

Comprehending related party transactions under the Companies Act 2013

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Section 188 of the Companies Act, 2013 relates to “related party transactions” (‘RPTs’) that prescribes certain contracts/arrangements with prescribed parties consent of Board of directors at Board meeting. In section 188, there are new concepts that are introduced such as : arm’s length, ordinary course of business and restriction on voting by a member who is a related party, etc. The author assists the readers in understanding basics of RPTs, complexities involved, probable solution, compliance of audit committee’s approval and requisite disclosures in Board’s report.

Basic ingredients for a transaction to qualify as related party transaction (‘RPT’)

1. A transaction will qualify as RPT if the all the following three conditions are satisfied :

A company [private company or public company]

Enters into any prescribed transaction [7 transaction laid down in section 188 of the Companies Act, 2013 (‘the Act’)]

With a related party [in accordance with section 2(76) of the Act].

If all these three conditions are satisfied, then only we need to refer the provisions of section in the following situations :

Private company enters into transaction with its holding company incorporated outside India for rendering software services. Section 188 is not applicable as two out of three conditions are satisfied. Company incorporated outside India cannot be a “related party” under clause (76) of section 2.

Private company enters into transaction with its public company for a transaction which is beyond the scope of seven transactions prescribed in sub-section (1) of section 188. Section 188 is not applicable as two out of three conditions are satisfied. RPT provisions are not applicable for transactions between two companies for a non-prescribed transaction.

Two more fundamental ingredients for section 188 compliance

2. Once a transaction is a ‘RPT’ then we need to comply with following essential/fundamental conditions for the compliance of section 188 :

Whether the RPT is in ordinary course of business ?

Whether the RPT is on arm’s length basis ?

If the transaction is in ordinary course of business and on arm’s length basis, then the company is not required to comply with the provisions of sub-section (1) of section 188. If the transaction is in ordinary course of business but not on arm’s length basis, then the company is required to comply with the provisions of that sub-section, by obtaining Board approval in Board meeting and shareholders’ approval by passing a special resolution in general meeting.

If the transaction is not in the ordinary course of business but at arm’s length basis, then the company is required to comply with the provisions of that sub-section, by obtaining Board approval in Board meeting and shareholders’ approval by passing a special resolution in general meeting. Therefore, the grapevine in the professional circles that “all RPTs are to be approved by shareholders” is baseless and ought not be relied on.

Ordinary course of business

3. The fundamental question is : what is the meaning of “ordinary course of business” and a transaction on “arm’s length basis” ? There is no guidance in the Act for the phrase “ordinary course of business” and some guidance for transaction on “arm’s length basis”, meaning a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest. Based on judicial precedents under other laws, it can be inferred that “ordinary course of business” would include usual transactions or as per customs and practices of a business and of the company. The ICAI has provided some guidance through Standard on Auditing (SA) 550 wherein some examples of transactions falling outside the ordinary course of business are specified. In many cases, it may be apparent that a transaction is in “ordinary course of business” or not ; however, in some cases, the assessment of whether a transaction is in ordinary course of business or not may be highly subjective, judgmental and will vary from case-to-case basis.

Transaction on arm’s length basis

4. The guidance provided by the Act for the phrase “arm’s length basis” is not only insufficient but also erroneous. Arm’s length basis means a “transaction between two related parties that is conducted as if they were unrelated”. The later part of the phrase “so that there is no conflict of interest” is completely irrelevant and adds no value, as there is obvious “conflict of interest”. For a transaction to be at “arm’s length”, one may refer to rules for registered valuers (which are yet to be notified) for some guidance, wherein valuation methodologies are prescribed for registered valuers. Some guidance may be drawn from methodologies and practices adopted under other statutes, i.e., Income-tax Act, 1961 (‘IT Act’). It should be noted that such guidance, if drawn, is not conclusive and would have only persuasive value, at best.

Deadlock situations in general meeting

5. Section 188 provides that no member of company shall vote to approve any contract or arrangement, if 'such' member is a related party. This provision was further clarified by Ministry of Corporate Affairs, by specifying that the term "related party" in this context would only mean that related party, which is "related party" in context of the contract or arrangement, for which resolution is passed by members. Though the intent of the provision seems logical, i.e., to mitigate conflict of interest that may arise in approval of RPTs. However, in the absence of any exemption for RPTs undertaken within privately owned groups (except for transactions with wholly owned subsidiary), in some cases, it has resulted in over-regulation, creating a deadlock in such situations.

Audit committee approval

6. In accordance with provisions of clause (iv) of sub-section (4) of section 177 of the Act, the audit committee (wherever required to be constituted) is required to approve RPT or any modification of RPT with company. Such approval is required for any RPT irrespective of any threshold, whether such transaction is at arm's length and in ordinary course of business or not. This means that every trivial transaction needs to be placed before the audit committee for approval. For mitigating the practical difficulties on account of audit committee approval requirements, SEBI has introduced concept of "omnibus approvals" in the Listing Agreement. The Government has also proposed an amendment to the Act (which is pending approval) for introducing a similar concept of "omnibus approvals". Also, there is no relaxation in the Act for obtaining a post facto approval of audit committee for any RPT, unlike approvals required from Board or shareholders, for which there is a prescribed timeframe of three months.

Disclosures of RPTs in Board's report

7. Sub-section (2) of section 188 provides that every contract or arrangement entered into shall be reported in the Board's report, along with the justification for entering into such contract or arrangement. This would essentially mean that transactions which are either not at arm's length or not in ordinary course of business would need to be disclosed in Board report along with justification. However, the new format (i.e., Form AOC-2) prescribed for disclosure of RPTs in the Board report has expanded the scope by even including the transactions which are at arm's length. This will make procedural compliance more difficult for companies, resulting in information overload for stakeholders, thereby making Board's report irrelevant to some extent.

Necessity for overhauling RPTs provisions

8. In order to achieve the objective of "ease of doing business" in India and address the key implementation issues, there is a pressing need for overhauling the provisions of RPTs in the Act. The Companies (Amendment) Bill, 2014, though it proposes amendments in RPTs, the provisions still needs a comprehensive review, e.g., exempting private companies from RPT compliance or detailing appropriate exemptions, detailed guidance on "ordinary course of business" and "arm's length transaction", appropriately defining role of audit committees, reducing disclosures in Board's report etc. This will help in addressing key implementation issues to a large extent and also reduce the probable scope of misuse of section 188.

FOOTNOTES

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