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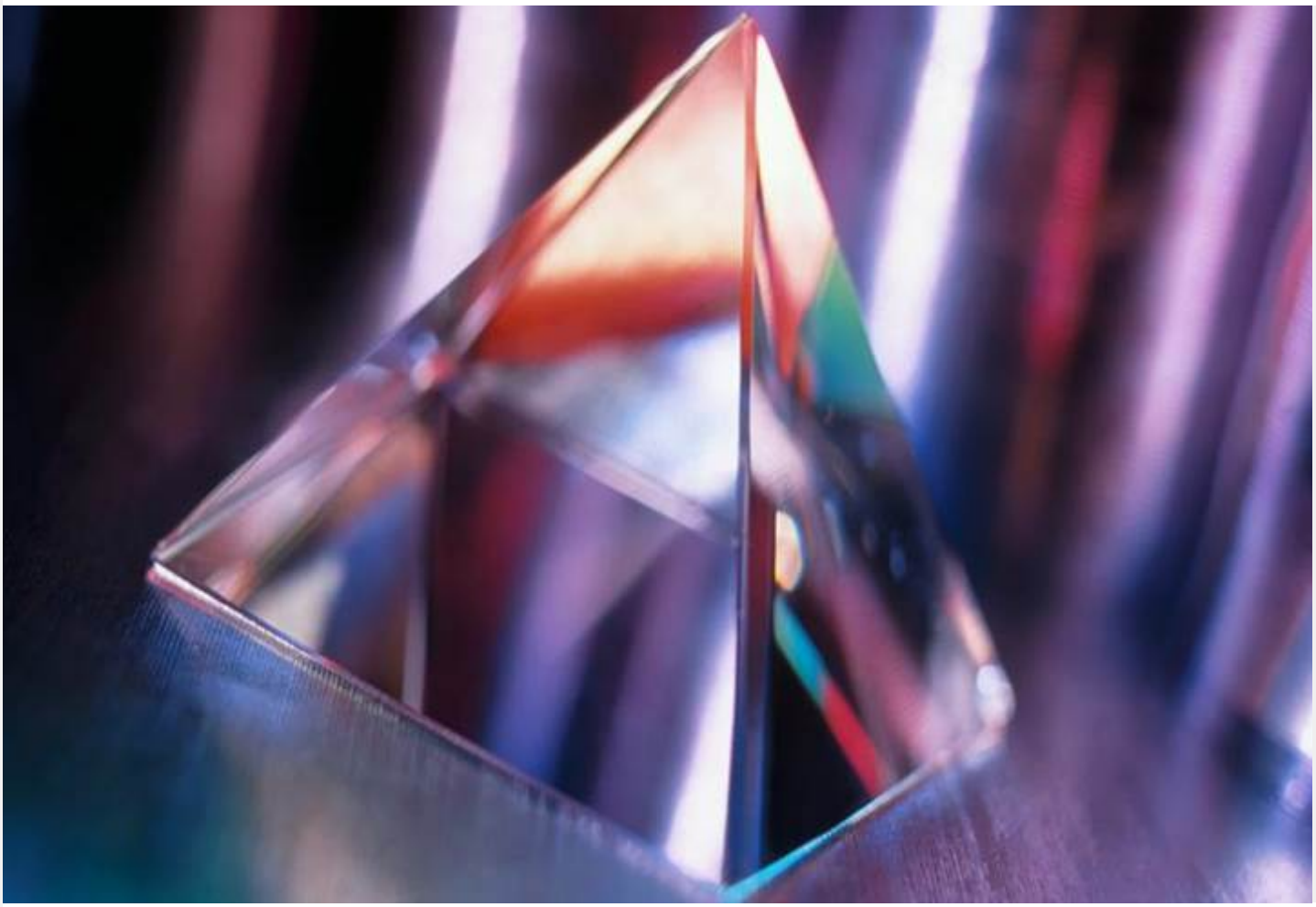


D’Prism

A series on the Companies Act, 2013

Related parties

Overview

The Companies Act, 2013 ('2013 Act') has introduced, within the legislation, the concept of 'related party'. The management, directors and committees of the board are now responsible for the identification, approval and disclosure of related parties and transactions with them. In this Issue, we discuss some matters pertaining to related parties that need to be considered by a company under the 2013 Act. It is pertinent to note that the provisions of the 2013 Act insofar as they cover related parties are applicable to all companies[1]. The requirements of revised Clause 49 of the Equity Listing Agreement (the 'ELA'), which are applicable only to listed companies, have not been comprehensively covered in this Issue.

Issue 3[2] Related Parties

August 2014

In this issue:

Key provisions of the 2013 Act in relation to related parties

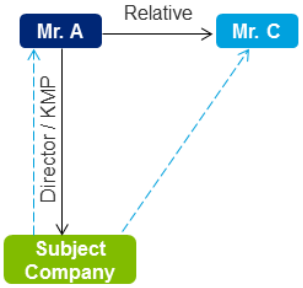
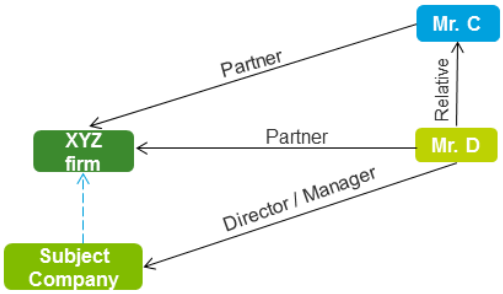
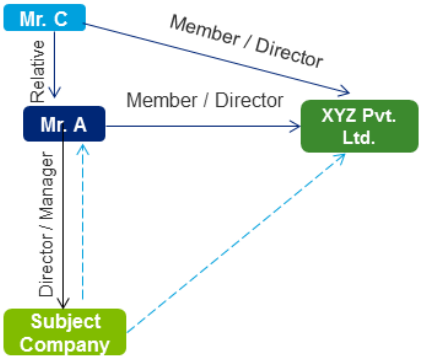
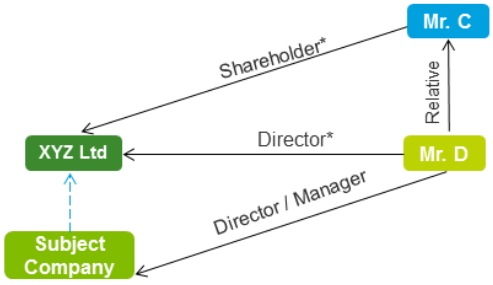
Particulars	2013 Act
Definition: Section 2(76)	Related party with reference to a company, means: • A director or his relative; • A key managerial personnel ('KMP') or his relative; • A firm, in which a director, manager or his relative is a partner; • A private company in which a director or manager [or his relative][3] is a member or director; • A public company in which a director or manager is a director and[4] holds along with his relatives, more than two per cent of its paid up share capital; • 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 those provided in a professional capacity); • Any person on whose advice, directions or instructions a director or manager is accustomed to act* (other than those provided in a professional capacity);

[1] The Ministry of Corporate Affairs (MCA) has, on 24 June 2014 released a draft notification stipulating, *inter alia,* that the provisions of section 188 relating to related party transactions will not apply to private companies. Pending finalisation, the provisions of the draft notification have not been considered for the purpose of this Issue.

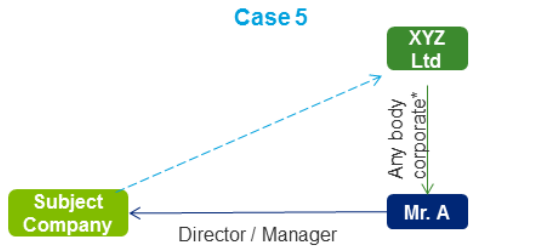
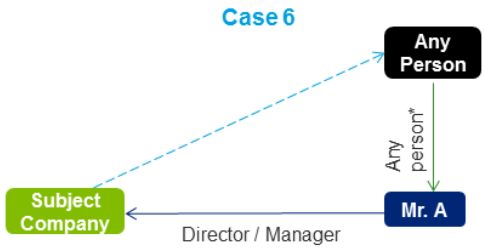
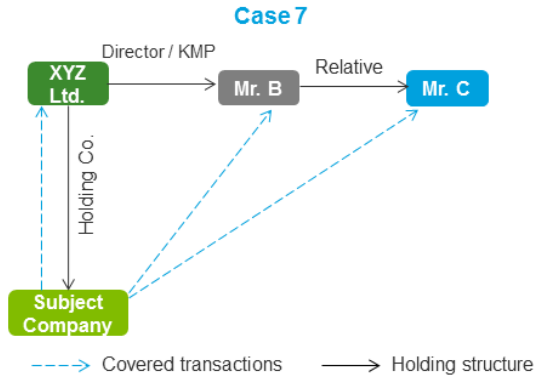
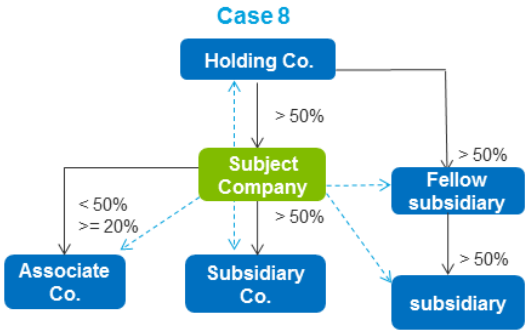
[2] Covers clarifications issued by the MCA upto 31 July 2014.

[3] Amended by the Companies (Removal of Difficulties) Sixth Order, 2014 dated 24 July 2014 which is yet to be published in the Official Gazette.

[4] 'or' has been replaced with 'and' in the Companies (Removal of Difficulties) Fifth Order, 2014 published in the Official Gazette on 9 July 2014.

	• Any company which is: — a holding, subsidiary or an associate company of such company; or — a subsidiary of a holding company to which it is also a subsidiary; • A director[5] or KMP of the holding company of such company or his relative. ** Discussed separately in this Issue.*
Section 2(77)	Relative with reference to a person means: • Members of a Hindu Undivided Family; • Husband and wife; • Father (including step father); • Mother (including step mother); • Son (including step son); • Son's wife; • Daughter; • Daughter's husband; • Brother (including step brother); • Sister (including step sister). **Some examples to depict related party relationships :-** Covered Related Parties under 2013 Act- Examples Case 1 – Director/ KMP and his relatives  Case 2 - Firm  Case 3 – Private Company  Case 4 – Public Company  * Director along with his relatives having more than 2% of its paid-up share capital

[5] A director shall be a director other that an Independent Director on notification of Companies (Specification of Definition Details) Amendment Rules, 2014 dated 17 July 2014 in the Official Gazette.

	 * whose Board, managing director, or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager  * under whose advice, directions or instructions a director or manager is accustomed to act  
Applicability to audit committees [section 177]	Every audit committee should act in accordance with the terms of reference specified in writing by the board which should include approval or any subsequent modification of transactions of the company with related parties.

Applicability to certain contracts or arrangements [section 188]	With respect to transactions which are not in the ordinary course of business or not at arm's length, prior approval of the board of directors (the 'board')/shareholders[6] is required with respect to the following contracts or arrangements with a related party: • Sale, purchase or supply of any goods or materials; • 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 • Underwriting the subscription of any securities or derivatives thereof, of the company. Where prior approval of the board/shareholders, as the case may be, is not obtained, such contract or arrangement requires ratification within three months from the date of contract or arrangement, else the same could be voidable at the option of the board. It is clear from the above that while section 177 deals with transactions with related parties, section 188 deals with contracts or arrangements with related parties. However, if a contract or arrangement is already approved by the audit committee, individual transactions emanating from such a contract or arrangement may not require approval of the audit committee again unless there are modifications to the terms of the contract or arrangement.

Arm's length	A transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

[6] Applicable for companies having a paid up share capital of not less than Rs. 10 crores or where transactions exceed a prescribed threshold.

Disclosures in the Board Report of particulars of contracts or arrangements with related parties	The Board Report to the shareholders should include: • Every contract or arrangement or transaction that is not at arm's length or not in the ordinary course of business with its salient terms and along with justification for entering into such contract or arrangement or transactions. • Every material contract or arrangement or transaction that is on an arm's length basis with its salient terms. The Board Report, amongst other things, requires disclosure of particulars of certain contracts or arrangements or transactions with related parties. It may be noted that the disclosure in the Board Report is not dependent on whether the contracts or arrangements or transactions are in the ordinary course of business or otherwise. Where contracts or arrangements or transactions with a related party are not at arm's length, certain details, including justification is required to be provided in the Board's Report. However, where such contracts or arrangements or transactions are at arm's length, details of only 'material' contracts or arrangements or transactions are required to be stated in the Board Report. As such, contracts or arrangements or transactions with related parties that are in the ordinary course of business need not be disclosed in the Board Report if they are at arm's length and are not 'material'. 'Material' in this context has neither been defined nor explained. Reference may be made to the following guidance in regard to interpretation of the term 'material'. • Accounting Standard 18, Related Party Disclosures requires disclosure in the financial statements for any related party transaction that is in excess of 10 percent (deemed to be material) of the total related party transactions of the same type. Clearly, in this case, 'material' has been considered for the purposes of segregating from aggregated related party transactions of a similar type, transactions with an individual party. • The Securities Exchange Board of India (the 'SEBI') has recently amended the ELA, effective 1 October 2014. As per the new requirements, companies have to formulate a policy on materiality of related party transactions. Also, it is stated that a transaction is material, if the transaction/transactions to be entered into individually or taken together with previous transactions during a financial year exceed the higher of 5 percent of the annual turnover or 20 percent of the net worth of the company as per its latest audited financial statements. It is pertinent to note that the threshold provided by SEBI is in the context of the company taken as a whole. Since the Board's Report provides information to stakeholders on the state of the company's affairs and matters relating to the company as a whole, it would be appropriate that the consideration that should apply to determining 'materiality' of related party transactions in the Board's Report should be with reference to the company as a whole. Accordingly, guidance may be drawn from the ELA as discussed above.

	This would also ensure that for listed companies, the disclosure is consistent with, and aligned to that made under the aforementioned ELA. For other companies also, the threshold/measure per the aforesaid ELA, though not applicable to them, could provide a balance between excessive disclosure and an inherent desire to limit disclosure to the bare minimum in the Board Report. Companies may, however, choose to set materiality thresholds lower than the aforementioned regulatory-provided threshold, as they may deem fit, for appropriate disclosure in the Board Report.
Penalties	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 section 188 will be punishable: • In case of listed companies, imprisonment upto one year or fine ranging from Rs. 25,000 to Rs. 5 lakhs or both. • In case of any other company, fine ranging from Rs. 25,000 to Rs. 5 lakhs.

Related party

The term related party, both in relation to a person and in relation to a company is wide and a careful and continuing assessment would be required to determine the parties covered. Related parties include KMPs/KMPs of the holding company and certain relatives. Companies will need to ensure that a process to update the list of related parties is established having regard to possible external changes that need to be considered. Thus, for example, changes in KMPs of a holding company need to be communicated to all subsidiaries to ensure their compliance and adherence.

Every company will be required to formulate a process to ensure that not only is the initial compilation of the list of related parties complete and correct, but subsequent modifications to such lists are also made in a timely manner. This would be possible through introduction of a system of periodic confirmations from various concerned parties and putting in place a robust review mechanism. Similar to how every director is required to disclose his interest in any company/ bodies corporate, firms, or other associations, all companies could formulate a system to obtain confirmations from other concerned parties. It may be noted that the disclosure of interest by directors in the requisite format does not include disclosure of list of relatives of directors. Consequently, companies should obtain such details separately from the directors. The process of obtaining periodic declarations from directors, KMPs and other concerned parties could be formalised as part of the internal financial controls system to be introduced by companies. The company secretary of every company is generally expected to be tasked with and be responsible for compilation of the list of related parties and its periodic updation.

The definition of a subsidiary company as per the 2013 Act requires evaluating the position based on total share capital, namely, equity and convertible preference share capital. Similarly, the definition of associate company, which now includes a joint venture company, is driven by significant influence, which is control of at least twenty per cent of the total share capital, namely, equity and convertible preference share capital, or of business decisions under an agreement.

Consequent to these definitions as per the 2013 Act being different from the definitions provided

under the Accounting Standards which consider control over the equity share capital only to determine whether a company is a subsidiary/associate, more entities could get scoped in as related parties. It is also pertinent to note that the term associate company applies only to entities incorporated as companies. Partnership firms/unincorporated joint ventures and the like are not covered as associate companies under the 2013 Act, although these are covered as 'associates' under the Accounting Standards.

Related party transactions

All related party transactions, including subsequent modifications require approval of the audit committee. All contracts or arrangements that are (i) not in the ordinary course of business but at arm's length (ii) in the ordinary course of business but not at arm's length or (iii) not in the ordinary course of business and not at arm's length, require the prior approval of the board of directors or shareholders, based on certain thresholds as stated in the table below [7]:

Particulars	2013 Act
Prior approval of the board of directors	Prior approval of the board of directors will be required for all transactions that are not in the ordinary course of business or are not at arm's length. 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. Where the transactions exceed certain thresholds (see 'Threshold for shareholder's approval'), prior approval of the shareholders will be required by way of a special resolution. In such cases, the members who are related parties cannot vote on the resolution.
Threshold for shareholders' approval	• Where paid up share capital[8] of the company is not less than Rs. 10 crores – all contracts or arrangements with related parties as envisaged in section 188. The date for determining the paid up capital has not been stated in the Act or the Rules. However, the date for determining turnover and net worth has been specifically stated as based on the audited financial statements of the preceding year. Since the tests are for determination of the threshold for shareholder's approval, pending an alternative clarification by the MCA, it may be appropriate that the paid up capital should also be on the basis of the audited financial statements of the preceding year.

[7] The MCA has, on 24 June 2014 released a draft notification stipulating, *inter alia*, that the provisions of section 188 relating to related party transactions will not apply to private companies. Pending finalisation, the provisions of the draft notification have not been considered for the purpose of this Issue.

[8] Paid up share capital means such aggregate amount of money credited as paid up as is equivalent to the amount received as paid up in respect of shares issued and also includes any amount credited as paid up in respect of shares of the company. Paid up share capital includes preference capital, whether convertible or redeemable and excludes Securities Premium Account.

However, since the date for determining paid up capital has not been specified, an alternative view could be that such paid up capital needs to be determined on the date of entering into the related party contract or arrangement or transaction.

- In all other cases (i.e., companies with paid up share capital of less than Rs. 10 crores) - with respect to contracts or arrangements, where value exceeds the threshold provided below:

Contracts or arrangements	Value[9]
Sale, purchase or supply of any goods or materials directly or through appointment of agents	> 25 percent of annual turnover
Selling or otherwise disposing of, or buying, property of any kind	> 10 percent of net worth
Leasing of property of any kind	> 10 percent of turnover or net worth
Availing or rendering of any services directly or through appointment of agents	> 10 percent of net worth

- With respect to the following, where value exceeds the threshold provided below:

Particulars	Value
Appointment to any office or place of profit in the company, its subsidiary company or associate company	Monthly remuneration > Rs 2.5 lakh
Underwriting the subscription of any securities or derivatives thereof, of the company	> 1 percent of net worth

The 2013 Act requires prior approval of the board/shareholders for all contracts or arrangements with related parties specified under section 188. Under section 177, audit committees are requested to approve transactions with related parties or any subsequent modification of such transactions. The transaction approval under section 177 is not a prior approval except in the case of equity listed entities, where prior approval will be required under the proposed amendments to clause 49 effective 1 October 2014.

However, it is anticipated that for all contracts or arrangements covered by section 188, prior to the approval of the board/shareholders, the audit committee would, having regard to governance policies, necessarily be required to review such contracts or arrangements.

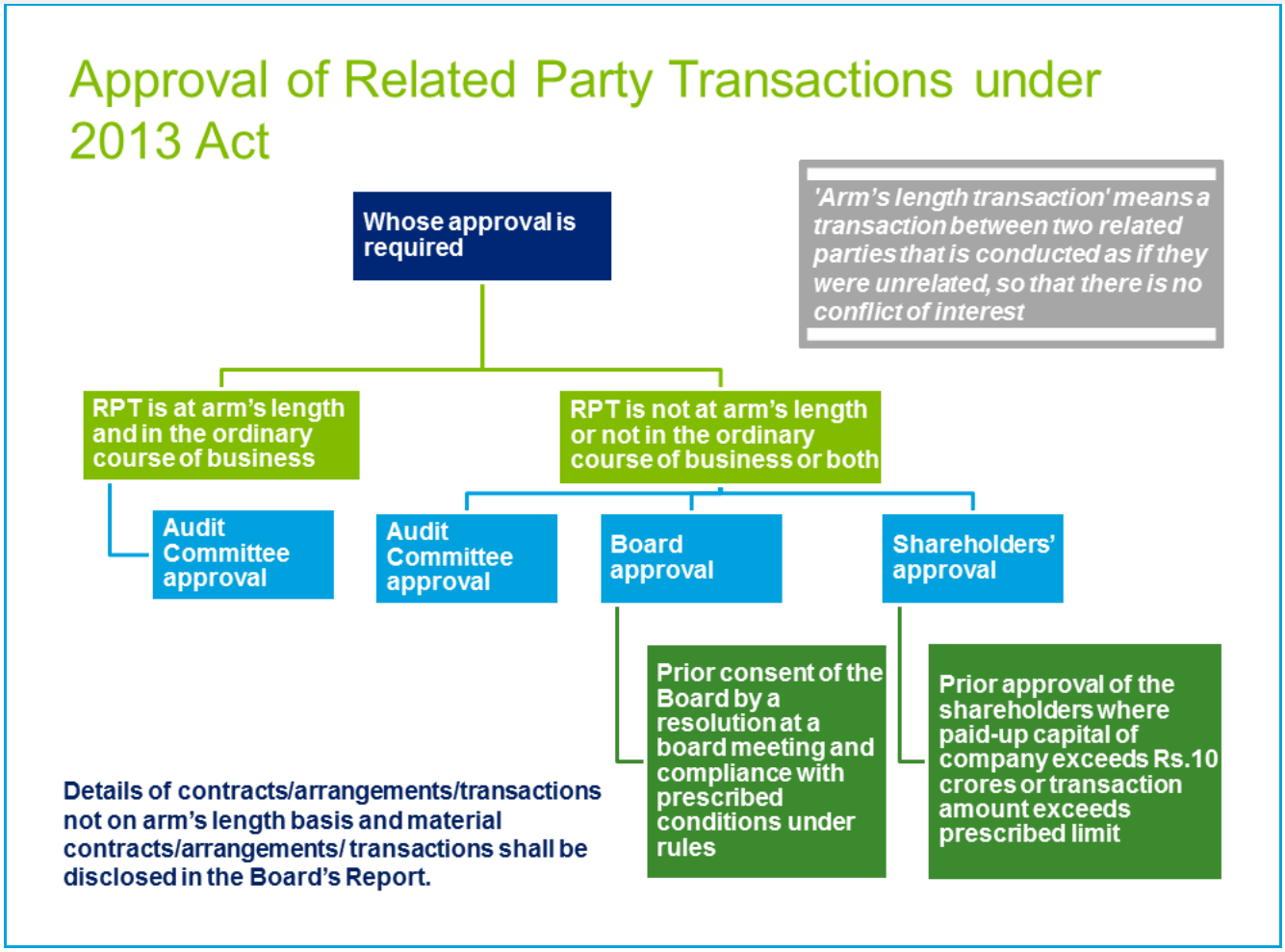
[9] Turnover and net worth is to be determined as defined in the 2013 Act on the basis of the audited financial statements of the preceding year. The turnover here would mean the standalone company's turnover and is not to be determined on a consolidated basis. The turnover would mean Revenue from Operations, including other operating income.

Audit committees would need to make themselves conversant with all of the transactions that do not require approvals of the board/shareholders. These therefore include all transactions which are in the ordinary course of business and at arm's length. For this purpose the following could be considered as appropriate:

- The management should indicate and identify contracts or arrangements that are determined to be in the ordinary course of business and at arm's length.
- For this purpose, the management could identify groups of transactions by nature or by related party or both (having regard to the facts and circumstances).
- Each of these groups of transactions needs to be identified as being in the ordinary course of business and at arm's length. 'Arm's length' and 'in the ordinary course of business' are discussed later in this Issue.
- For this purpose, a collective examination of all facts and circumstances will need to be made such as nature of the transaction, frequency, ability of the related party to transact, nature of the business of the related party, terms and conditions, similar terms with independent third parties, etc.
- All other related party contracts/arrangements, will need to be addressed as required under section 188.
- Periodically, such as quarterly, all transactions (arising in a preceding quarter) covered above, will need to be placed before the audit committee as required under section 177 for their examination.

This means that contracts/arrangements that have been approved by the audit committee as 'being in the ordinary course of business' and at 'arm's length' will not need prior approval in the case of unlisted companies, but could be placed before an audit committee at a later date, being the next audit committee meeting. It is anticipated that these would make up a bulk of the transactions with related parties in such companies; all other transactions will require prior approval.

However, with effect from 1 October 2014 under an amendment to the ELA, the audit committees of listed companies have to accord prior approval for all related party transactions.



The applicability of section 188 of the 2013 Act in case of Compromises, Arrangements and Amalgamations (which includes mergers and demergers) with related parties has been recently clarified by the MCA[10]. It has been clarified that transactions arising out of Compromises, Arrangements and Amalgamations dealt with under specific provisions of the Companies Act, 1956 ('1956 Act') or the 2013 Act will not attract the requirements of section 188.

On a careful reading of this clarification, it appears to cover Compromises, Arrangements and Amalgamations under Chapter V (sections 390-396A) of the 1956 Act and Chapter XV (sections 230-240) of the 2013 Act only. Any other mergers, demergers or purchase/sale of an undertaking are not covered under this clarification. Accordingly, where these and other transactions are with related parties, it would be necessary to ensure additional compliance with section 188.

[10] General Circular 30/2014 dated 17 July 2014.

Summary of approval matrix

Nature	Audit committee	Board of directors	Shareholders[11]
In the ordinary course of business and at arm's length #	x		
Not in the ordinary course of business but at arm's length @	x	x	x
In the ordinary course of business but not at arm's length @	x	x	x
Not in the ordinary course of business and not at arm's length @	x	x	x

Prior approval in case of equity listed entities as per the proposed amendment to clause 49 of the ELA effective 1 October 2014

@ Prior approval

A distinction has been made in the 2013 Act between contracts/arrangements (covered under section 188) and transactions (covered under section 177). Since section 188 is applicable only to contracts/arrangements entered into from 1 April 2014, it is reasonable to conclude that contracts or arrangements (subsisting as on 1 April 2014 but validly entered into prior to 31 March 2014) do not require an approval under section 188, though it will need approval when the underlying transaction materialises under section 177.

For e.g., a contract for the supply of goods over a one year period commencing 1 January 2014 entered into on that date does not require a re-approval on 1 April 2014, although goods will continue to be supplied under such contract throughout 2014. However, each transaction of supply of goods will need to be approved by the audit committee under section 177 and this may be through appropriate aggregation as referred to elsewhere in this Issue.

As part of good corporate practice, it may be advisable that all 'open' contracts/arrangements with related parties as on 31 March 2014 be placed before the audit committee for their understanding and noting.[12]

Accustomed to act

While most parts of the definition of related party are fairly straightforward, judgement will be required while interpreting the term a person on whose advice, directions or instructions a director or manager is 'accustomed to act'.

The concept of 'accustomed to act' is not new in the 2013 Act. A similar concept existed in the 1956 Act and a person in accordance with whose advice, directions or instructions a director or manager or the board is accustomed to act is generally referred to as a 'shadow director'.

[11] For thresholds refer section 'Related party transactions'.

[12] The MCA has clarified that contracts, in compliance with section 297 of the 1956 Act, which came into effect before 1 April 2014, will not require fresh approval under section 188, until the expiry of the original term of such contract or modification.

Accordingly, related parties would include a ‘shadow director’ i.e., any person under whose advice, directions or instructions the company’s director or manager or board of directors is accustomed to act.

In order to prove shadow directorship, it must be shown that the directors of the company did not exercise any discretion or judgement of their own, but acted in accordance with the directions of the ‘alleged’ shadow director. The words ‘accustomed to act’ require general conduct on the part of the directors indicating that they are in the habit of carrying out the instructions or directions of the third person (‘shadow director’) concerned. The term is meant to identify those, other than professional advisers, with real influence over the corporate affairs and the concept seems to be to hold responsible (as ‘related parties’) those persons who truly control the company and are able to direct the affairs of the company, by appointing as directors, their own delegates or persons subservient to them.

It is possible for a holding company (through the actions of its directors) to be a shadow director of its subsidiary companies. Where a holding company deputes its employee to be on the board of its subsidiary company, it is more likely than not that such employee would be accustomed to act in accordance with the advice, directions or instructions of the directors of the holding company.

It is common for an investor in a company to have a nominee on the board without being branded as a shadow director. To show that a person is a shadow director, it must be proved that the director followed a consistent pattern of compliance with the instructions of the ‘alleged’ shadow. Evidence that the directors followed a direction from an outside influence in an isolated incident would not normally suffice.

It is also pertinent to note that while ‘person’ has not been defined in the 2013 Act, the 1956 Act had made it clear that the person in accordance with whose directions or instructions, directors are accustomed to act need not necessarily be an individual. The person may be a body corporate. Generally holding companies may come under this term in relation to the directors of their subsidiary companies.

Since every case is unique, the position of ‘accustomed to act’ will have to be decided on the facts of each case. There are numerous judicial pronouncements in this regard.

In this era of heightened governance, the proof of burden could well shift on the director to demonstrate that he is not accustomed to act in accordance with the advice, directions or instructions of an individual/body corporate, be it the holding company or any of its directors or otherwise. In our view, in this case, a deliberate and cautious approach to identify all related parties will only enhance corporate governance.

Arm’s length

Neither the 2013 Act nor the Rules provide a methodology to determine what constitutes arm’s length pricing. Under the 2013 Act, 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.

Determining whether a transaction is at arm’s length is a matter of significant judgement. This is because companies may be structured to provide specific goods or services that are not available to independent third parties. Similarly, control over/significant influence exercised by an entity could have pricing and non-pricing connotations. However, to determine arm’s length pricing, audit committees/boards and management could resort to various documented processes which include:

1. Competitive bidding including e-auction of equivalent products/service.
2. Determination of fairness of pricing formulae having regard to the conditions of the contract.
3. Expert valuations.

The use of methodologies prescribed under the Transfer Pricing ('TP') regulations may be construed as the starting point for providing guidance required for (2) above in respect of those transactions that may be covered under either domestic or international TP regulations. It must, however, be noted that the methods prescribed under each regulation is primarily to address the need of such regulation. The fairness of the method and the appropriateness of the choice should be independently documented by management and concurred upon by the audit committee/board and should not be related back to any particular legislation as increased regulatory challenge may causes entities to 'accept' positions adopted by the regulatory authorities that are at variance with those adopted by the entities at a later date. Caution must be exercised by entities to ensure that their determination of arm's length is not jeopardised by such regulatory challenges.

Ordinary course of business

Ordinary course has not been defined in the 2013 Act or the Rules.

What is ordinary for one business may not necessarily be ordinary for another. Related party transactions which are scoped in by a company for disclosure under 'Revenue from Operations' or corresponding costs will generally be in the 'ordinary course of business', if the terms and conditions for such contracts/arrangements/transactions are similar to those with 'other than related parties'. Transactions which are disclosed as part of 'other income' or 'other expenses', 'exceptional or extraordinary items' would require assessment on a case to case basis. Substantiation of one-off transactions as 'in the ordinary course of business' may require use of judgement.

Determination of whether a transaction is in the ordinary course of business or at arm's length is very critical, since this judgement would trigger the 'approval matrix', referred to elsewhere in this Issue. Support may be considered by reference to Standard on Auditing ('SA') 550, Related Parties which provides some examples of transactions that may be considered to be outside the entity's normal course of business which include:

- 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 following questions may help determine that the audit committee has an efficient process for fulfilling its responsibility for approving related party transactions.

- What process will the committee follow in reviewing and approving related party transactions? Is this process documented? Will qualitative and quantitative thresholds be set for approval?
- Will special meetings be called as potential transactions arise?
- What information does the committee need to make an informed judgment about the appropriateness of a transaction?
- Who will be responsible for presenting this information?

For each transaction brought for approval, the audit committee may consider asking:

- What are the business reasons for the transaction? Are these reasons in line with the company's overall strategy and objectives?
- How will investors view the transaction when it is disclosed?
- Which insiders will benefit from the transaction and in what way?
- What impact will the transaction have on the financial statements?
- Are any outside advisers needed to help understand the implications of the transaction?

In order to faithfully comply with the provisions of the 2013 Act, the following are expected to occur:

- Increase in time spent for identifying related parties consequent to the enhancement of definition of related parties.
- Increase in time spent for determining if a transaction is at arm's length or in ordinary course of business.
- Audit committee members increasingly desirous of escalating transactions for approval to the board/shareholders where adequate justification is not provided by management. This will result in more engagement by management and audit committees.
- Surge in seeking external assistance, thereby increasing the cost of a transaction.

Rule of the majority of the minority

Section 188 read with the Rules thereon mandates that in cases where prior approval is required from the board or shareholders, the related parties cannot vote. In respect of resolutions that need the approval of shareholder/members (general body), on a plain reading of the 2013 Act, it appears that any member (shareholder) falling under the ambit of 'related party' is prohibited from voting on any contract or arrangement or transaction simply because the member is a 'related party' whether or not the member has any interest, other than as a member, in the contract or arrangement or transaction. Therefore a member-associate company or the member-sister of the company's independent director (a defined 'relative') would not be able to vote on a contract for the payment of royalty to the entity's immediate parent, as they would be a 'related party' though their interest in the proposed special resolution is no different from other members.

To alleviate this, the MCA has clarified that a related party who shall not vote on such a resolution should be construed with reference to only the contract or arrangement for which the special resolution is being passed.

This MCA clarification is not abundantly clear as to whether only the 'related parties' to the contract or arrangement cannot vote or there are more related parties who should not be allowed to vote.

In our view, the clarification steps in to prevent holding back rights of shareholders to participate in the governance process, unless their 'immediate and direct' interests are sought to be voted on. In other words, members who have 'immediate and direct interests' in contracts or arrangements or transactions with the company, should not be allowed to vote. Therefore, in respect of a transaction for the payment of royalty to its immediate parent, the holding company should not be (and therefore is not) permitted to vote as its interest is 'immediate and direct'.

Further, it is appropriate that other members whose interest could be fairly construed as 'immediate and direct' should also not participate in the special resolution and therefore vote – this could include member-ultimate/other holding companies and member-fellow subsidiaries (subsidiaries of the holding company).

On the other hand, member related parties whose interest is not 'immediate and direct' to either of the parties to the contract should be fairly able to exercise their rights solely as shareholders. These may include member-directors, member-KMPs, member-relatives, etc. in respect of a proposed contract between the company and its holding company, unless the said director, KMP or relative is construed as a related party with reference to the contract or arrangement for which the special resolution is being passed.

The following steps would assist companies in identifying related parties who are permitted to vote on a contract or arrangement or transaction:

1. Identify all 'related parties' to a company. Identify which of them are members of the company. Those related parties that are members would be the population of 'related parties' who should be considered.
2. Identify all 'related parties' to the contract or arrangement or transaction.
3. Determine whether such shareholder (member) related parties (identified in 1 above) are those that have immediate and direct interests in the contract or arrangement or transaction. These would be those shareholder related parties (individuals or entities) who are controlled by or under the control of either party or parties to the contract or arrangement or transaction referred to in 2 above.
4. All shareholder (member) related parties identified in 2 and 3 above will not vote on the contract or arrangement or transaction. All other members can vote.
5. This exercise will be done separately for each resolution that is put to vote.

Accordingly, when a related party contract or arrangement or transaction needs approval of the shareholders, the approval is essentially sought from the 'majority of the minority' by special resolution (i.e., where 75 percent of the valid votes cast are in favour of the resolution).

In the case of a wholly owned subsidiary, a special resolution of the members of the holding company is deemed sufficient for the purpose of entering into a transaction between the wholly owned subsidiary and holding company. The relaxation applies for transactions to be entered into between the wholly owned subsidiary and the holding company and, consequently, it appears that resolution by the members of the immediate holding company alone would be sufficient.

However, the MCA needs to clarify how shareholder approval in the case of contracts or arrangements between two wholly owned fellow subsidiaries, joint venture companies and other similarly organised entities are to be obtained.

Conclusion

The governance plank of the 2013 Act has been given a significant fillip with the introduction of the concept of ‘related parties’. The board as a whole and independent directors in particular, have a significant responsibility to enable appropriate participation across all stakeholder groups in so far as contracts or arrangements or transactions with related parties are concerned. The 2013 Act being largely driven by an ‘entity only’ concept, albeit separately including considerations for consolidated groups in specific areas, requires significant added (probably avoidable) effort by corporates. It may, therefore, have been more practicable if all related party transactions and the required robust approval mechanisms, had been limited to the ultimate parent in India and to all listed entities or those with significant public interest, such as financial institutions and banks; and in all such cases, for transactions inter-se (no significant implications to the stakeholders of the parent) that get eliminated on consolidation being allowed to operate under a ‘communicate and disclose’ policy at the level of the individual boards. Additional safeguards could be provided for transactions by entities in the group (such as subsidiaries) which conduct transactions with related parties outside the group and where there could be perceived dilution in shareholder value.