

## Effect of decriminalising RPT non-compliance

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In line with the Government's objective of promoting 'ease of living' by providing 'ease of doing business' to law abiding corporates, fostering improved corporate compliance for stakeholders at large and also to address emerging issues having impact on the working of corporates in the country, the Government constituted Company Law Committee ('CLC') for examining and making recommendations on various provisions and issues pertaining to implementation of Companies Act, 2013 ('Act') and LLP Act, 2008<sup>1</sup>.

Based on CLC's recommendations and internal review, it was proposed to amend various provisions of the Act to decriminalise minor procedural or technical lapses into civil wrong. Taking into consideration the overall pendency of the courts, a principle-based approach was adopted to further remove criminality in case of defaults, which can be determined objectively and which otherwise lack any element of fraud or do not involve larger public interest. In addition, the Government also proposed to provide greater ease of living to corporates through certain other amendments to the Act<sup>2</sup>.

The Companies (Amendment) Bill, 2020 was introduced in Lok Sabha on March 17, 2020. The Bill was passed in Lok Sabha on September 19, 2020 and in Rajya Sabha on September 22, 2020. The Bill received Presidential assent on September 28, 2020. In this article, I have analysed the impact of decriminalising non-compliance of provisions relating to related party transactions ('RPT').

**Introduction to RPT provisions:** According to section 188 of the Act, the consent of board of directors at its meeting is required for entering into a prescribed transaction with related party (as defined in section 2(76) of the Act). The provisions require shareholders' approval, if paid-up share capital or transaction value exceeds prescribed amount. A member of the company shall not vote on the resolution approving such RPT resolution, if such member is a 'related party'. The consent of board of directors and shareholders' approval is not required if RPT is in ordinary course of business and on arm's length basis.

**Extant provisions for non-compliance of section 188 of the Act:** Where any contract or arrangement is entered into by a director or any other employee, without obtaining board consent or shareholders' approval, and if it is not ratified by board or shareholders, as the case may be, within 3 months from the date of such contract or arrangement, then it

shall be voidable at the option of board of directors or shareholders, as the case may be. Further, if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it. In any case, it shall be open to the company to proceed against a director or any other employee who had entered into such contract or arrangement in contravention of the provisions for recovery of any loss sustained by it as a result of such contract or arrangement.

According to section 188(5) of the Act (prior amendment), any director or any other employee of a company, who had entered into or authorised a contract or arrangement in violation of said the provisions shall:

- (i) *In case of listed company*, be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not be less than Rs. 25,000/- but which may extend to Rs. 5,00,000/- or with both; and
- (ii) *In case of any other company*, be punishable with fine which shall not be less than Rs. 25,000/- but which may extend to Rs. 5,00,000/-.

**CLC's Recommendations:** CLC noted that section 188(5) of the Act stipulates that transactions with related parties without compliance of the provisions would give rise to a lapse and such contracts would be voidable at the option of board or shareholders, as the case may. Additionally, the company can also proceed against the errant individuals. CLC observed that thresholds w.r.t. board/shareholders' approval are also well laid out under relevant rules. Accordingly, CLC proposed that the said offence may be shifted to 'in-house adjudication' framework<sup>3</sup>.

**Decriminalising RPT non-compliance:** Based on CLC's recommendation, the relevant provisions were proposed to be amended, wherein in any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of section 188 of the Act shall:

- (i) *In case of listed company*, be liable to a penalty of Rs. 25 lacs; and
- (ii) *In case of any other company*, be liable to a penalty of Rs. 5 lacs.

**Process of Adjudication & analysis of amendment:** Pursuant to section 454 of the Act, Central Government may appoint officers not below the rank of Registrar of Companies, as Adjudicating Officers ('AO') for adjudging penalty under the provisions of the Act. The AO may, by an order: (i) Impose penalty on company, officer who is in default, or any other person, as the case may be, stating therein any non-compliance or default under the relevant provisions of the Act; and (ii) Direct such company, or officer who is in default, or any other person, as the case may be, to rectify the default, wherever he considers fit. The AO shall, before

imposing any penalty, give a reasonable opportunity of being heard to such company, the officer who is in default or any other person. W.r.t. RPT non-compliance, AO would have ready access to the following information/e-Forms filed by the company:

- (i) Financial statements, Annual Return and related e-Forms,
- (ii) Particulars of contracts or arrangements with related parties<sup>4</sup> (Form AOC - 2),
- (iii) Audit Report. Under Companies (Auditor's Report) Order, 2016, there is a specific reporting whether all transactions with related parties are in compliance with Sections 177 and 188 of the Act and details have been disclosed in financial statements, as required by applicable Accounting Standards,
- (iv) Compliance with section 188 of the Act - Annual Return (in Form No. MGT. 8 - certified by Company Secretary in practice) filed by listed company or certain class of companies,
- (v) Secretarial Audit Report.

Taking into consideration the fact that accounts/finance team of listed company have prepared the financial statements, statutory auditors and secretarial auditors have conducted audit of the company and independent directors (through Audit Committee) have examined, scrutinised and approved RPTs, the AO will then exercise his expertise and review such RPTs. Such scrutiny of transactions would require more details *i.e.* method of identifying related parties, nature of transactions covered, inclusion and exclusion of certain transactions, etc. Such details are generally available with the auditors or company executives.

Broadly, the objective of Accounting Standards/Indian Accounting Standards is ensuring transparency and adequate disclosures to all stakeholders. Therefore, certain RPTs under AS 18/IndAS 24 are not RPTs under the Companies Act *i.e.* finance (including loans and equity contributions in cash or in kind), guarantees and collaterals. Such transactions may fall under section 185 of the Act as well (relating to 'Loans from directors, etc.'). There is an overlap of transactions under section 188 of the Act with Accounting Standards and section 185 of the Act with Accounting Standards. Interestingly, the definition of 'related party' under Act and Accounting Standards is also different, which practically affects compliance of said provisions. In order to ensure, proper and adequate compliance of RPT provisions, MCA needs to clarify and align the provisions of Accounting Standards with section 188 of the Act (or vice versa). This will ensure uniformity in reporting of transactions and at the same time assist the AOs in taking appropriate action.

According to Rule 3 of the Companies (Adjudication of Penalties) Rules, 2014, while adjudging quantum of penalty, the AO shall have due regard to the certain factors, namely: company's size, nature of business, injury to public interest, nature of default, repetition of default, amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default; and amount of loss caused to an investor or group of

investors or creditors as a result of the default. In certain closely-held companies, the non-compliance of RPT provisions would not cause an injury to public interest or loss caused to an investor or group of investors or creditors or any amount of disproportionate gain or unfair advantage. In such cases, what would be the parameter for AO to impose penalty under section 188 read with section 454 of the Act - whether amount of RPT or company's share capital structure?

Another important issue is - can AO question some basic aspects of RPTs *i.e.* whether transaction is in ordinary course of business or on arm's length basis or both. If such questions are raised by AO, then replies from companies or non-compliance, would fall within the purview of Audit Committee.

It is also important to note that the provisions relating to RPTs are not independent provisions. Many provisions are inter-connected and inter-dependent with the provisions of section 188 of the Act, which includes Audit Committee (section 177), Loans to directors, etc. (section 185), Register of contracts or arrangements in which directors are interested (section 189), Contract by OPC (section 193), etc. However, only non-compliances under section 188 of the Act are decriminalised. In other cases, the company and its officers have an option for making an application for compounding of offences under section 441 of the Act.

Section 164 of the Act relates to 'disqualifications for appointment of director'. According to clause (g) of sub-section (1) to section 164 of the Act, a person shall not be eligible for appointment as a director of a company, if he has been convicted of the offence dealing with RPTs under section 188 of the Act at any time during the last preceding 5 years. As the RPT non-compliance would fall under in-house adjudication framework and that the AO may impose penalty, the question is - whether Companies (Amendment) Act, 2020 has effectively decriminalised such non-compliance?

In my view, enforcing non-compliance of RPT provisions would be easy for all Regulators if compliance provisions and disclosure requirements under Companies Act, Accounting Standards and SEBI (Listing Obligations and Disclosure Requirements) Regulations are integrated and aligned. The companies would then be required to maintain high degree of disclosures and transparency, which would ultimately leave no room in creating 'exceptions' to RPT provisions.

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1. Order F. No. 2/1/2018-CL-V, dated September 18, 2019.

- [2.](#) Paragraph No. 3 of the Statement of Objects and Reasons to the Companies (Amendment) 2020 introduced in Lok Sabha
- [3.](#) Clause 2.20, Page No. 24 of the CLC Report.
- [4.](#) sub-section (1) of section 188 in the prescribed form.