

INTERNATIONAL JOURNAL OF LEGAL SCIENCE AND INNOVATION

[ISSN 2581-9453]

Volume 6 | Issue 1

2024

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Related Party Transactions under the Companies Act and Other Allied Rules

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ABSTRACT

The following paper provides a comprehensive study regarding Related Party Transaction (RPTs) under the Companies Act 2013 and other allied rules. The study delves deep into the provisions of all the statutes and rules and the regulatory mechanisms established to govern RPTs between corporate entities and related parties.

The main objective of this research is to elucidate the legal framework governing related party transactions and to critically assess the efficiency of these regulations in practical life in promoting transparency, fairness and accountability. The analysis encompasses an exploration of relevant provisions of the Companies Act and the associated rules-shedding some light on the requirements, approval processes and the role of the board and the shareholders in overseeing such transactions. The method used is analysing and reviewing the statutory provisions, and the judicial precedents related to RPT to understand those transactions taking place in a corporate entity and how they enhance the corporate governance structure.

Keywords: RPT-Related Party Transaction, Companies Act, SEBI, LODR, Company Rules.

I. INTRODUCTION

A related-party transaction is a business deal between two parties that is related to a common interest or business relationship. This can include any regular transaction between businesses that are affiliated in any way. For example, a shareholder who owns real estate and has a lease agreement with the corporation they own shares in for office space is a related-party transaction.

(A) Definition Of Related Parties:

A person or organisation related to the reporting authority is a related party. The term “person” also refers to a legal person, including a local authority, a company, an individual or a firm.

Related party is defined **u/s 2(76) of the Companies Act, 2013**²:

“Related party”, with reference to a company, means—

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² The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

- (i) a director or his relative;
- (ii) key managerial personnel or his relative;
- (iii) a firm, in which a director, manager or his relative is a partner;
- (iv) a private company in which a director or manager or his relative is a member or director;
- (v) a public company in which a director or manager is a director and holds along with his relatives, more than two per cent (2%) of its paid-up share capital;
- (vi) anybody corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
- (vii) any person on whose advice, directions or instructions a director or manager is accustomed to act:

Provided that nothing in sub-clauses (vi) and (vii) shall apply to the advice, directions or instructions given in a professional capacity;

- (viii) anybody corporate which is—
 - a holding, subsidiary or an associate company of such company;
 - a subsidiary of a holding company to which it is also a subsidiary; or
 - an investing company or the venturer of the company.
- (ix) such other person as may be prescribed

According to **Rule 3 of Companies (Specification of Definitions Details) Rules, 2014**³ for the purposes of section 2(76)(ix) of the Act, a director other than independent director or key managerial personnel of the holding company or his relative with reference to a company, shall be deemed to be a related party.

As per the **SEBI (LODR)**⁴, **Regulation 2(1) (zb)**, any person is a related party of a listed entity if it is: (i) a related party under the Companies Act or applicable accounting standards; or

(ii) any promoter or member of the promoter group of the listed entity irrespective of its shareholding; or

(iii) any person holding 10% or more of the listed entity's equity shareholding whether directly

³ The Companies (Specification of Definitions Details) Rules, 2014

⁴ The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) (LODR) Regulation 2015

or as a beneficial owner under the Companies Act.

As per **Ind AS 24**⁵ the following categories are included within the definition of a 'related party':

- i. A person or a close family member is a related party of a company if such person:
 - a. has control or joint control/ significant influence over the company, or
 - b. is a key management personnel of the company or its parent company?
- ii. An entity is a related party of a company if:
 - a. such entity and the company are members of the same group;
 - b. such entity is an associate or joint venture of the company, or vice versa;
 - c. such entity and the company are joint ventures of the same third party;
 - d. such entity is a joint venture of a third entity and the company is an associate of such third entity;
 - e. such entity offers a post-employment benefit plan for the benefit of the employees of either the company or an entity related to the company;
 - f. such entity is controlled or jointly controlled by a person identified in paragraph (i) above;
 - g. if a person identified above in paragraph (i)(a) has significant influence over such entity or is a key management personnel of such entity (or of the parent the entity); or
 - h. such entity or any member of a group of which such entity is a part, provides key management personnel services to the company or the parent of the company.

Relatives in terms of related party u/s 2(77) of the Companies Act⁶:

Relative means anyone who is related to another if-

- (1) they are members of Hindu Undivided Family;
- (2) they are husband and wife; or
- (3) one person is related to other in accordance with **Rule 4 of the Companies (Specification of Definitions Details) Rules, 2014**⁷.

A person shall be deemed to be the relative of another, if he or she is related to another in the

⁵ Indian Accounting Standard 24 (2018) notified under the Companies Act 2013

⁶ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

⁷ The Companies (Specification of Definitions Details) Rules, 2014

following manner, namely-

(1) Father:

Provided that the term “Father” includes stepfather.

(2) Mother:

Provided that the term “Mother” includes the stepmother.

(3) Son:

Provided that the term “Son” includes the stepson.

(4) Son’s wife

(5) Daughter

(6) Daughter’s husband

(7) Brother:

Provided that the term “Brother” includes the stepbrother;

(8) Sister

Provided that the term “Sister” includes the stepsister.’

As per the **SEBI (Listing Obligation and Disclosure Requirement)⁸, Regulation 2(1) (zd)** states relative means relative as defined u/s 2(77) of the Companies Act, 2013 and rules prescribed there under. Provided this definition shall not be applicable for the units issued by mutual funds that are listed on a recognised stock exchange.

Under the **Insolvency and Bankruptcy Code, 2016⁹**: The related party is defined as **u/s 5(24)**. Related parties to a corporate debtor include directors, partners, key managerial personnel, limited liability partnerships, partnership firms, private companies, public companies, body corporates, and individuals with significant control over the corporate debtor.

II. DEFINITION OF RELATED PARTY TRANSACTIONS

Related party transactions are commercial transactions between related parties. Companies regularly control their existing resources and enter into agreements with pre-existing networks.

Section 188 of the Companies Act, 2013¹⁰ defines RTP as:

⁸ The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) (LODR) Regulation 2015

⁹ The Insolvency and Bankruptcy Code, 2016, No. 31 of 2016

¹⁰ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

Any contract or arrangement with a related party with respect to:

- i. sale, purchase or supply of any goods or materials;
- ii. selling or otherwise disposing of, or buying property of any kind;
- iii. leasing of property of any kind;
- iv. availing or rendering any services;
- v. appointment of any agent for the purchase or sale of goods, materials, services or property;
- vi. such related party's appointment to any office or place of profit in the company or its subsidiary or associate; and
- vii. underwriting the subscription of securities of the company or derivatives thereof,

An exclusion under this definition is given to RPTs undertaken at an arm's length basis by a company in its ordinary course of business.

Section 188 (1) of the Act¹¹ provides that without the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as prescribed under Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014¹², no company shall enter into any contract or arrangement with a related party concerning sale, purchase, selling etc.

Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014¹³ provides that a company shall enter into any contract or arrangement with a related party subject to the following conditions, namely: -

(1) The agenda of the Board meeting at which the resolution is proposed to be moved shall disclose-

- a) the name of the related party and nature of the relationship;
- b) the nature, duration of the contract and particulars of the contract or arrangement;
- c) the material terms of the contract or arrangement including the value, if any;
- d) any advance paid or received for the contract or arrangement, if any;
- e) the manner of determining the pricing and other commercial terms, both included as part of the contract and not considered as part of the contract;

¹¹ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

¹² The Companies (Meetings of Board and its Powers) Rules, 2014

¹³ The Companies (Meetings of Board and its Powers) Rules, 2014

- f) whether all factors relevant to the contract have been considered, if not, the details of factors not considered with the rationale for not considering those factors; and
- g) any other information relevant or important for the Board to decide on the proposed transaction.

(2) Where any director is interested in any contract or arrangement with a related party, such director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement.

SEBI (LODR)¹⁴ Regulation 23 defines related party transactions as:

- (4) The listed entity shall formulate a policy on the materiality of related party transactions and on dealing with related party transactions including clear threshold limits duly approved by the board of directors and such policy shall be reviewed by the board of directors at least once every three years and updated accordingly:

Provided that a transaction with a related party shall be considered material, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds rupees one thousand crore or ten per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity, whichever is lower.

Explanation. - A transaction with a related party shall be considered material if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds ten percent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity.

(1A) Notwithstanding the above, a transaction involving payments made to a related party with respect to brand usage or royalty shall be considered material if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year exceed five per cent of the annual consolidated turnover of the listed entity as per the last audited financial statement of the listed entity.

(2) All related party transactions and subsequent material modifications shall require prior approval of the audit committee of the list entity.

Provided that only those members of the audit committee, who are independent directors, shall approve related party transactions.

¹⁴ The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) (LODR) Regulation 2015

Provided further that:

(a) the audit committee of a listed entity shall define “material modifications” and disclose it as part of the policy on materiality of related party transactions and on dealing with related party transactions;

(b) a related party transaction to which the subsidiary of a listed entity is a party but the listed entity is not a party, shall require prior approval of the audit committee of the listed entity if the value of such transaction whether entered into individually or taken together with previous transactions during a financial year exceeds ten per cent of the annual consolidated turnover, as per the last audited financial statements of the listed entity;

(c) a related party transaction to which the subsidiary of a listed entity is a party but the listed entity is not a party, shall require prior approval of the audit committee of the listed entity if the value of such transaction whether entered into individually or taken together with previous transactions during a financial year, exceeds ten per cent of the annual standalone turnover, as per the last audited financial statements of the subsidiary;

(d) prior approval of the audit committee of the listed entity shall not be required for a related party transaction to which the listed subsidiary is a party but the listed entity is not a party, if regulation 23 and sub-regulation (2) of regulation 15 of these regulations are applicable to such listed subsidiary.

Explanation: For related party transactions of unlisted subsidiaries of a listed subsidiary as referred to in (d) above, the prior approval of the audit committee of the listed subsidiary shall suffice.

(3) The audit committee may grant omnibus approval for related party transactions proposed to be entered into by the listed entity subject to the following conditions, namely-

(a) the audit committee shall lay down the criteria for granting the omnibus approval in line with the policy on related party transactions of the listed entity and such approval shall be applicable in respect of transactions that are repetitive in nature;

(b) the audit committee shall satisfy itself regarding the need for such omnibus approval and that such approval is in the interest of the listed entity;

(c) the omnibus approval shall specify:

(i) the name(s) of the related party, nature of the transaction, period of transaction, the maximum amount of transactions that shall be entered into,

(ii) the indicative base price / current contracted price and the formula for variation in the

price if any; and

(iii) such other conditions as the audit committee may deem fit:

Provided that where the need for related party transaction cannot be foreseen and aforesaid details are not available, the audit committee may grant omnibus approval for such transactions subject to their value not exceeding rupees one crore per transaction.

(d) the audit committee shall review, at least on a quarterly basis, the details of related party transactions entered into by the listed entity pursuant to each of the omnibus approvals given.

(e) Such omnibus approvals shall be valid for a period not exceeding one year and shall require fresh approvals after the expiry of one year:

(4) All material related party transactions and subsequent material modifications as defined by the audit committee under sub-regulation (2), shall require prior approval of the shareholders through resolution and the related party no related party shall vote to approve such resolutions whether the entity is a related party to the particular transaction or not.

Provided that prior approval of the shareholders of a listed entity shall not be required for a related party transaction to which the listed subsidiary is a party but the listed entity is not a party, if regulation 23 and sub-regulation (2) of regulation 15 of these regulations are applicable to such listed subsidiary.

Explanation: For related party transactions of unlisted subsidiaries of a listed subsidiary as referred above, the prior approval of the shareholders of the listed subsidiary shall suffice

Provided further that the requirements specified under this sub-regulation shall not apply in respect of a resolution plan approved under section 31 of the Insolvency Code, subject to the event being disclosed to the recognized stock exchanges within one day of the resolution plan being approved;

(5) The provisions of sub-regulations (2), (3) and (4) shall not be applicable in the following cases:

(a) transactions entered into between two government companies;

(b) 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.

(c) transactions entered into between two wholly-owned subsidiaries of the listed

holding company, whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval

Explanation. - For the purpose of clause (a), “government company(ies)” means Government company as defined in sub-section (45) of section 2 of the Companies Act, 2013.

(6) The provisions of this regulation shall be applicable to all prospective transactions.

(7) For the purpose of this regulation, all entities falling under the definition of related parties shall abstain from voting not to vote to approve the relevant transaction irrespective of whether the entity is a party to the particular transaction or not.

(8) All existing material related party contracts or arrangements entered into prior to the date of notification of these regulations and which may continue beyond such date shall be placed for approval of the shareholders in the first General Meeting subsequent to notification of these regulations.

(9) The listed entity shall submit to the stock exchange disclosures of related party transactions in the format as specified by the Board from time to time publish them, and publish the same on its website. Provided that a high-value debt-listed entity’ shall submit such disclosures along with its standalone financial results for the half year:

Provided further that the listed entity shall make such disclosures every six months within fifteen days from the date of publication of its standalone and consolidated financial results: Provided further that the listed entity shall make such disclosures every six months on the date of publication of its standalone and consolidated financial results with effect from April 1, 2023.

(9) The listed entity shall submit within 30 days from the date of publishment of its standalone and consolidated financial results for the half-year, disclosures of related party transactions on a consolidated basis, in the format specified in the relevant accounting standard for annual results to the stock exchanges and publish the same on its website. Provided that a high-value debt listed shall submit such disclosure along with its standard financial results for the half year.

SEBI (LODR)¹⁵ Regulation 2(1) (zc) defines RTP as a transaction involving a transfer of resources, services or obligations between:

- i. a listed entity/ any of its subsidiaries and a related party of the listed entity/any of its

¹⁵ The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) (LODR) Regulation 2015

subsidiaries; or

- ii. a listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries, regardless of whether a price is charged.

According to the **Ind AS 24**¹⁶, a parent company must declare all commercial interactions with subsidiaries, joint ventures, and other connected parties. As a result, a party associated to the reporting entity is referred to as a related party.

III. WHAT CONSTITUTES 'ORDINARY COURSE' AND 'ARM'S LENGTH'?

Section 188(1)¹⁷ shall not apply to any transactions entered into by the company in its ordinary course of business other than transactions that are not on an arm's length basis.

The phrase "in the ordinary course of business" has been used in various places under the Act for example under Sections 67, 179, 180, 185, 186, 188 and mostly, it is used context of related party/ related party transactions. Generally, "in the ordinary course of business" understood as the ordinary course of business will cover the usual transactions, customs and practices of a business and of a company.

In *Seksaria Biswan Sugar Factory Ltd. v. Commissioner of Income-tax*¹⁸, the Bombay High Court stated that:

"If a particular act is done in the course of business is not the question of fact and that fact must be determined according to the evidence led and the circumstances of the case. It must be found as to whether the particular act has any connection with the normal business that the company is carrying on and whether it is so related to the business of the company that it can be considered to be performed in the ordinary course of the business of that company."

As **per explanation (2) to Section 188(1) of the Companies Act**, 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.

The expression 'arm's length transaction' means any transaction where two or more unrelated parties agree to do business and act independently and in their own interests so that no conflict of interest takes place.

Section 188 of the Companies Act, 2013 cannot be applied if the transaction is done in the

¹⁶ Indian Accounting Standard 24 (2018) notified under the Companies Act 2013

¹⁷ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

¹⁸ AIR 1950 Bom 200

ordinary course of business and is at arm's length. If a transaction takes place at arm's length, then no resolution is needed. The burden of establishing whether the transaction is at arm's length or not is upon the company. It is the company's responsibility to properly set up and maintain appropriate and suitable information and documentation regarding price and terms of supply.

In the case of *IndusInd Bank v. Additional Commissioner of Income Tax (2012)*¹⁹, the meaning of 'arm's length transaction' was defined as an amount for which assets can be exchanged between a willing and knowledgeable buyer and a willing and knowledgeable seller in an arm's length transaction.

In another case of *Needle Industries Ltd. v. Needle Industries Newey (India) Holding Ltd. (1982)*²⁰ question raised was whether all the transactions with related parties needed scrutiny and compliance with Section 188 of this Act. The **third provision to Section 188 (1)**²¹ answers this question, as it is an exemption clause. It exempts any transaction that is entered into by the entity in the ordinary course of business other than those transactions that are not based on arm's length.

In the case of *Madhu Ashok Kapur v. Rana Kapoor*²², the Court was dealing with the issue of whether the reappointment of the Managing Director was a related party transaction or whether it was protected under an arm's length transaction. The Court held that the appointment was made at an arm's length basis where it looked at the nature of prerequisites which the Managing Directors are ordinarily entitled to rather than emphasizing on the procedural requirements.

IV. WHEN IS THE BOARD AND SHAREHOLDER'S APPROVAL REQUIRED?

First Proviso to **Section 188 (1) of the Companies Act**²³ provides 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 prescribed, shall be entered into except with the prior approval of the company by a resolution.

As per Section 188 of the Companies Act, passing of a board resolution is not required 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. The approval process for RPTs under the Companies Act

¹⁹ (2012) 15 ITR (T) 89 (Mum)

²⁰ 1981 AIR 1298

²¹ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

²² 2015 SCC Online Bom 5818

²³ The Companies Act, 2013, Act No. 18 of 2013, Act of Parliament (29th August 2013)

(except for transactions with wholly owned subsidiaries) is as follows:

- i. All RPTs require the Audit Committee's approval if constituted.
- ii. All RPTs that are not in the ordinary course of business and/or on an arm's length basis require approval from the board of directors.
- iii. All RPTs that are not in the ordinary course of business and/or on an arm's length basis require shareholders' approval when exceeding the specified limits provided in **Rule 15 of the Companies (Meetings of the Board and its Powers) Rules²⁴, 2014**, which are:
 - sale, purchase or supply of goods and materials amounting to 10% or more of the turnover of the company;
 - selling, disposing of or buying property of any kind amounting to 10% or more of the net worth of the company;
 - leasing of property of any kind amounting to 10% or more of the turnover of the company;
 - availing or rendering services amounting to 10% or more of the turnover of the company;
 - related party's appointment to any office or place of profit in the company or its subsidiary or associate at a monthly remuneration exceeding INR 2.5 Lakhs; and
 - giving remuneration for underwriting the subscription of any securities or derivatives thereto exceeding 1% of the net worth of the company.

SEBI (LODR)²⁵ Regulation 23(1): The listed entity shall formulate a policy on the materiality of related party transactions and on dealing with related party transactions [including clear threshold limits duly approved by the board of directors and such policy shall be reviewed by the board of directors at least once every three years and updated accordingly]

Provided that a transaction with a related party shall be considered material, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds rupees one thousand crore or ten per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity, whichever is lower.

²⁴ The Companies (Meetings of Board and its Powers) Rules, 2014

²⁵ The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) (LODR) Regulation 2015

V. CONCLUSION

By importing a wider meaning to 'related party' and RPTs, SEBI has increased the ambit of its radar to keep an eye on many persons/ entities and transactions of the listed entities as well as their unlisted subsidiaries. As a result, listed entities along with their subsidiaries will have to be more transparent in their dealings with parties that may be considered related parties. However, what remains to be seen is the change in the current regulatory framework for unlisted companies, which the legislature may bring to harmonize the framework under the Listing Regulations and the Companies Act.

While theoretically most of the recommendations of the WG Report have been adopted by SEBI, the real effect of the recommendations will emanate from April 1, 2022, which will be the litmus test to check whether such recommendations of the WG Report are a positive step towards good corporate governance.
