

Related Party Transaction – Section 188

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SECTION 188 – RELATED PARTY TRANSACTION

Section No 2013	–	188 of Companies Act
About	–	Related Party Transactions
Applicable on company both.	–	Private and Public limited
Applicable from	–	1 st April 2014

What we will be discussing:-

- Definition/Meaning of Related Party
- Transactions which are deemed as related party transactions
- Nature of approvals required
- Disclosure norms
- Consequences of non-compliance

DEFINITION OF RELATED PARTY

Section 2(76), read with relevant rules made there under, defines a related party as under:

“Related party”, with reference to a company, means -
Point 1, 2, 3 , 5 & 9

These clauses include the relatives also.

- a) A **Director** or A key Managerial Person or their relative.
- b) A **firm** in which Director, Manager or his relative is a partner.
- c) A **Public Limited company** in which Director or Relative hold more than 2 % of Share Capital.
- d) Director Or relative of Holding, Subsidiary or Associate company.

Point 4 & 5

These clauses only include the Director and Manager.

- a) A company (Pvt. or Public) in which Director or manager is Director or Member.

b) A senior management person in the company or its subsidiary, holding or Associate.

Point 6, 7 & 8

a) A body corporate or a Person on advice or directions of whom BOD is accustomed to act.

b) A holding, subsidiary or associate of such company.

c) A fellow subsidiary.

CRUX

Other Than Individuals who are related party.

- A firm, in which a director, manager or his relative is a partner
- A private company in which a director or manager is a member or director
- A holding, subsidiary or an associate company
- A fellow subsidiary
- A public company in which a director or manager is a director or holds along with his relatives, more than 2 percent of its paid-up share capital
- Anybody-corporate whose BODs, MD or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager

MEANING OF

Relative

A) Husband and Wife.

- B) Members of HUF.
- C) Mother and Father.
- D) Grandmother and Grandfather. (Dada And Dadi)
- E) Maternal Grandmother and Grandfather. (Nana And Nani)
- F) Son and Daughter.
- G) Spouse of Son and daughter.

Key Managerial Personnel (KMP) - “Key managerial personnel”, in relation to a company, means — (i) the Chief Executive Officer or the Managing Director or the Manager (ii) the Company Secretary (iii) the Chief Financial Officer; and (iv) such other officer as may be prescribed [section 2(51) of the 2013 Act]

Transactions Regarded as Related Party Transactions.

Any transaction between a Company and its related party relating 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.

NATURE OF APPROVAL

By BOD

- Every company needs to seek the approval of its Board of Directors for entering into any related party transaction, as listed above, irrespective of the capital of the company or the value of the transaction.
- 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.

By BOD + Prior Special Resolution

- Paid-up share capital of the company is equal to or exceeds Rs. 1 Crore,
- The value of transaction individually or taken together with previous related party transactions during a financial year, exceeds 5 percent of the annual turnover or 20 percent of the net worth of the

company as per the last audited financial statements of the company, whichever is higher,

- The transaction relates to appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs. 1 Lakh.
- The transaction relates to remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding Rs. 10 Lakhs.
- *No member of the company shall vote on such special resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party.*
- *In case of wholly owned subsidiary, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.*

EXEMPTIONS

The above mentioned provisions will not be applicable in case of transactions entered into by the company in its ordinary course of business, which are on arm's length basis.

MEANING OF ORDINARY COURSE OF BUSINESS

The phrase “ordinary course of business” is not defined under the Companies Act 2013 or rules made there under. It seems that the ordinary course of business will cover the usual transactions, customs and practices of a business and of a company. In its guidance to auditors, the ICAI has included following few examples of transactions that are considered outside the entity’s normal (or ordinary) course of business:

- * Complex equity transactions, such as corporate restructurings or acquisitions.
- * Transactions with offshore entities in jurisdictions with weak corporate laws. ? The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- * Sales transactions with unusually large discounts or returns.
- * Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- * Transactions under contracts whose terms are changed before expiry.

The assessment of whether a transaction is in ordinary course of business is very subjective, judgmental and can vary on case-to-case basis giving consideration to nature of business and objects of the entity. The purpose of

making such assessment is to determine whether the transaction is usual or customary to the company and/ or its line of business. Companies should consider variety of factors like size and volume of transactions, arms-length, frequency, purpose, etc, to make this assessment.

MEANING OF ARM LENGTHS PRICE

“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.

Most commonly used guidance in this regard under income tax provisions is given in international and domestic tax laws in context of transfer pricing regime. One may even refer to rules for registered valuers wherein valuation methodologies are prescribed for registered valuers. It should be noted that these guidelines are not conclusive and have only persuasive value. One may consider various qualitative and quantitative assessments to determine arm’s length.

For example, let’s assume a bank whose normal course of business provides 9% rate to its customers for placing fixed deposit for a two-year tenure. It offers 9.25%, higher rate, to all its group employees. One may argue that the same is not at arm’s length. Alternatively, one may argue that banks devise different strategies for various categories of customers. Employee population of entire group provide a significant customer-base for the

bank and hence providing higher rate is in accordance with business strategy and meets the criteria of arm's length. The arm's length assessment is subjective exercise and requires judgment after considering various parameters.

PRACTICAL DIFFICULTIES REGARDING SECTION 188

Q. How do we handle related party contract cases wherein the Company has only husband and wife as both Directors and members in a Company?

These types of Companies have to bring in two outsiders as shareholders giving one share each and pass special resolutions for all related party contracts in a General Meeting and file E Form No.MGT14 and register such special resolutions. This is the only way these contracts could be regularized at least for the time being till the Ministry comes out with some relaxations/clarifications.

Q. A corporate group has several foreign subsidiaries. Will provisions in relation to related parties apply to foreign companies as well?

The term 'company', as defined under the Companies Act 2013, is a company incorporated under this Act or any previous company law. Company incorporated under the relevant legislation of a foreign country is not a

‘company’ under Companies Act 2013. However, transactions by Indian company with a foreign company, which is a subsidiary, associate, fellow subsidiary, joint venture of the same venture or company under control of same promoter, would be covered, based on understanding of combined reading of revised clause 49 and Companies Act 2013.

Q. What assessment is required of the existing RPTs, if any?

All companies are required to comply with requirements in relation with RPTs, prospectively from the date of applicability of underlying regulation. Any default will be regarded as non-compliance and may attract penal provisions under the Companies Act 2013. Following actions are recommended to avoid any risk of default:

- * Companies should carefully review its related parties under the regulations and identify all existing and new related parties together with all existing and new contracts, arrangements and transactions, etc. Amongst other matters, the manner of dealings shall cover aspects relating to determination of key terms including arm’s length price.

- * An immediate dialogue needs to be initiated with the audit committee to assess and confirm their expectations from the policy and review/approval protocols. A careful evaluation of existing and proposed RPTs is not unwarranted.

Q. Definition of related parties is very wide. What are

the key actions which management and Auditor should take to ensure a robust process for identifying related parties?

Under New Companies Act, 2014 the Directors are required to file form MBP-1 which requires disclosure of his interest in other companies, firms and other related party.

The company and Auditor can rely on such documents and the onus of burden of proof would be on Director in case of any discrepancy.

Q. Under the regulations, no member of the company is permitted to vote on a special resolution to approve any contract or arrangement which may be entered into by the company, if such a member is a related party. Does the bar from voting apply to all shareholders who are related parties or only those related parties who are conflicted?

In cases where shareholders are ‘related’ in some way or the other with the company (but are neither the intended transacting party nor interested in the transaction directly or indirectly that has been put up for approval) it will be inappropriate to interpret the law to say that all such shareholders are prohibited from voting. The principles of “majority of minority” voting must not result in any unfair advantage to the minority. However, plain reading

of the regulations would suggest all related parties shall abstain from voting, whether related or unrelated. Consultation with legal experts might be required to ascertain intent of these provisions.

Q. Many companies have existing contracts or MOUs or other arrangement entered into, prior to introduction of these new regulations but the underlying transactions are likely to be operationalised in period after the introduction of the new regulations. Would such contracts require a review and approval of the audit committee/board or the shareholders, as the case may be, considering effective execution in the period after introduction of the new regulations?

MOUs are merely an understanding and not a definitive contract or arrangement. Clearly, these would require rigor of review under the new framework, prior to execution of definitive agreement. In relation to other contracts or arrangements, covered above, although differing views may exist when evaluating the manner of how regulations have been made, it would be improper to assume that such contracts or arrangements are not required to go through rigor of review now required considering these are operationalised only under the new regime of regulations.

CONSEQUENCES OF NON COMPLIANCE

If any related party transaction or contract is entered without seeking Board's and/or members' approval and if the same is not ratified by the Board and/or members as the case may be, within 3 months at a meeting, then the contract or transaction will be voidable at the option of the Board and if the transaction is with any related party to any director or is authorized by any other director, then the concerned directors are liable to indemnify any loss incurred by the company.

ii. Additionally, the company can also proceed against a director or employee who had entered into such contract or arrangement in contravention of the provisions of this section for recovery of any loss sustained by it as a result of such contract or arrangement.

iii. Any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of the provisions of this section shall –

(a) 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

(b) 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/-.

iv. One is disqualified to be a Director for five years if he is convicted of an offence dealing with related party transactions under Section 188 during the last preceding five years.