court held that the sales cannot be 'mere casual dealings' or 'isolated transactions' but acts done in the carrying on or carrying out of the firm's business and that frequency, regularity and the volume of sales of cattle by the assessee in the present case are such that they can be regarded as 'an activity in the course of the business of the assessee'. Accordingly, the High Court accepted the view taken by sales-tax authorities that the petitioner's sale of dry cows was part of its business, constituting it 'dealer' within the meaning of Sales Tax Act and attracted liability to taxation in respect thereof.

- In the *State of Bombay v. Ahmedabad Education Society* [1956] 7 STC 497, the Bombay High Court noted the facts that Ahmedabad Education Society ('Society') had as its objects the spread of education, the starting and taking over arts colleges and other similar objects. In furtherance of these objects the Society gave contract to a contractor for construction of buildings for colleges, residential quarters for the staff and hostels for students and realizing that it would be cheaper and more economical to manufacture bricks for the construction of the buildings, the Society set-up a brick-factory and supplied the manufactured bricks to their contractor. However, the bricks manufactured were in excess and therefore, the Society sold the excess quantity to sister educational institutions. Similarly, the Society also imported steel on obtaining permission and sold it to its contractor for utilizing it in the construction of its buildings. The excess quantity of steel also was disposed of by selling it to such persons. The revenue sought to tax these sales in the hands of the Society. The Court held that the Society was not liable to pay any tax on the sales inasmuch as the Society was not carrying on the business of selling and supplying goods, and therefore was not a 'dealer' within the meaning of the Act. The mere activity of selling would not constitute the business of selling and supplying, but what would constitute a particular transaction as 'transaction in business' would be a person purchasing goods with the object of selling them, or a person producing the goods with the object of selling them.

Broad factors for determining ordinary course of business

4. Based on the above discussion, following are few broad factors that can be considered for determining whether a transaction is in ordinary course of business or not. These are not conclusive factors, but will provide assistance to professionals and corporates in determining one of the very significant RPTs conditions. Also, the below factors and its application will depend on case-to case basis :

- *Objects clause* – The proposed transaction relating to a particular activity can be part of memorandum of association, either under the head of 'Objects for which the company is incorporated' (*i.e.*, main objects) or under the head of 'any matter for the furtherance of objects specified' (*i.e.*, ancillary objects).

However, it is worth noting that 'all intra-vires activities do not amount to transactions in the ordinary course of business and all the transactions in the ordinary course of business are not necessarily intra-vires activities'.

- *Nature of business and industry* – The industry and the nature of company's business is also one of the essential factors in determining whether transaction is in ordinary course of business or not.
- *History of the transaction* – The existence of events/history of transactions – prior to the enactment of the provisions of section 188 (*i.e.*, 1st April, 2014) and the continuation of such events after enactment of the provisions, may fall under the category of 'related party transaction'. The existence of events/history of transactions can be a 'precedence' created by the company.
- *Periodicity* – An ad-hoc transaction, which does not occur in the regular course of business, would not fall under the purview of 'ordinary course of business'.

Conclusion

5. The phrase 'ordinary course of business' is a relative term and cannot be applied as thumb-rule for all companies. For a particular company, the transaction can be in its ordinary course of business, whereas the same transaction for other company may not be in the ordinary course of business. The phrase is very subjective, and it seems difficult that there could be any guidance from any statutory authority, considering the operational complexities of diversified sectors, varied organization structures and unique transaction structures. Therefore, the compliance officers or consultants have to take an independent and informed decision for determining whether the transaction is in ordinary course of business or not. ❖❖❖