

Interplay of Related Party
Transactions between Companies
Act, 2013 & SEBI (LODR)
Regulations

23.07.2022

Roadmap

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- Definition: Related Party, Relative and Related Party Transaction
- Approval Mechanism
- Disclosure Requirements
- Penal Provisions
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Introduction

- Every transaction with a related party may not be a ‘related party transaction’ although every ‘related party transaction’ is necessarily a transaction with a related party.
- A related party transaction (“**RPT**”) - Where there is a pre-existing relationship between the parties who are related.
- Pre-existing relation under the Companies Act, 2013 (“**Act**”) and SEBI (LODR), 2015 (“**LODR**”)

Key Provisions to understand the Pre-existing Relationship between the Parties

- ‘Related Party’ under Section 2(76) of the Act and Regulation 2(1)(z)(b) of LODR;
- ‘Relative’ under Section 2(77) of the Act read with Rule 4 of the Companies (Specification of Definitions Details) Rules, 2014 and Regulation 2(1)(z)(d) of LODR; and
- ‘Related Party Transaction’ under Section 188 of the Act and Regulation 2(1)(z)(c) of LODR and Regulation 23 of LODR.

‘Related Party’ – Section 2(76) of the Act

- i. a director or his **relative**;
- ii. a 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 2% of its paid-up share capital;
- vi. any body 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 (other than any advice/ guidance given in professional capacity);
- vii. any person on whose advice, directions or instructions a director or manager is **accustomed to act**. (other than any advice/ guidance given in professional capacity).

Who is a **Relative**?

What is **Accustomed to Act**?

Related Party - Act

Contd...

viii. Any body corporate which is —

A. a holding, subsidiary or an associate company of such company;

B. a subsidiary of a holding company to which it is also a subsidiary; or

C. an investing company or the venturer of the company.

Explanation - For the purpose of this clause, “the investing company or the venturer of a company” means a body corporate whose investment in the company would result in the company becoming an associate company of the body corporate.

ix. **Deemed** to be a related party. [*Rule 3 of Companies (Specification of Definitions Details) Rules, 2014 - a director other than an 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*]

‘Relative’ – Section 2(77) of the Act

- Section 2(77) of the Companies Act read with the relevant rules made thereunder define ‘relative’ as:
 1. Members of HUF; or
 2. Husband and Wife; or
 3. One person is related to the other, being their:
 - Father, including step-father;
 - Mother, including step-mother;
 - Son including step-son;
 - Son’s wife;
 - Daughter;
 - Daughter’s husband;
 - Brother including step-brother; and
 - Sister including step-sister.

LODR borrows the definition of ‘Relative’ from Section 2(77) of the Act and rules prescribed thereunder.

Accustomed to Act

- ‘Shadow director’.
- Established general conduct - Directors of a company habitual of carrying out tasks on the instructions of a third person/ party without exercising own discretion/ judgement.
- There must be cogent evidence.
- This excludes advice/ guidance given in professional capacity.
- Person includes individual and/ or body corporate.

Related Party - LODR

Regulation 2(1)(z)(b):

- Related party as defined under Section 2(76) of the Act or under the applicable accounting standards – either AS 18 or Ind AS 24, whichever is applicable.
- If the condition is met under either the Act or applicable accounting standard, as the case may be, the party should be considered as a related party under LODR.
- ***Deemed*** to be a related party under LODR?
 1. Any **person** forming a part of the promoter or belonging to the promoter group of the listed entity.
 2. Any **person** holding equity shareholding in the listed entity:
 - (a) Amounting to 20% or more; or
 - (b) Effective from 01.04.2023, 10% or more either directly or on a beneficial interest basis at any time, during the immediately preceding financial year.

RPT - Section 188 of the Act

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) 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.

RPT - Regulation 2(1)(z)(c) of LODR

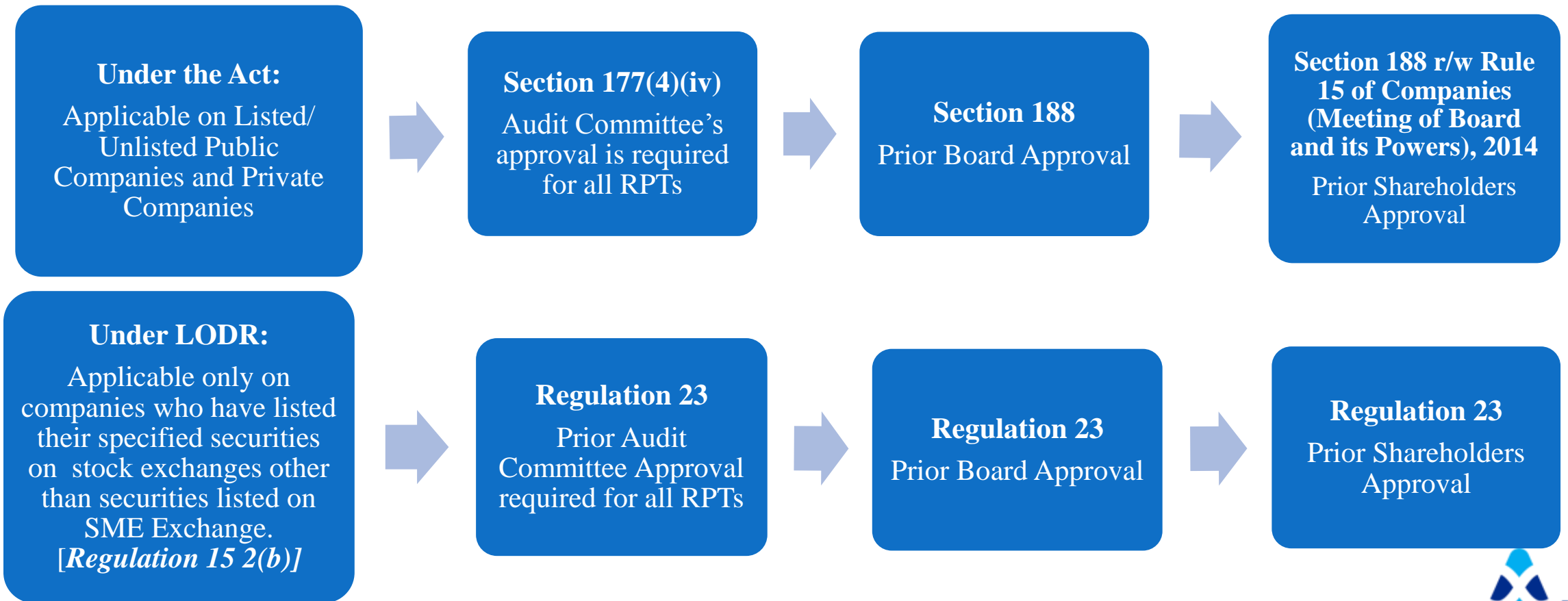
- Regardless of whether a price is charged for a transaction, a RPT involves transfer of resources, services or obligations between:
 - a. A listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or
 - b. Effective from 01.04.2023, a listed entity or any of its subsidiaries with any other person or entity on the other hand for the ultimate objective of providing benefit to a related party of the listed entity or any of its subsidiaries.

This above-mentioned definition is not applicable for the units issued by mutual funds which are listed on a recognised stock exchange(s).

Exceptions to RPT - LODR

- If a listed entity subject to compliance of SEBI (ICDR) Regulations, 2018 issues specified securities on a preferential basis.
- Corporate actions by the listed entity which are uniformly applicable/offered to all the shareholders in proportion of their shareholding:
 - i. Payment of dividend;
 - ii. Subdivision or consolidation of securities;
 - iii. Issuance of securities by way of a rights issue or a bonus issue; and
 - iv. Buy-back of securities.
- Acceptance of fixed deposits by banks/NBFC's at the terms uniformly applicable/offered to all shareholders/public, subject to disclosure of the same along with the disclosure of related party transactions every six months to the stock exchange(s), in the format as specified by the Securities Exchange Board of India.

Approvals under the Act and LODR



Approval of Audit Committee

- Approval of audit committee for all transactions with related parties is required, including transactions that are entered into in **ordinary course of business** and are on **arms length basis**. [*Section 188(1) explanation (b)*]
- Audit committee has the power to grant **omnibus approval**. [*Rule 6A the Companies (Meetings of Board and its Powers) Rules, 2014.*]
- Audit committee has the power to **ratify transactions**. [*Section 177(4)(iv) 3rd Proviso*]
- Approval not required for RPT entered into between holding company and its wholly owned subsidiary (“WOS”).
- Effective from 01.01.2022 under LODR, only independent directors in audit committee to approve RPTs.

Approval of Audit Committee Contd..

- Transaction entered into by subsidiary of listed entity:-
 - i. Effective from 01.04.2022 prior approval is required - Where value of transaction exceeds 10% Annual Consolidated Turnover of the company.
 - ii. Effective from 01.04.2023, prior approval is required- Where value of transaction exceeds 10% Annual Standalone Turnover of the company.
- Effective from 01.04.2022, prior approval of the audit committee is required for all **subsequent material modification**.
- What is **material modification**?
- The audit committee shall review the status of long-term (more than one year) or recurring RPTs on an annual basis. [*Point 5 SEBI circular dated 22.11.2021.*]

Omnibus Approval under LODR

- Audit committee to lay down the criteria for grant of omnibus approval.
- Transactions should be repetitive in nature.
- **Details** to be mentioned while giving omnibus approval.
- Quarterly review.
- Validity of omnibus approval shall not exceed one financial year.
- An RPT for which the audit committee has granted omnibus approval in the financial year 2021-2022, is required to be placed before the shareholders if it is **material** in terms of Regulation 23(1) of the LODR Regulations. [**SEBI Clarification dated 30.03.2022.**]

Prior Board Approval



Prior board of director's approval for RPT is required under both the Act and LODR.



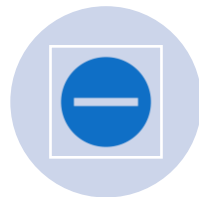
The agenda for the board meeting shall disclose details about the related party and proposed RPT.



Can a resolution for entering into RPT be passed by circulation?



Can a director who is interested in a RPT be present while the related party agenda is being discussed in the board meeting?



Exemption to prior board approval? [***Prior approval is not required for RPTs in ordinary course of business and at arms length.***]



Will Section 188 be applicable on corporate restructuring, amalgamations? [***MCA clarification dated 17.07.2014***]

No prior board approval is required for a transaction between a holding company and its WOS, if WOS accounts is consolidated with holding company and are presented in front of the shareholders for their approval.

Prior Shareholder Approval - Act

- i. Transaction of sale, purchase or supply of any goods or material, directly or through appointment of agent - Amounting to 10% or more of the **turnover** of the company.
- ii. Transaction of selling or otherwise disposing of or buying property of any kind, directly or through appointment of agent - Amounting to 10% or more of the net worth of the company.
- iii. Transaction of leasing of property of any kind - Amounting to 10% or more of the **turnover** of the company.
- iv. Availing or rendering of any services, directly or through appointment of agent - Amounting to 10% or more of the **turnover** of the company.
- v. Place of profit in the company or any of its subsidiary company or associate company – Exceeding INR 2,50,000.
- vi. Underwriting remuneration – Exceeding 1% of the net worth.

Limits mentioned in (i-iv) above shall apply on a transaction or a proposed transaction either individually or taken together with previous transactions during a financial year.

Prior Shareholder Approval - Act Contd...

- Can an equity shareholder who is classified as a related party in the company vote on agenda of a proposed RPT? [*MCA circular dated 17.07.2014 - only concerned related party cannot vote.*]
- Every concerned related party may vote in a company where 90% or more members in number are relatives of promoters or are related parties.
- An ordinary resolution passed by the equity shareholders of the holding company is sufficient for WOS, subject to WOS accounts being consolidated with holding company and placed before shareholders for their approval at the general meeting.

Turnover

- Turnover: Aggregate value made from sale, supply or distribution of goods or services rendered by the company during a financial year. [*Section 2(91) of the Act*]
- Accordingly, while calculating turnover should we consider revenue generated from other income?
- Turnover under the Act to be computed on the basis of previous years audited financial statement of the company.
- Under LODR consolidated turnover should be considered while computing the turnover.

Prior Shareholder Approval - LODR

- It is required if the transaction is of **material nature**.
- **Material nature:**
 - a) If the transaction(s) to be entered into individually or taken together with all the previous transactions during a financial year is/ are in excess of INR 1,000 crore or 10% of the annual consolidated turnover, whichever is lower.
 - b) Transaction of brand usage or royalty exceed 5% of the annual consolidated turnover of the company.
- No related party shall vote to approve a transaction, irrespective of whether the related party is involved in the proposed RPT or not.
- Can the said related party **vote against** the RPT resolution in the general meeting?

Exceptions to RPT

- In private companies a related party can vote on a resolution approving the RPT.
- Transactions between 2 government companies. [*MCA notification dated 02.03.2020, and Regulation 23(5) of LODR.*]
- Transactions between:
 - a) Holding company and WOS; or
 - b) Two WOS of the listed holding company.
- Subject to accounts being consolidated with such holding company and placed before the shareholders of the holding company at the general meeting for their approval.

Disclosure Requirement - Act

- Every RPT shall be mentioned in the relevant Board Report of the company.
- Is disclosure in **Form AOC-2** mandatory? [*Yes, regardless of whether the RPT is on arms length basis or not.*]
- Explanatory Statement of proposed RPT under the Act shall include: [*Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014.*]
 - a) name of the related party;
 - b) name of the director or key managerial personnel who is related, if any;
 - c) nature of relationship;
 - d) nature, material terms, monetary value and particulars of the contract or arrangements; and
 - e) any other information relevant or important for the members to take a decision on the proposed resolution.

Disclosure Requirement - LODR

- **Information** to be provided to audit committee for review of proposed RPT. [*Point 4 of SEBI circular dated 22.11.2021*]
- Additional information to be mentioned in explanatory statement under LODR:
 - a. A summary of the information provided by the management of the listed entity to the audit committee;
 - b. Justification for why the proposed transaction is in the interest of the listed entity;
 - c. Where the transaction relates to any loans, inter-corporate deposits, advances or investments made or given by the listed entity or its subsidiary, the details specified under point 4(f) above; (The requirement of disclosing source of funds and cost of funds shall not be applicable to listed banks/NBFCs.)
 - d. If any statement of valuation or other external report is relied upon by the listed entity in relation to the proposed transaction, then the same is to be sent to the registered email address of the shareholders;
 - e. % of the counter-party's annual consolidated turnover that is represented by the value of the proposed RPT, on a voluntary basis;
 - f. Any other information that may be relevant.

Disclosure Requirement – LODR Contd...

- The listed entity shall make RPT disclosure to the stock exchange every 6 months within 15 days from the date of disclosure/ publication of listed entities standalone or consolidated financials results in the format given in annexure of SEBI circular dated 22.11.2021.
- Listed entity shall disclose these disclosure on the company's website from time to time.
- Effective from April 2023 this disclosure is required to be made at the time of disclosure/ publication of its standalone or consolidated financials results.
- High value debt listed entity shall submit such disclosures along with its standalone financial results for the half year.
- The said disclosure is to be made every 6 months for both the first and the second half year (six-month end basis). [*Q3. Guidance note on disclosure of RPT dated 25.04.2022.*]
- RPT disclosure is required to be made even if there are no new related party transaction during the reporting period. [*Q6.Guidance note on disclosure of RPT dated 25.04.2022*]

Penal Provisions

- Any director or employee that enters into a contract or arrangement in violation of Section 188:
 - i. Listed entity:** Shall be liable to a penalty of INR 25,00,000, or
 - ii. Other Company:** Shall be liable to a penalty of INR 5,00,000.
- Is such a contract or arrangement **voidable** at the option of the board of directors or shareholders as the case may be? [*Section 188(3) of the Act.*]
- Can company ask for **indemnification of financial loss** from the directors or employees that enter into a contract or arrangement with related party without prior approval of board of directors or shareholder, as the case may be? [*Section 188(4) of the Act.*]
- Non-compliance of RPT disclosure on consolidated basis shall attract a penalty of INR 5,000 per day. [*SEBI Circular dated 22.1.2020.*]

Example

Example 1: A holding listed company and its unlisted subsidiary enter into a contract or arrangement of renewable nature wherein the unlisted subsidiary is required to deposit performance guarantee to the holding entity. The said performance guarantee is of rolling nature and can be forfeited by the holding entity if the performance of unlisted subsidiary is unsatisfactory. Further, the holding company is required to pay the unlisted subsidiary a service fees/ commission on the basis of the performance of the unlisted subsidiary during that particular year.

- **Q1.** Will the approvals mechanism mentioned under the Act and/ or LODR be required for every subsequent year the RPT contract is renewed?
- **Q2.** Will the prior board approval and/ or prior shareholders approval be required if the transaction is at arms length basis and is in the ordinary course of business?
- **Q3.** Is it mandatory to obtain a arms length transaction certificate to show the nature of the RPT?

Example Contd...

A1. Yes, prior board approval and/ or prior shareholders approval, as the case may be, shall be required for every subsequent financial year the contract is renewed.

A2. The prior approval of the board and/ or the shareholders of the listed entity will not be required under the Act if the contract or arrangement is on arms length basis and is entered into in the ordinary course of business.

Under LODR there is no such exemption for contract or arrangement entered into on arms length basis and in ordinary course of business. Prior approval of the board or shareholders is to be taken wherever the prescribed thresholds are breached.

A3. It is the responsibility of the company to assure themselves and in case of an enquiry by the relevant authorities that the contract or arrangement was entered into on arms length basis and in ordinary course of business. Accordingly, it is not mandatory to acquire an arms length transaction certificate from an independent professional.

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ALPHA CORPORATE LEGAL

**24th Floor, Etherea Coworking,
Alphathum, Tower B, Sector 90,
Gautam Buddha Nagar – 201305.**

**Email: sumit@acl.law
Mob: + 91 9818697266**