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# A Critical Analysis on the Scope of Related Party Transactions: A Possibility of Expansion

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**Abstract:** ***Related party transactions can be legitimate and value-enhancing for a corporation, but they can also serve as a vehicle for illegitimate expropriation of corporate value by management or controlling shareholders. Related party transactions assume greater significance in a market context where there is high promoter ownership in group companies and a prevalence of listed companies under promoter-controlled groups. Abuses of related party transactions have been linked to negative consequences to minority investors in Indian companies, and have played a key part in some high-profile cases of corporate fraud. Currently, the Indian legal regime does not contain adequate safeguards for preventing abuse of related party transactions. This paper describes this problem in a comparative framework, examines disclosure regarding related party transactions contained in the annual reports of some of India's largest public companies, and makes several proposals for regulatory reform by looking into the scope of Section 188 of the Companies Act, 2013.***

**Keywords:** related party dealings, corporate governance, minority investor protection, promoter control, regulatory reform

In Chapter I, this paper discusses the problem of related party transactions from a theoretical perspective. Chapter II provides a brief overview of the Indian legal regime covering related party transactions, Chapter III of the paper examines the disclosure about related party transactions in companies in India. The examination reveals that disclosures do not provide adequate information, especially when compared to similar types of disclosures in other jurisdictions. The paper proposes that minority investors will be more effectively protected through the adoption of clearer legal standards regarding disclosure, as well as measures requiring approval of different categories of related party transactions by the audit committee, by a special committee of disinterested directors, or by a vote of disinterested shareholders.

## 1. Introduction

In recent years, a number of observers have noted that abuse of related party transactions is a significant concern for corporate governance reformers in Asian countries in general, and in India in particular. [1] The problem is rooted in two aspects of the ownership structure of Indian companies. First, there is high concentration of ownership, which gives particular individuals or families actual or effective control of most companies, even publicly traded companies. A 2007 study found that the-

*…average BSE 100 company has a promoter who owns over 48% of the company. Only ten of the BSE 100 companies have promoters holding stakes below the critical 25% threshold. Looking at the broader BSE 500 set of companies produces similar results: the average promoter owns roughly 49%, and fewer than 9% of promoters have stakes below 25%.*[2]

If anything, this estimate probably represents an understatement of the degree of concentration, as a percentage of promoter ownership is "often hidden in the form of other corporate bodies or individual shareholders." [3] Second, a large number of companies in India are grouped together under the common control of a single shareholder or family. [4] In other words, not only are most firms effectively controlled by a promoter group, but the same promoter group often controls a large number of firms.

This pattern of ownership gives rise to serious potential for conflicts of interest between the promoter group and the minority investors. If the firm makes profits, the promoter group is required to share the firm's profits with the minority investors. But if the promoter can divert the resources to himself, or to another firm within the promoter group in which he has a higher share of ownership, then he will be able to capture a higher share of the firm's profits. One of the primary methods of diverting resources is to engage in self-dealing transactions that have the effect of shifting value from one firm to another within the promoter group. This is a particular risk in an environment with a large number of business groups, in which a number of companies are controlled by the same individual or family. This might be done by such mechanisms as having group companies "give each other high (or low) interest rate loans, manipulate transfer prices, or sell assets to each other at above or below market prices, to name just a few." [5] Such strategies are frequently described as tunnelling, because they create channels by which value can flow from one firm to another. One attempt to empirically evaluate the effects of tunnelling in Indian business groups came to the striking conclusion that tunnelling enables controlling shareholders to extract more than 25% of the marginal profits that would otherwise be shared with minority investors. [6]

Anecdotal evidence also provides some indication of the problem. Several recent corporate controversies in India have been connected to related party transactions. One example involves the Subhiksha retailing firm, which, facing serious liquidity problems, has been seeking amalgamation with another company with the same promoter over the objections of minority investors and creditors. Additionally, the accounting fraud at Satyam Computer Services was revealed only after an attempt to acquire two other companies that were related to Satyam's founder and chairman. [7]

A pervasive atmosphere of related party transactions can be problematic even if most such transactions are negotiated in

good faith. Even if there are no transactions at all, the existence of relationships among companies may be sufficient to affect dealings with other parties, and thus merits disclosure.[8] Moreover, if there is a general lack of transparency regarding these transactions, then the perception of potential abuse can be just as damaging as the actual abuses that may occur. Thus, related party transactions do not merely pose the potential harm of direct expropriation of value from minority investors, but they can also reinforce negative perceptions of the country's capital markets as a whole, and lead to a general discounting of equity markets. [9] There is, therefore, a strong case for mandating disclosure and transparency regardless of whether related party transactions are used abusively or even at all.

The problem of related party transactions also illustrates some of the broader pitfalls in the method of legal transplantation that has been followed in Indian corporate regulation. The structure of Indian company law has traditionally borrowed from English and American models. The Companies Act of 1956 was largely based on the English law at the time, and the recent adoption of Clause 49 followed a report by the Birla Committee that explicitly relied heavily on practices in the United States. [10] Much scholarship has been written on the concept of legal transplants, especially in the area of corporate law. One of the leading criticisms of legal transplantation has been that laws designed for one economic, social, and institutional context are unlikely to be well-suited to an entirely different context. A transplant that is not suited to the needs of the recipient is unlikely to be effective. Related party transactions offer a particularly salient example of this problem. The two countries that have been the primary source of inspiration for India's corporate law regime- the United States and the United Kingdom- are characterized by widely dispersed shareholding and a general lack of control relationships among different public companies. [11] One would generally not expect these legal regimes to place a great emphasis on mechanisms to prevent abuse of related party transactions. Therefore, related party transactions are an area where reformers may be well-advised to look to non-Anglo-American models for inspiration. Two countries with similar experiences to India that have adopted stricter regulations concerning related party transactions are Singapore and Hong Kong, and this paper will pay special attention to these models.

## 2. Indian Law on Related Party Transactions

1) Companies Act, 2013-
- Section 2(76) defines a “related party” [12]
- Section 188 defines a “related party transaction” [13]

The Companies Act, 2013 has unveiled a new era in the Indian Corporate Sector, which places more reliance on disclosure norms rather than regulatory approvals. One such area is “related party transactions”. [14] While the Companies Act, 1956 warranted approval of Central Government for related party transaction by large cap companies, Companies Act, 2013 calls for greater disclosures with members' approval. The scope of transactions has also been widened to include transactions relating to immovable property also which were earlier left outside the ambit of Section 297 of the Companies Act, 1956.

Under the Companies Act, 2013, the whole concept of related party transactions has been capsulated in a single section, namely Section 188 which combines the erstwhile Sections 297 and 314 of the Companies Act, 1956 and also contains many new provisions within its scope. The section is deeply layered with many sets of provisions and leaves the mind perplexed with its scope and coverage.

Section 188 is placed in “Chapter 12 – Meeting of Board and its Powers”. Section 188 requires a company to obtain approval of the Board and of the members, in certain situations, prior to entering of any transaction or agreement with a related party. The following section is applicable to both private as well as public companies.

The amended provisions issued by the Ministry in the name of Companies (Meeting of Board and its Powers) Second Amendment, 2014 is a good effort by the Ministry which needs to be praised. They have somehow reduced the difficulties of the companies but along with that increased the practical difficulties to larger companies. These provisions are a treat to small and medium enterprises and a black dot for larger companies. But the Ministry from time to time has reduced the difficulties faced by the Companies, and it will definitely bring the necessary provisions for removing these drawbacks. The Ministry of Corporate affairs should introduce a provision related to transaction between two wholly owned subsidiaries and also consider about making having an executive director instead of Audit committee for approving the related party transactions with only transactions that are not at arm's length or in the ordinary course of business or material, to be brought to the Audit Committee for their additional approval.

Prior to the launch of the new Companies Act in 2013, there was no clarity on the approval of related party transactions by any group or party. This led to a lot of chaos and confusion in the during the dawn of the century. The board had no power in this regard as any remotely related party could claim related party transaction. [15] There was no requirement for the permission or consent of the board of directors when it came to related party transactions. [16] Therefore, the approval of Board of Directors clause had to be inserted in the year 2014. This was brought under Rule 15 of the Companies (Meeting of Board and its powers) Rules, 2014[17] which includes Approval of Board Directors wherein the consent of the board of directors is mandatory for any related party transaction. However, there is no means to bring about the prior approval of the members for the related party transactions. [18] Therefore, the scope of the related party transactions in this regard is very rigid as the members' approval prior to the transaction is not considered. [19] It is merely the approval of the Board of Directors, which itself was brought about only in 2014 under Rule 15 of the Companies (Meeting of Board and its powers) Rules, 2014. [20] Thus, there is a possibility in the expansion of scope of this very provision as a special resolution can be passed to get the prior approval of members of the company as well. This will bring about more clarity and the members powers will also not be marginalized.

## 3. Indian Law on Disclosures

With respect to the disclosure's clause, there is a lot of ambiguity which was observed by the Supreme Court. [21] The Companies (Meeting of Board and its powers) Rules, 2014 tried to bring about some clarity with respect to the loopholes existing in the disclosure procedure. There must be a disclosure done to the board of directors in the board meeting through a notice. However, it must be noted that no explanatory notice needs to be annexed through this notice to the board. This creates a lot of ambiguity in law and therefore there is a definite scope of expansion. A report must therefore be made at the end of every board meeting that includes the disclosure done with respect to related party transactions under Section 188 of the Companies Act, 2013. There must also be a disclosure made in the register of contracts or arrangements in which directors are interested to close this loophole. A total closure can be brought about if the interested directors too are compelled to disclose when it comes to the acceptance of a related party transaction. These amendments can be brought under the related party transactions under Section 188[22] itself as the section specifically deals with the knowledge and approval of directors which has been reiterated under Rule 15 of the Companies (Meeting of Board and its powers) Rules, 2014.

A clear reform can be made if the very scope of the definition of related party is widened to capture horizontal relationships between companies within common control, as well as other associated companies and parties. One approach would be to explicitly include the promoter and promoter groups. Next is to improve the oversight of the Board of Directors who are responsible for overseeing the functions of the company. [23] The suggestions specified in the previous chapter can be a first step in order to improve the oversight of the Board.

The disclosure and shareholder approval requirements are also an important area wherein there is plenty of scope for expansion of the ambit of related party transactions. Overall, disclosure of related party transactions should be significantly expanded. Shareholders in listed companies should receive enough information about related party transactions to make informed investment and voting decisions. [24] Currently, the information provided by listed companies is so inadequate that a shareholder might not even learn that a related party transaction has occurred, let alone learn any of the material facts regarding the transaction.[25] The need for disclosure should be balanced against the overall regulatory burden of disclosure. Requiring disclosure of every related party transaction would impose an undue regulatory burden on listed companies. Furthermore, over- disclosure may present a confusing picture to shareholders. Therefore, disclosure requirements should be based on a mandatory materiality threshold. All related party transactions above a certain rupee threshold or above a certain percentage of the company's net assets or revenue should be disclosed. [26]

In order to give minority shareholders meaningful input on related party transactions, listed companies should be required to seek shareholder approval from disinterested shareholders for extraordinary or significant related party transactions, as well as for certain on-going transactions with related parties. The stock exchanges should require that all extraordinary and significant transactions with related parties be approved by the disinterested stockholders. Extraordinary transactions would include equity or preferential issuances to related parties, amalgamations with related parties, and transactions above a threshold amount or percentage of company assets. [27] Issuances of preferential warrants in India have been used by related parties to increase ownership at discounted prices, to dilute minority shareholders, and to transact in the company's equity based on inside information. [28] In addition to approval for preferential issuances, the Listing Agreement should require that all amalgamations of companies within the promoter group. [29] Finally, the approval of disinterested shareholders should be required for all other significant transactions with related parties above a certain rupee threshold or above a certain percentage of the company's total assets or revenue. This threshold would be higher than the threshold for the disclosure of related party transactions. [30]

When shareholder approval from the disinterested stockholders is sought for any of the circumstances described above, the shareholders should be provided sufficient disclosure to make an informed decision. The disclosure should include details regarding the terms of the transaction, the nature of the relationship between the company and the related party, the interest of the related party, whether the transaction is on commercially reasonable and fair terms for the company, whether the Audit Committee or another independent committee has reviewed the transaction, and other relevant information. The independent directors who have reviewed the transaction should provide a statement explaining the rationale for the transaction to the shareholders. [31] Finally, the stock exchanges should require the company to obtain a fairness opinion on the valuation of the transaction from an independent financial adviser, and the opinion should be provided to the shareholders. [32]

## 4. Conclusion

Despite the fact that multiple aspects of corporate ownership in India raise special concerns about abusive related party transactions, the laws governing these transactions in India are comparatively weak by international standards. Research into the substance of corporate disclosures in India, as compared to similar disclosures elsewhere, highlights that the relative weakness of the law leads to inadequate disclosures that do not enable minority shareholders to make informed decisions. A stronger regulatory structure that increases transparency and empowers disinterested directors and shareholders to police potential abuses by controlling shareholders would lead to significant progress in the fairness and efficiency of Indian capital markets.

## References

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[22] Supra Note 13.
[23] Supra Note 4.
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[26] Supra Note 2.
[27] Supra Note 3.
[28] Supra Note 4.
[29] Id.
[30] Supra Note 3.
[31] Supra Note 1.
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