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**[2025] 170 taxmann.com 577 (Article)©**Date of Publishing: **January 21, 2025****Critical analysis of Adjudication Order on the trigger point for shareholders' approval for RPTs.****GAURAV PINGLE**

Practising Company Secretary

Approval of related party transactions under the Companies Act, 2013 ('Companies Act') and the SEBI Listing Regulations are very critical. The entire process of obtaining approval involves identifying the trigger point for obtaining approval, disclosures made by company to the directors/shareholders, voting on such resolutions, statutory restriction on certain parties to vote of such resolution, etc. Compared to section 188 of the Companies Act and the Rules made thereunder, the provisions of SEBI Listing Regulations are very strict and there are hardly any exemptions.

This article is an analysis of the provisions of section 188 of the Companies Act read with the Rules in relation to the recent Adjudication Order passed by the Office of Registrar of Companies, Uttar Pradesh.

**Facts of the case:** In the matter of Watai Electronic Private Limited ('WEPL'), the Registrar of Companies, Kanpur, passed an order<sup>1</sup> of adjudication of penalty under section 454 of the Companies Act, 2013 read with Rule 3 of the Companies (Adjudication of Penalties) Rules, 2014 for violation of provisions of section 188 of the Companies Act, 2013.

WEPL had entered into a transaction with a related party (i.e. with one of its group companies) for sale, purchase or supply of goods or material directly or through appointment of agent amount to 10% or more of the turnover of the company (as per clause (a) and clause (e) of section 188(1) of the Companies Act). For the said transaction, the board of directors had given its consent under section 188(1) of the Companies Act.

Considering that the transaction exceeded the prescribed threshold of as mentioned in Rule 15(3)(a) of the Companies (Meeting of Board and its Powers) Rules, 2014, the Adjudicating Officer contended that WEPL was required to take prior approval of members in general meeting by passing ordinary resolution. Since WEPL did not obtain prior approval of the members, the Adjudicating Officer observed that the company and its directors shall be liable for prosecution under section 188(5)(ii) of the Companies Act for the FY 2019-2020.

The company in its reply to the Adjudication Officer stated that there has been no violation of section 188 of the Companies Act, as according to the fourth proviso to section 188(1) – the approval of the board of directors and shareholders is not necessary if the transactions are conducted in the ordinary course of business and on arm's length basis. The Adjudicating Officer observed that the said response is not tenable and hence penalty is to be imposed. Accordingly, the Adjudication Officer imposed a penalty of Rs. 5,00,00/- each on the directors of WEPL.

**Clause by clause analysis of section 188(1) of the Companies Act:** Sub-section (1) of section 188 of the Companies Act states as follows:

*(1) Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to—*

- (a) sale, purchase or supply of any goods or materials;*
- (b) selling or otherwise disposing of, or buying, property of any kind;*
- (c) leasing of property of any kind;*
- (d) availing or rendering of any services;*
- (e) appointment of any agent for purchase or sale of goods, materials, services or property;*
- (f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and*
- (g) underwriting the subscription of any securities or derivatives thereof, of the company:*

*Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a resolution:*

*Provided further that no member of the company shall vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party:*

*Provided also that nothing contained in the second proviso shall apply to a company in which ninety per cent or more members, in number, are relatives of promoters or are related parties:*

*Provided also 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:*

*Provided also that the requirement of passing the resolution under first proviso shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.*

Explanation.— In this sub-section,—

- (a) the expression "office or place of profit" means any office or place—*
  - (i) where such office or place is held by a director, if the director holding it receives from the company anything by way of remuneration over and above the remuneration to which he is entitled as director, by way of salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;*
  - (ii) where such office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it receives from the company anything by way of remuneration, salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;*
- (b) the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.*

According to sub-section (1) of section 188 of the Companies Act that the board of directors of the company shall give its consent at board meeting for certain contracts or arrangements with related parties. The conditions are provided in Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014. Such conditions in the Rules are summarised as follows:

- (1) The agenda of board meeting at which the resolution is proposed to be moved shall have certain details<sup>2</sup>;*

- (2) The interested director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement<sup>3</sup>;
- (3) Prior approval of shareholders by ordinary resolution<sup>4</sup>.

Therefore, sub-section (1) of section 188 of the Companies Act shall be read with Rule 15(1) of the Companies (Meetings of Board and its Powers) Rules, 2014.

Sub-section (1) of section 188 of the Companies Act has 5 provisos and the same are summarised as follows:

- (1) A contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed<sup>5</sup>, shall be entered into except with the prior approval of the company by a resolution<sup>6</sup>.
- (2) The member of the company shall not vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party<sup>7</sup>.
- (3) The above conditions shall not apply to a company in which 90% or more members, in number, are relatives of promoters or are related parties<sup>8</sup>
- (4) The provisions of sub-section (1) of Section 188 of the Companies Act shall not 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<sup>9</sup>.
- (5) The requirement of passing the ordinary resolution of shareholders shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval<sup>10</sup>.

**Meaning of Proviso:** Supreme Court in *Dashrath Rupsing Rathod v. State of Maharashtra* AIR 2014 SC 3519, elucidated the concept and function of the proviso as: "That a proviso is an exception to the general rule is well settled. A proviso is added to an enactment to qualify or create an exception to what is contained in the enactment. It does not by itself state a general rule. It simply qualifies the generality of the main enactment, a portion which but for the proviso would fall within the main enactment. The P. Ramanatha Aiyar, Law Lexicon, 2nd Edition, Wadhwa & Co. at page 1552 defines proviso as follows: The word "proviso" is used frequently to denote the clause the first words of which are "provided that" inserted in deeds and instruments generally. And containing a condition or stipulation on the performance or non-performance of which, as the case maybe. The effect of a proceeding clause or of the deed depends. A Clause inserted in a legal or formal document, making some condition, stipulation, exception or limitation or upon the observance of which the operation or validity of the instrument depends .... A proviso is generally intended to restrain the enacting clause and to except something which would have otherwise been within it or in some measure to modify the enacting clause."Therefore, 'proviso' in a statutory provision carves out an exception to the main provision to which it has been enacted.

**Analysis of section 188 of the Companies Act and reference to the Adjudication Order of WEPL:** For the related party transaction, WEPL had obtained the approval of the board of directors. Even if the transaction was beyond prescribed monetary threshold the company had not obtained the approval of the shareholders – as contemplated in second proviso to section 188(1) of the Companies Act. WEPL argued that the said related party transaction was done in the ordinary course of business and on arm's length basis i.e. WEPL relied on the fourth proviso to sub-section (1) of section 188 of the Companies Act, which states that – Provided also 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. The proviso creates an exception to the entire sub-section (1) of section 188 of the Companies Act, which provides for consent of the board of directors at the board meeting and the approval of the shareholders. Therefore, if the relevant sub-section (1) of section 188 of the Companies Act is not applicable then the applicable Rules (i.e. Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014) made there under will also not apply – as Rules are made under the relevant statutory provisions of the law. The Adjudication Officer has not elaborated for rejecting the argument of WEPL and has stated that "*the said response is not tenable and hence penalty is to be imposed*". This order lays down a wrong precedent for the two following reasons:

- (1) The relevant Rules of interpretation are not considered by the Adjudicating Officer i.e. meaning and interpretation of 'proviso' read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014;
- (2) Unreasoned order of the statutory authority. Ideally all the orders of Adjudication shall explain the facts of case, details of the company, non-compliance, relevant provisions, compliance requirement, submission of parties, documents presented and detailed reasons with relevant legal provisions for accepting / rejecting the arguments of the company or directors or KMP or officer in default.

The observations of the adjudicating officer ultimately means that shareholders' approval (by ordinary resolution) shall be obtained when the monetary thresholds (as provided in Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014) are breached, irrespective of the fact that the transaction in the ordinary course of business and at arm's length basis<sup>11</sup>. By this kind of interpretation, the proviso will not have any relevance in interpretation of the said provisions and all proposals exceeding the threshold will require shareholders' approval.

Section 188 of the Companies Act has not defined the expression 'arm's length basis' but has defined the expression 'arm's length transaction'<sup>12</sup> which means that a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest. The Companies Act has not defined the expression 'ordinary course of business' and would subjective case, depending upon the type of company, nature of transaction, etc. In any case, the adjudicating order has not considered the provisions of section 188 of the Companies Act and the Rules in light of the relevant principles of interpretation of statutes.

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1. Adjudication Order – No. 07/01/Adj./2024/Watai/5078+05080 dated December 26, 2024.
2. Rule 15(1) of the Companies (Meetings of Board and its Powers) Rules, 2014.
3. Rule 15(2) of the Companies (Meetings of Board and its Powers) Rules, 2014.
4. Rule 15(3) of the Companies (Meetings of Board and its Powers) Rules, 2014.
5. As provided in Rule 15(1) of the Companies (Meetings of Board and its Powers) Rules, 2014.
6. First provision to sub-section (1) of section 188 of the Companies Act.
7. Second provision to sub-section (1) of section 188 of the Companies Act.
8. Third provision to sub-section (1) of section 188 of the Companies Act.
9. Fourth provision to sub-section (1) of section 188 of the Companies Act.
10. Fifth provision to sub-section (1) of section 188 of the Companies Act.
11. as provided in fourth proviso to sub-section (1) of section 188 of the Companies Act.
12. Explanation (b) to section 188(1) of the Companies Act.