

## RELATED PARTY TRANSACTIONS: THE LEGAL FRAMEWORK IN INDIA

### **INTRODUCTION**

The economic activities revealed by way of financial statements of companies are many a times trusted to be the result of fair transactions between independent parties occurring at arm's length and being witnessed on account of normal course of operations of such companies. However, sometimes the reality may be otherwise. Though, related party relationship is normal feature of commerce and business, companies may adopt 'Related Party Transactions' ("RPT") as a tool for corporate abuse. Transfer of economic resources to a related party at less than standard price may be compelled for various reasons ranging from tax liability to siphon-off the resources. RPT can be defined as a contract or arrangement between two parties who are joined by a special relationship prior to the contract or arrangement. The legal framework on RPT enumerates those special relationships which may be termed as 'related party'.

The present article attempts to discuss the legal framework designed to keep a check on the practice of RPT in India and the capability of these restricting provisions to curb the adverse effect of RPT.

### **RESTRICTIONS UNDER LAW**

Three primary sources of legislation which governs the issue of RPT in India are the Companies Act, 1956 ("the Act"), Clause 49 of the Listing Agreement for all stock exchanges in India ("Clause 49") and the Accounting Standards 18 ("AS 18") issued by the Institutes of Charter Accountants of India.

#### **Companies Act, 1956**

##### **Section 297: Board's sanction to be required for certain contracts in which particular directors are interested**

Section 297 of the Act provides that certain transaction with the following persons comes under the purview of RPT-

- a director of the company
- relative of the director
- a firm in which such a director or relative is a partner
- any other partner in such a firm
- a private company of which the director is a member or director

The objective of Section 297 is to ensure that board has knowledge about the interest of a director (or of any person connected with the director) in any

contractual dealings with the company; and that the board consents to such dealings. Section 297 requires that the board approves of any contract in which particular directors are interested. In cases where Section 297 applies, and the paid-up capital of the company is more than Rs. 1 crore, approval of the Central Government is also required.

Section 297 covers only such contracts that relate to sale or purchase of goods, materials and services or for underwriting the subscription of any shares or debentures of a company. Certain contracts that have been exempted from applicability of Section 297 are – (i) contract for purchase or sale of goods, materials or services for cash at prevailing market price; (ii) contracts that involve goods, materials or services, in which the company or the director regularly trades or conducts business and the value of such goods does not exceed Rs. 5,000 in any year.

#### Section 299 and 300: Disclosure and Abstention by Interested Directors

The principal restriction on RPT is covered by Section 299 and 300 of the Act. All existing and proposed contracts with the company in which any of the director is 'in any way', 'directly or indirectly' interested has been covered under these provisions. Section 299 of the Act requires disclosure of the director's interest in any contract or arrangement to the board of directors; and Section 300 requires the interested director to abstain from voting in the contracts or arrangement in which he is interested. However, the actual requirements of these provisions are relatively relaxed and have significant exceptions.

Section 299(3)(a) of the Act requires only a 'general notice' to the effect that the director is a director or member of the entity with which the contract or arrangement is proposed and should be regarded as interested in that particular contract or arrangement. It provides that such a 'general notice' shall be sufficient, thus, it makes it voluntary upon the interested director to disclose any detailed information with respect to the nature and extent of his pecuniary interest. In *Naini Oxygen & Acetylene Gas Ltd. v. Bisheshwar Nath (1986) 60 Com Cases 990 (All)*, the Court held that non-disclosure under this section does not render the contract void or unenforceable, therefore the 'general notice' by the interested director appears to be a matter of procedure.

Section 300(1) provides that presence of an interested director at a meeting will not be considered for determining whether the quorum has been established; and a vote of an interested director will be void. Further, Section 300(2) (a) exempts private companies from its operation so that the directors of a private company can count for a quorum at a meeting which is considering the subject matter of their interest and can also participate in voting. However, in *T. N. Raghunath v Lake Side Medical Centre Pvt Ltd(2008) 4 Camp LJ 144 (CLB)*, it has been held that- an

interested director of a private company can count for quorum; but he cannot participate or vote on any contract or arrangement entered into on 'behalf of the company'. He can participate in voting only when the meeting is considering the subject matter of 'his' interest.

### Section 297 v Section 299

There is no ambiguity regarding the scope of Section 297 and 299. Section 299 refers to the interest of a director 'in any way directly or indirectly'. Therefore, Section 299 appears to be wider in scope as compared to Section 297, which refers to certain direct contracts only. Unlike Section 297, Section 299 extends to contracts with public as well as private limited companies in which the directors are interested.

### Clause 49 of Listing Agreement

Clause 49 provides both requirements and suggestions regarding RPT by listed companies. It addresses RPT broadly in four areas- role of audit committee, disclosure of RPT to the audit committee, disclosure of management related RPT to the board of directors and suggest disclosure of RPT to shareholders in annual reports.

Section II(D) of Clause 49 provides that role of the audit committee includes reviewing annual financial statements with particular reference to RPT. Section IV (A) further requires that certain RPT be disclosed to the audit committee, which includes:

- the management must periodically place a statement of RPT in ordinary course of business before the audit committee;
- the management must provide details of material individual transactions with related parties which are not in the ordinary course of business; and
- the management should provide details of material individual transactions which are not on arm's length basis, together with justification thereof.

Under Clause 49, in addition to the audit committee the board of directors of a listed company is also entitled to certain disclosures about RPT. Section IV (F) of Clause 49 requires the senior management of a listed company to disclose, to the board of directors, all material financial and commercial transactions in which they are interested or have a conflict of interest with the company at large. It is further to be noted that 'senior management' under Clause 49 does not include directors, but includes other functional heads of the company.

### Accounting Standards 18

The definition of 'Related Party' as contemplated under the AS 18 issued by Institute of Chartered Accountant in India is- *"Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party*

*or exercise significant influence over the other party in making financial and/or operating decisions” and Related Party Transaction means “a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.*

Therefore, the following are the related parties as per AS 18

- Holding companies, subsidiaries and fellow subsidiaries
- Associates and joint ventures
- Individuals (including their relatives) having voting power
- Key management personnel including their relatives
- Enterprises where controlling individual or key managerial personnel has significant influence

Comparing the provision of AS 18 and the Act, we understand that the restriction under AS 18 is wider than those contained under the Act. The Act requires approval only when a director and his/her relatives are involved in a transaction. However, AS 18 makes disclosure of even those transactions mandatory where company's key management personnel, whether or not a director, has any pecuniary interest attached.

### **OECD'S OBSERVATIONS**

The Organization for Economic Co-operation and Development (OECD) has made certain observations with respect to the framework of RPT laws in India. Under Chapter IV of its report on 'Related Party Transactions and Minority Shareholders' (2012), OECD has assessed that India, in spite of having a sound corporate governance framework, effecting means of redress for minority shareholders is lacking; disclosures about the company group needs to be better developed and Section 299 and 300 of the Act needs to be tightened to cover conflicts of interest with controlling shareholders and company groups.

### **CHANGES UNDER COMPANIES BILL, 2012**

The term “related party” has been defined under clause 1(76) of the Companies Bill, 2012 (the Bill) which is pending before the parliament of India. Moreover, clause 188 of the Bill deals with RPT. The Bill is more extensive in nature than the Act as far as RPTs are concerned. Under the definition of related party, the Bill includes, a holding, subsidiary or an associate company of such company or a subsidiary of a holding company to which it is also a subsidiary; key managerial personnel or his relative; any person on whose advice, directions or instructions a director or manager is accustomed to act; and 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, provided that nothing apply to the advice, directions or instructions given in a professional capacity

Further, clause 188 of the Bill appears to be more preventive if compared to Section 297 of the Act with respect to a company entering into a contract or arrangement with a related party. Unlike Section 297 of the Act, Clause 188 of the Bill prohibits a company to enter into contracts with a related party for the following contracts or arrangements-

- Selling or otherwise disposing of, or buying, property of any kind;
- Leasing of property of any kind;
- Availing or rendering of any services;
- Appointment of any agent for purchase or sale of goods, materials, services or property;
- Such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and

Moreover, Clause 188 of the Bill also proposes that for entering into such contracts, prior approval of shareholders along with the consent of board of directors is required in case the paid up capital of the company or transaction amount exceeds the limit. However, the Bill exempts any transaction entered by a company in its ordinary course of business other than transactions which are not an arm's length basis.

### **CONCLUSION**

The provisions enacted under Section 297, 299 and 300 of the Act are based on the principle that a director is precluded from dealing on behalf of the company as himself and entering into engagements in which he has a personal interest conflicting or which possibly may conflict with the interest of those with whom he is bound by the fiduciary duty. It appears that the provisions stipulated under AS 18 as well as Clause 49 carry the same principle underlying the provisions of the Act.

It was held in the case of *Yashovardhan Saboo v Groz-Beckert Saboo Ltd. (1995) 83 Com Cases 371 (CLB)* that a director occupies a fiduciary position in relation to a company and he must act bona fide in the interest of the company. If a director makes a contract with the company and does not disclose his interest, he will be committing breach of trust. It appears that by including extensive provisions for RPTs, the Bill eliminates the current relaxations as provided in the Act and satisfies the principle as indicated in the aforesaid Saboo judgment.

It is understood that these provisions will not operate to deprive a third party of any benefit of his contract with the company if he had no notice of the defect in the director's authority because of his interest.

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### **Procedural law is determined by the seat of arbitration**

The prospective effect of principle laid down in *Bharat Aluminum Co.* case is quite

visible in the recent judgment of Delhi High Court in *Aargus Global Logistics Pvt. vs NNR Global Logistics (Shanghai) Co. Ltd.*, wherein the Court allowed challenging a foreign award in India under section 34 of the Act. In this case, the Delhi High Court provided clarity to a larger extent pertaining to the prospective applicability of the principle laid down in *Bharat Aluminum Case* by applying the principle held in *Bhatia International Case* wherein the Supreme Court had held that Part I of the Act applies to the impugned foreign Award since the substantive law governing the contract was Indian law.

Whilst analyzing the issue of applicability of procedural law, the Delhi High Court further held that the procedural law applicable in arbitration is determined by the seat of arbitration and not by the governing law of the agreement in which the arbitration clause resides.

In *Bharat Aluminum Co.* judgment, passed on September 6, 2012, the Supreme Court overruled its judgment in *Bhatia International* case and observed that Part I of the Arbitration and Conciliation Act, 1996 (the Act) is inapplicable on such cases where the seat of arbitration is outside India. However, the Apex Court clarified that this ruling will have a prospective effect.

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## JUSTICE VERMA COMMITTEE REPORT

The three member committee headed by former Chief Justice of India, J.S.Verma, Justice (retd) Leila Seth and former Solicitor General, Gopal Subramaniam, has been set up after the gang rape of a twenty three old student in Delhi. The committee has submitted its report on January 23rd January, 2013.

According to the committee report it is “the duty of the state as well as civil society to deconstruct the paradigm of shame-honour in connection with a rape victim”.

The salient points put forth by the committee in its report for the very first time in the Indian law are as follows –

- It has recognized that a married woman is an autonomous individual who has a right to refuse to the sexual intercourse with her “lawfully wedded husband”.
- The sexual violence against women committed by the members of the armed forces should come under purview of Indian criminal law. It has further laid emphasis on ‘review of AFSPA AND AFSPA like legal protocols as soon as possible.’ The sanction which is required for prosecuting these offences committed by uniformed personal has been done away with.
- It has introduced the concept of ‘command responsibility’, according to which a public servant who has the control or supervision of the armed forces or police, would be held responsible for the actions of his subordinates resulting in any

form of sexual assault.

- The report has further elaborated the definition of those who could be affected by sexual assault, which include men as well as homosexual and the transgender persons. Thus law protects all persons from rape and sexual assault.

The committee has refused to yield to the public demand for the death penalty for those accused of the brutal rape. It has also rejected both the chemical and surgical castration and has termed them as 'cruel and unusual' punishments, according to the committee it is against the ethics of the Indian Constitution. Further the plea of lowering the age of juvenile from 18 years to 16 years has also been rejected by the committee.

## News 10 @ a glance

### **India And Abu Dhabi To Sign An Investment Protection Pact**

After a long discussion between the Commerce and Industry Minister and the chairman of Abu Dhabi Crown Prince Court, India and UAE have in-principle agreed to ink Bilateral Investment Promotion and Protection Agreement to boost the two-way trade, and allocate \$2 billion for investments in infrastructure projects and in establishing strategic oil reserve in the South Asian nation.

### **CCI Imposed A Penalty Of 52.24 Crore On BCCI For Abuse Of Position**

A penalty of 52.24 crore has been imposed on the Board of Control for Cricket in India (BCCI) by the Competition Commission of India (CCI) for being indulged in anti-competitive practices. The CCI in its verdict claimed that BCCI abused its dominant position and directed it to cease its all practices of denying market access to the potential



competitors. The regulator also stated that the stance of BCCI was of serious concern and quantum of penalty which should be levied that is proportional to the seriousness of violation.

### **Karnataka Mines Allowed To Be Resumed Partially**

The Supreme Court appointed Central Empowered Committee (CEC), looking into environmental compliance by miners accused of irregularities in Karnataka said that satisfactory progress has been made in the implementation of the lease-wise reclamation and rehabilitation (R&R) plans in respect of Category-A and Category-B mining leases. It said that Category-B mines be permitted to resume operations on the condition that they pay compensation as per the court's order, which sought, among other things, an undertaking for payment of additional charge, if held liable, on the basis of the final determination of the amount of compensatory payment to be made by lease holders.

### **India And Bangladesh Signed Agreements On Extradition And Visa Regime**

India and Bangladesh on 28 January 2013 signed two landmark agreements on extradition of criminals and terrorists and liberalising the visa regime. However, refusal provisions were incorporated into the extradition



treaty. The other agreement has provision for a friendlier visa regime for citizens of Bangladesh.

Businessmen will be provided a five-year, multiple-entry visa. Those travelling on medical grounds will be eligible for a two-year, multiple-entry visa, which could be extended for one more year. Three attendants of a patient will also be given visa.

Until now, India was granting Bangladeshi tourists visas for up to six months and had allowed one person to accompany a patient.

### **Illegal Clinical Trials**

In the wake of public interest litigations being filed whose subject matter being the illegal clinical trials taking place in India, the Drug Controller General of India, under the Ministry of Health and Family Welfare has passed an order that no new clinical trials will be permitted to be conducted in India for at least two months from January 22, 2013 unless a new “regulatory regime” for conducting such clinical trials is established and it gets the approval of the supreme court of India.

### **Supreme Court Of India Directed Karnataka To Release 2.44 TMC Cauvery Water To TN**

The Supreme Court of India on has directed Karnataka to release 2.44 thousand million cubic feet of Cauvery water to the state of Tamil Nadu with immediate effect. The bench gave the order on the basis

of report submitted by the committee of Central Water Commission that was appointed on the orders of the Apex Court.

### **Supreme Court Of India Asked SEBI To Freeze Accounts Of Two Companies Of Sahara**

The Supreme Court of India recently gave its ruling against Sahara Group setting the Securities and Exchange Board of India (SEBI) free for seizing the properties and freezing the accounts of the two companies of Sahara Group for disobeying the Apex Courts orders of refunding 24000 crore rupees of investors. The Supreme Court also issued a notice against Sahara Group seeking response within four weeks that why the contempt proceedings should not be initiated against the group.

### **Rajasthan HC Stayed The Decision For Giving 4% Additional Reservation**

The division bench of the Rajasthan High Court on 29 January 2013 stayed the state government's decision forgiving 4 per cent additional reservation to Gurjar, Raika-Rebari, GadiaLuhar and Banjara communities after the state's decision was challenged by a petitioner that it will provide 54 per cent reservation which is violation of Supreme Court's order.

### **Goa Objects To CEC Probe Into Illegal Mining**

The Goa state government in its affidavit filed in the illegal mining case has informed the Supreme Court (SC) that it has serious objections to bodies like the Central Empowered Committee (CEC) inquiring into the mining issue in Goa. It said that it would have no objection to a committee headed by a retired SC judge looking into the mining issue.

The state alleged that the CEC had appeared at the first hearing of the writ petition without notice, apparently on being informed by the petitioners Goa Foundation and made a statement that the situation in Goa is worse than in Karnataka, which was not a correct assessment and an uncalled for statement.

### **Kashmiri Militant “Afzal Guru” Executed**

India has executed Kashmiri militant Afzal Guru who was sentenced to death 10 years ago for an attack on the parliament in 2001. The president rejected a mercy petition from Mohammad Afzal Guru and he was hung. Indian national Guru was convicted for helping organise arms for the parliament marauders and a place for them to stay.