Presentation on Sections 185, 186 & 188 of the Companies Act, 2013

-Vinod Kothari

Corporate Law Group
18.04.2014
Vinod Kothari & Company
Practising Company Secretaries

1012 Krishna
224 AJC Bose Road
Kolkata – 700017
Phone 033-22811276/ 22813742/
22817715
E-mail – corplaw@vinodkothari.com

601-C, Neelkanth,
98 Marine Drive,
Mumbai 400002
Phone 022-22817427
E-mail: bombay@vinodkothari.com

www.vinodkothari.com
Email: vinod@vinodkothari.com
About Us

- Vinod Kothari & Company, Company Secretaries in Practice
  - Based out of Kolkata, Mumbai
- We are a team of consultants, advisors & qualified professionals having recently completed 25 years of practice.

Our Organization’s Credo:

Focus on capabilities; opportunities follow
Quick Overview of the Act, 2013

There are lots of materials and articles on the Companies Act, 2013 here:

http://india-financing.com/component/content/article/article/281.html
Introduction

- Structure of Act, 2013
  - 470 Sections and 7 Schedules, divided into 29 Chapters

- Number of Sections enforced – 282 (98 w.e.f. September 12, 2013 and 184 w.e.f. April 1, 2014)

- It would be misleading to believe that the Act is simpler or shorter.
  - Huge amount of law has been moved to Rules
  - Several sections have been consolidated to single schedule.

- In fact, there are lot of new provisions, new restrictions , and approvals to be sought
  - 74 occurrences of Special Resolution
  - 15 occurrences of the approval of Central Government.
## Several new concepts

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<td>Mandatory corporate social responsibility</td>
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<td>Mandatory retirement of independent directors</td>
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Several new definitions

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Expected Coverage of this presentation

- Loans to Directors & related entities
- Loans and investments by companies
- Basics of S. 188 including some case studies
- Restriction on layers of subsidiaries
- Interplay between Sec. 164 and Sec. 188
- Matrix of related parties as per section 188
- Abusive RPTs as per SEBI’s consultative paper on Review of Corporate Governance Norms in India
Section 185

Loans to Directors and related entities
Loans to directors etc. [Sec. 185] – 1/2

A company *shall not* give loan (including book debt), provide security, guarantee to any director or *other person in whom he is interested*.

**Directly or indirectly**

**Exemption to:**
- Loan to MD/WTD as part conditions of service to all employees and pursuant to a scheme approved by an SR.
- In the ordinary course of business where interest charged not less than RBI Bank rate i.e. by a loan/banking company.

“*any other person in whom the director is interested*” has been defined *(next slide)*

**Fine for contravention**

Company -- Rs. 5 lakh to Rs. 25 lakhs, and

the director or the other person to whom any loan is advanced or guarantee or security is given or provided shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than Rs. 5 lakhs but which may extend to Rs. 25 lakhs, or with both.
Loans to directors (Sec. 185) - 2/2

• ‘Any other person in whom director is interested’ shall mean:
  ▫ any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
  ▫ any firm in which any such director or relative is a partner;
  ▫ any private company of which any such director is a director or member;
  ▫ any body corporate at a general meeting of which not less than twenty five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or
  ▫ any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.
Restricts giving of loans, guarantee and security provided in connection with the loan

Also includes book debt (sec. 296 of Act, 1956 has been subsumed into sec. 185 of Act, 2013)

Section enforced w.e.f 12.09.2013

A few exemptions as granted under S. 295 of Act, 1956 have been retained
Sec. 185 - compared with Sec. 295 of the 1956-Act

The contents of s. 185 are similar to section 295

Disparity between the two sections is that section 185 does not exempt private companies. It however, exempts loans provided in ordinary course of business, loans to MD or WTD as a part of condition of service.

Further, the notified Rules brings out following segregation to exemptions allowed to subsidiaries -

* Loans/Guarantee/Security provided to wholly owned subsidiaries has been exempted
* Guarantee/Security for loans availed from bank or FI by any other subsidiary also exempted

(Provided such loans should be utilized in the principal business activities of the subsidiary)

S. 186 only lays down the amount of loan/guarantee that can be provided. It is not a conflict of interest provision. So, s. 185 and 186 can be applicable to a particular case even if s. 185 starts with “save as otherwise provided in this Act”
• As regards Guarantees/ securities
  ▫ If given in respect of Wholly Owned Subsidiary (WOS)
    • Fully exempted
  ▫ If given in respect of loans availed by other subsidiary, from Banks/FIs
    • Also exempted
  ▫ If given to persons other than Banks/FIs
    • Not exempted
As regards Loans

- If given in respect of WOS
  - Fully exempted

- If given to others - which includes partly owned subsidiaries too
  - Not exempted
Is “deposit” covered by Sec. 185?

- By way of Press Note, dated 4-6-1985: (1986) 59 Com Cases (St) 8, the MCA stated that:
  - The Law Ministry has advised that deposits kept by one company with another company is ‘loan’ as envisaged under section 295/370
    - Keeping with this loans under Sec. 295 of Act, 1956 will also include ‘deposits’
  - Loans and deposits are of course not same
    - There are various case laws to prove this.
    - S. 185 does not employ the same language as S. 370 of Act, 1956 wherein loans were taken to include deposits
    - Unless expressly specified by way of clarification or similar, S. 185 may not include a deposit
What is meant by “ordinary course of business” in proviso to S. 185(1)

- The phrase does not mean ‘principal business’, ‘main objects’
- Also, does not mean what is ‘extra-ordinary’ in the ordinary course of business. What is extra-ordinary is classified under the head “extra-ordinary” items in the balance sheet.
- Any business which is carried on with regularity and frequency can be taken to be ‘ordinary course of business’
- If say any manufacturing company has a separate treasury department dedicated to giving loans to directors, if such loans are forwarded only for financial accommodation of directors and not as a separate line of business, then not covered.

Are deposits covered?

- The section does not make any separate distinction as such.
- Going by the case laws in this case, loans are different than deposits
  - The line of difference is thin and circumstantial
- Thus, deposits are not covered by the section
Sec. 185 - a few thinkers -2/4

Are advances covered?

- Advances are money advances against some due which is to be become due at a later period.
  - It is a pre-payment against goods or services
  - So, advances are not covered.

Does the section apply to book debts?

- Section is applicable only if loan or ‘loan in substance’ is advance.
  - This intent was also discussed in point 12.65 of the Standing Committee’s on Finance’s report on Companies Bill, 2009
  - S. 296 of Act, 1956 made reference to book debts
  - If a book debt is prolonged beyond the usual credit period, so as to allow more time to a debtor, such a debt may also amount to a loan.
Sec. 185 - a few thinkers -3/4

If A is WOS of B, will S. 185 be applicable?

The relevant Rules stating exemptions were notified from 01.04.2014; how will the transactions entered during 12.09.13 to 01.04.14 be dealt with??

In case of holding-subsidiary relationship, can “accustomed to act” be assumed?

No. This being not defined is purely circumstantial and onus is on the person alleging the same to prove.

If it can be proved that instructions were given consistently and the board of the subsidiary applied such instructions without analyzing the rationale, then ‘accustomed to act’ can be established.
If loan is extended to private company in which relative of a director is director, will S. 185 be applicable?

• No. Section will be attracted if director is a director or a member in the private company.

If the director exercises more than 25% of total voting power in LLP and loan is extended to it, will S. 185 be applicable?

• Yes, by virtue of explanation (d) to S. 185(1).
• Since, the explanation envisages ‘body corporate’, company incorporated outside India will also be covered.

Is the section applicable to WOS?

• Before the final rules were issued, one would say yes at the first blush looking at explanations (d) and (e).
• Rules anyhow have put such speculations to rest.
The good news about Sec. 185 -1/2

- Section has been enforced w.e.f. 12.09.2013
- Unlike certain sections like appointment of director, disqualification of directors, which have a retroactive effect
  - This section does not go back in the past
  - Resultantly, s. 6(b) of General Clauses Act, 1897 shall prevail
  - Existing loans can be continued on terms agreed upon initially

- Further, as per Rules notified w.e.f. 01.04.2014
  - Loans/Guarantees/Security to wholly owned subsidiaries has been exempted
  - Guarantees/security for loan availed from bank or FI by any other subsidiary also exempted
    - Such loans should be utilized in the principal business activities of the subsidiary
What about guarantees issued after 12.09.2013 but before 01.04.2014?

- When was the sanction letter issued?
- If before 12.09.2013, then execution of guarantee agreement was in relation to this sanction letter and thus, this loan was not covered under S. 185.
- The guarantee shall prevail

Does the section also cover personal guarantees by directors?

- The section only covers guarantees extended by companies in relation to loans given by its director or related entities
- Personal guarantees are thus not covered
Violation of Sec. 185

- Company
  - Shall be punishable with:
    - Fine – not less than Rs. 5.00 lakhs and extending to Rs. 25.00 lakhs

- Director or other person
  - Punishable with:
    - Imprisonment – extending to 6 months
    - Fine – not less than Rs. 5.00 lakhs and extending to Rs. 25.00 lakhs OR
    - With both

- Under S. 295 of Act, 1956
  - Every person who was knowingly a part and person to whom loan is provided punishable with fine extending to Rs. 50,000 rupees or with simple
    - imprisonment extending to 6 months

- In S. 295 of Act, 1956, punishment by way of imprisonment was waived off if loan was repaid in full and if it was repaid in part, then maximum imprisonment, would be proportionately reduced.
- S. 185 of Act, 2013 does not contain similar provision
Section 186

Loan and Investment by company
Loan and Investment by company

[Sec 186]

• Investments through not more than 2 layers of investment companies
• Not give loans or provide guarantees and securities or make subscription to shares exceeding:
  • 60% of paid up capital + free reserves + securities premium or 100% of free reserves + securities premium
• Unless prior approval by way of SR is passed

Exemption to

• Banking, insurance, HFCs, companies engaged in financing of companies
• NBFCs
• Investment companies exempted from limits on acquisition of shares
• Wholly owned Subsidiaries and JV Cos. by way of rules
• No exemption to Private Cos.

• Loan to be at rate of interest not lower than the prevailing yield of one year, three year, five year or ten year G-secs closest to the tenor of the loan
• Full disclosure to be made in financial statements
• Section effective from 1st April, 2014
• Corresponding to section 372A of Act 1956

Investments

Other key points
Layers of subsidiaries

S. 186(1) + S. 2(87) → Restriction on no. of subsidiaries
Rationale behind prescribing subsidiaries

**JJ Irani Committee**

Was strictly against any such restriction stating that it would make the environment rigid

**Standing Committee of Finance on Companies Bill, 2009**

Committee and the MCA agreed to stop at the first line of subsidiary to restrict diversion of fund

**Standing Committee of Finance on Companies Bill, 2011**

Committee suggested that limit of 2 layers of subsidiaries is restrictive and should be revised to provide the required flexibility in view of the commercial realities. Ministry however felt the restriction would enable formation of SPVs.
Discussion on Layers u/s 2(87)-1/2

- What is meant by layer?
  - Section 2(87) refers it to mean subsidiary or subsidiaries of the holding company
  - S. 186(2) restricts investment through not more than 2 layers of investment companies
  - The intent of both the sections is to limit the number of subsidiaries a company can have

- Does the section prescribes any limit on the number of layers?
  - This is to come by way of rules. The set of final rules presently issued are silent on this.
    - Since, the word layer also means subsidiaries and not just a subsidiary, the limit shall surely be more than 2.
    - Observing the limit is being put at 2, this shall serve as a double whammy for all Indian corporates – may require major restructurings.
Discussion on Layers u/s 2(87) -2/2

- What if number of layers is not defined?
  - No restriction on the number of subsidiaries that a company can have
- Does the layer have to consist of companies only?
  - No it includes body corporate also
- Is section 2(87) applicable to all companies?
  - Presently yes.
  - Proviso states: limit shall be on a certain class of holding companies.
- What about existing companies? Will they have to reduce the number of subsidiaries once the limit is notified?
  - The section is not retroactive and hence the present structure can be continued.
- What if any company has more than the prescribed number of subsidiaries after the limit is prescribed u/s 2(87)?
  - This will be taken as violation. Since it is the holding company which shall be forming subsidiaries, the violation shall also be taken to be by the holding company.
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<th>Criteria</th>
<th>2(87)</th>
<th>186(1)</th>
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<tr>
<td>Applicability</td>
<td>Presently on all companies</td>
<td>Presently on all companies</td>
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<td>Restriction on</td>
<td>Holding company having layers of subsidiaries as may be prescribed.</td>
<td>Investing through more than 2 layers of investment subsidiaries</td>
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<tr>
<td>Entity at the end of the loop of the</td>
<td>Can be a body corporate</td>
<td>Has to be a company</td>
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<td>layer</td>
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<td>Investment through</td>
<td>Can be through body corporates</td>
<td>Has to be necessarily through investment companies</td>
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<td>Criteria establishing</td>
<td>Subsidiary can be either by way of control of composition of board of</td>
<td>Holding company has to invest through investment subsidiaries. Investment can</td>
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<td>relationship</td>
<td>directors or by way of investment in total share capital of company</td>
<td>be in any security.</td>
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What is meant by “investment” under Sec. 186(1)?

Counted as investment:
- Subscription or purchase of share
- Subscription or purchase of share warrants
- Subscription or purchase of debenture bonds or similar debt securities

Not counted as investment:
- Making of loans
- Making of advances
- Any other financial transactions like leases, purchase of receivables or other credit facilities
Case Studies - 1/9

- When is an investment said to be made through layers?
- Illustration A

If A makes an investment in B, B with that money, goes and makes investment in C, and C with that money makes investment in D, one would say, A has invested in D, through B and C. B and C merely acted as layers, as the flow of investment was clear.
On the contrary, if A makes investment in B, and A makes investment in C as well, and B and C make an investment in D, then obviously there will be one layer only.

Thus, the restriction is not on horizontal propagation.
Case Studies -3/9

If C is holding an investment in D. Now, A makes an investment in B, and makes an investment in C, can the section be said to be applicable?

• Answer should be yes, if C is merely an investment company. That is the purpose of A making an investment in B and B investing in C is actually not to buy C, but to buy D since C is merely an investment company. An investment company is merely shareholding device. A could not have intended to make an investment in C as the actual target investment is D.

• In the instant case, A might well have made investment in C directly instead of using B as a conduit.

Can A make an investment in B, which in turn has already made investment in C and D?

• Section 186(1) seems to put a complete bar on such a structure. With the intent of the section being to limit vertical propagation, such a structure will attract the charging sub-section of section 186. A will thus have to make choice between letting go off the investment in D or not acquire B altogether.
Case Studies -4/9

D is an operating company, held by C, and C is an investment company held by B. A now wants to buy D. Can it be said that A is making investment in D through B and C?

- The answer in this case must be surely negative. There is no question of channelizing A’s investment into D, as B has already invested into D. There is no bar on buying a grandfather company. The bar is on routing of investment through more than 2 layers. In the instant case, A could not have had the choice of making direct investment into D as the shares of D are held two layers up by B.

If A, a company incorporated in India, invests in B, C and D, will the section still be applicable? B, C and D are companies incorporated outside India, then?

- The section is only applicable to investments done through more than 2 investment companies.
- ‘Company’ would of course denote company incorporated in India. Company which has been incorporated outside India will thus not be covered by the scope of this section and thus, any investment made by A will not be covered by section 186.
Case Studies -5/9

Does the target entity into which investment flows have to be a company?

No. This is because section 186(2)(c) talks about investment in a body corporate

Does the intermediary company through which investment is made have to be a company?

Yes – as the section applies only in case of investments made through investment companies.

Assume A Ltd makes an investment in B Ltd. B Ltd makes an investment in C LLP. C LLP now holds shares in D Ltd. Is this a violation of sec 186 (1)?

No because there are not two layers of investment companies in the process.
Case Studies - 6/9

Are there any exceptions to section 186(1)?

- Yes. The proviso exempts the applicability of this section to
- Acquiring of any company incorporated outside India if that company has investment subsidiaries beyond two layers as per the laws of that country.
- Subsidiary company from having an investment subsidiary to fulfill any regulatory requirement.

Assuming there is an investment made through more than 2 layers. Who has violated the section? The investing company or the target company?

- The restraint is clearly on the making of the investment. Hence, it is maker of the investment who violates the section. There is no implication on the recipient company.
Is it at all necessary or advisable for the investee company to seek any declaration from the investor company whether the investment made by the investor is coming from more than two layers up?

• Although, it is the investor company which shall be held liable in case of any violation of the section, yet since in light of the Government clarification the investment shall also be void in case of violation, the investee company may seek a declaration from the investor company whether the investment made by the investor is coming from more than two layers up.
Case Studies - 8/9

What is the implication of the violation?

- The fine leviable has been increased to Rs. 25000.00 upto Rs. 5.00 lakhs for contravention by the company and in case of an officer, the default shall be punishable with imprisonment for a term which may extend to 2 years and fine which may be between Rs. 25000.00 and Rs. 1.00 lakhs.

In case of violation, will the investment be void?

- Section 374 of the Companies Act, 1956 prescribed penalty for contravention of sections 372 and 373. Further, by way of a Government clarification, it was stated that where any investment is in violation of public interest, simply payment of fine shall not suffice. The investment shall also be taken as void.

- Although, Act, 2013 does not have a corresponding section as section 374, yet the principle laid down by the Government clarification can be taken to apply to violation of section 186(1) too and consequently, any investment in violation of the same shall be void.
• Suppose A has invested in B and C. C now makes investment in D. Will A be charged for violation of section 186?
  - It is the holding company which will be held as having violated the section. The section is applicable to such a scenario where in A makes investment through more than 2 layers of subsidiaries. The idea is to trace the investments made by A and thereby keep the structure easy. Thus, when C makes an investment in D, the section will be attracted.
  - This can serve as an impediment for the other loops in the layers from making further investments out of their own funds. The applicability of this section under such circumstances can be mitigated if it can be proved that the investment in D was out of the own funds of C and not out of the investment made by
Section 188

Related Party Transactions
Highlights of RPTs

Scope has been widened to include the following:

- KMP or their relatives
- Private Company in which the manager is member or director
- Firm in which manager or his relative is a partner

Cash at prevailing market price has now been substituted with ‘arm’s length transaction’ which has been defined in the section

The 2013 Act has widened the ambit of transactions by covering leasing of property of any kind, appointment of any agent for purchase and sale of goods, material, services or property.

Transactions entered into with related parties now to be included in the board’s report along with justification for entering into such contracts and arrangements.

Only non-interested shareholders can vote in GM on any RPT. This was also proposed in “consultative paper on review of corporate governance norms in India” issued by SEBI
Definition of Related Party - Enforced - 1/2

- **Related Party** - with reference to a company, means:

  - Director or his relative
  - KMP or his relative
  - Firm, in which a director, manager or his relative is a partner
  - Private company in which a director or manager is a member or director;
  - 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 **

**clause revised by way of Companies 1st (Removal of Difficulties) Order, 2014**
Definition of Related Party - Enforced - 2/2

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;

any person on whose advice, directions or instructions a director or manager is accustomed to act:

any company which is—
(A) a holding, subsidiary or an associate company of such company; or
(B) a subsidiary of a holding company to which it is also a subsidiary;

Such other person as may be prescribed— Rule 3 of the Companies (Specification of definitions details) Rules, 2014 prescribe that a 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.

- Compared with draft Rules, Director or KMP of associate and JV companies have been excluded.
- Also, any person appointed in senior management in the company or its holding, subsidiary or associate company has also been excluded.
Definition becomes very wide indeed.
- Definition similar to accounting standard
  - Includes family members of HUF

Related party transactions under the law are subject to serious restraint.

Most transactions that a company may have with “related parties” require approval of Board.

However, in the general meeting the member or his related party shall not vote.

CG approval dispensed with.

All transactions with related parties though not covered by section 188, shall require approval of Audit Committee.
Section 2(76) defines “related party”

- By way of Companies 1st (Removal of Difficulties) Order, 2014, the lacuna in drafting of section 2(76)(v) has been rectified to now read as:
  - public company in which a director or manager is a director AND holds along with his relatives, more than two per cent. of its paid-up share capital
- The apprehension about companies having common IDs being classified as a related party has been mitigated

Rule 3 of the Companies (Specification of definitions details) Rules, 2014 also defines ‘related party’

- Harmonizing sec. 2(76) with the Rules -
  - Director, KMP or relatives of holding company shall be deemed as related party
Related Parties and Related Party Transactions (Sec 188) - 3/4

- As per Rule 15 of Companies (Meetings of Board and its Powers) Rules, 2014, company shall not enter into a contract or arrangement with related party for the following **without prior approval of company by SR**:

  - a company having a paid-up share capital of Rs. 10 crores or more shall not enter into a contract or arrangement with any related party; or
  - a company shall not enter into a transaction or transactions, where the transaction or transactions to be entered into – as contracts or arrangements with respect to clauses (a) to (e) of sub-section (1) of section 188 with criteria, as mentioned below –

    - sale, purchase or supply of any goods or materials directly or through appointment of agents > 25% of the annual turnover
    - selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents > 10% of net worth
Related Parties and Related Party Transactions (Sec 188) - 4/4

- leasing of property of any kind > 10% of the net worth or 10% of the turnover
- availing or rendering of any services directly or through appointment of agents > 10% of the net worth
- appointment to any place of profit in the company, its subsidiary or associate company at a monthly remuneration > Rs. 2.5 lakhs
- remuneration for underwriting the subscription of any securities or derivatives thereof of the company > 1% of the net worth

The turnover or net worth referred in the above sub rules shall be on the basis of the Audited Financial Statement of the preceding financial year

Note: any transaction entered into ordinary course of business or transactions on ‘arm’s length basis’ shall not require any approval through SR.

['arm’s length’ transaction would mean a transaction between two related parties that is conducted without any conflict of interest]
## Comparison of definition of Related Party between Act, 2013 & AS 18 -1/2

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<th>Particulars</th>
<th>Whether related party under Act, 2013</th>
<th>Whether related party under AS-18</th>
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<tbody>
<tr>
<td>Director or relative</td>
<td>Yes</td>
<td>If only common then no. If the director can affect policies, then yes.</td>
</tr>
<tr>
<td>KMP or relative</td>
<td>Yes. KMP defined to include persons with authority and responsibility for planning, controlling activities</td>
<td>Yes. KMP defined to mean MD/CEO/MANAGER, WTD, CS, CFO.</td>
</tr>
<tr>
<td>Firm in which director, manager or his relative is a partner</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Private company in which director or manager is member or director</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Public company with common director or director and relatives hold 2%</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
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## Comparison of definition of Related Party between Act, 2013 & AS 18 - 2/2

<table>
<thead>
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<th>Particulars</th>
<th>Whether related party under Act, 2013</th>
<th>Whether related party under AS-18</th>
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</thead>
<tbody>
<tr>
<td>BoD accustomed to act in accordance with directions of director or manager</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Holding company, subsidiary or associate</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Fellow subsidiary</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Joint venture</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>A person on whose advice a director or manager accustomed to act</td>
<td>Yes</td>
<td>Yes. In case of individual, there must be an interest in the voting power that gives them control or significant influence. Relatives of such individuals shall also be related party.</td>
</tr>
</tbody>
</table>
Transactions covered under Sec 188

Sale, purchase or supply of any goods or materials;
The Act, 1956 included services in the above. However, now its has been included separately covering supply as well as availing of services

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

Underwriting the subscription of any securities or derivatives thereof, of the company

Such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company
Sequence of approvals required u/s 188

- **Contract in Ordinary Course of business and on arm’s length basis**
  - Only Audit Committee approval
    - Need not be prior approval

- **Contracts in Ordinary Course of business not on Arm’s Length basis**
  - If falling within exemption limits → Board + Audit Committee approval needed
    - Need not be prior approval
  - If NOT falling within exemption limits → Board + Audit Committee approval + Prior approval by shareholder needed
    - If approval of Board or prior approval of S/H not obtained
      - Needs to be ratified within 3 months from date.
**NA – Not Applicable**

**Specified transaction under 1st proviso to Section 188(1) read with Rule 15**
(a) as contracts or arrangements w.r.t. sec.188 (1) with criterias (i) to (iv) (refer rule)
(b) relates to appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding 2.5 lakh rupees
(c) is for a remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of net worth
Related Party - Illustrations -1/2

KMP in A + KMP in B = A & B are Related Party (only if KMP of A is a MD/WTD of B or vice versa)

- If KMP is MD/WTD/Manager in A:
  - If KMP in A & Director in B: A & B are related Party
  - If KMP is CEO (who is not a director)? CS/CFO
    - A & B are not related party
Related Party - Illustrations - 2/2

SMP in A + SMP in B = A & B are not Related Party

SMP in A + Director in B = A & B are not Related Party
Some case studies  -1/6

If A is related to B, does it mean that B is related to A?

No. If A is related to B, this does not essentially mean that B is also related to A. One has to refer to the definition of ‘related party’ under the Act, 2013 to establish the relationship of related party.

For instance, Company A is accustomed to act according to the directions of Company B, however, Company B is not accustomed to act according to the directions of Company A. In this case, though B is a related party to A, A is not a related party to B.
Some case studies -2/6

Whether a common director of two private companies are related parties?

• Yes. Section 2 (76) (iv) of the Act, 2013 provides that if a director or manager of any company (private or public) is a director or member in private company, then the private company would be a related party to the other company.

Whether merely a common director of two public companies, would be considered as related parties?

• Essentially, no. section 2(76)(v) presently requires if the director of any company (private or public) is also a director of a public company and holds, along with his relatives, more than 2% of its paid-up share capital, then the public company would be a related party.

• So, the apprehension of having merely common IDs and being classified as a related party, has now been mitigated
A director in company A does not hold any shares in public company B but his relatives hold more than 2% paid up share capital in B. Will A & B still be related?

• Here, though the director is not holding any shares in B, however, he along with his relatives is still holding more than 2% of the paid up share capital in B. Here the expression ‘along with’ will have to be seen in an expansive sense and not in a restrictive sense. It will not serve the purpose of the definition if a director could get away with the impact of the section merely by parking his interest in B in the name of his relatives.

• Therefore, A and B will be related parties under the Act, 2013.
A is a member of company B, and is also a related party to B. In this scenario, can A vote on the special resolution to be passed by B for entering into a RPT?

The answer would be No. The second *proviso to Section 188 (1) of the Act, 2013* provides that no member, who is also a related party, can vote on a special resolution, to approve any contract or arrangement which may be entered into by the company.

What will be the position in case of a wholly owned subsidiary company, where the holding company is the only member of the subsidiary and is also a related party?

The Act, 2013 does not provide any clarity to this aspect. However, the Rules to the Act, 2013 provides that in case of wholly owned subsidiaries, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the RPT between a wholly owned subsidiary and holding company, *i.e. the wholly owned subsidiary will not need to separately pass a special resolution*.
A is a related party to B but is not interested in the special resolution for RPT. Can A vote on the special resolution to be passed for entering in a RPT?

No. The section clearly implies that even if A is *not interested in the related party* contract or arrangement, merely by virtue of his being a ‘related party’ to Y, he is prohibited from voting on such resolution. Neither do the Rules state anything to the contrary.

Will RPTs which are on an arms’ length basis but does not take place in the ordinary course of business be covered by the provisions of Section 188 (1) of the Act, 2013?

Yes. A RPT to be exempted from the provisions of Section 188 (1) of the Act, 2013 must necessarily be in the ordinary course of business. It is prerequisite for availing the exemption.

Accordingly, RPTs on an arms’ length basis but not in the ordinary course of business will be covered by the provisions of Section 188 (1) of the Act, 2013.
Can we presume that the disinterested minority shareholders will now dictate the results of the special resolution which may negatively impact a Company and create a situation of deadlock?

The language of the Section 188 seems to imply as much.

Imagine a scenario where 60% of the majority shareholding in A is held by those prohibited from voting in the general meeting, which mean that only the remaining 40% disinterested shareholders would vote. Since, approvals under Section 188 are to be taken by special resolution, 30% approval of disinterested shareholders would be required. In this way, any shareholder holding 10% or more in A can impede any such RPT from being passed which can make functioning of companies difficult, resulting in a situation of 'hung companies'.
Will related party transactions entered into in the ‘ordinary course of business’ require to be passed by such special resolutions?

• The third proviso to Section 188 (1) of the Act, 2013 provides that the company will not require the approval of the Board and / or shareholders provided the transactions are entered into by the company with the related party:
  • in the ordinary course of business; and
  • such transactions are on an arms’ length basis
• Accordingly, any transaction which takes place in the ordinary course of business, but is not on an arms’ length basis will be covered under the provisions of Section 188 (1) of the Act, 2013.

Has any criteria been prescribed for determining which RPTs has been entered into on an arms’ length basis?

• No. The Act, 2013 does not prescribe any criteria for determining whether the RPT was entered into on an arms’ length basis. It would, therefore, be a subjective decision to be decided upon by the Board of Directors of every company.
Has any exemption been given to transactions between holding and subsidiary companies, considering that most of the transactions between them can never be on arms’ length basis?

- The very concept of a holding subsidiary relationship is that the subsidiaries mainly thrive on the transactions with their holding companies.
- However, no exemption has been given to holding subsidiary transactions which are not on an arms’ length transactions.
- This will make passing of resolutions between them difficult, especially when special resolution is required to be passed by the companies.
• Does it mean that RPTs which are in the ordinary course of business and on an arms’ length basis will not be required to be passed by the Board?

The Act, 2013 provides that nothing contained in Section 188 (1) shall apply to RPTs which are in the ordinary course of business and on an arms’ length basis. Accordingly, it can be derived that RPTs in the ordinary course of business and on an arms’ length basis will not require a board resolution.

However, all RPTs entered into by a company along with any modifications to the same will require prior approval of the Audit Committee of the company, if any.

Therefore, it seems that while all arms’ length transactions in ordinary course of business with related parties are not required to be approved by the Board or shareholders, they would still require approval of the Audit Committee, if any.
Section 188 - other provisions -4/5

- Are directors liable for any loss suffered by the company with respect to RPTs?

Any RPTs entered into by a director or any other employee, without prior approval of the Board or passing of special resolution by the shareholders, if required, the transaction needs to be ratified by the necessary resolution within 3 months of entering into such RTPs. If the same is not ratified within the said 3 months:

- The RPT shall become voidable at the instance of the Board; and
- If the RTP is with a related party to any director, or is authorized by any other director, the director(s) concerned shall indemnify the company against any loss incurred by it.

The company has power to initiate any proceeding against director or employee who has entered into such contract or arrangement.

Section 164 provides that a person who has been convicted of an offence relating to RPTs during the preceding 5 years, he shall be disqualified for appointment as a director of any other company.
Section 188 - other provisions - 5/5

- **Is it mandatory for a company to get its RPTs approved by an Audit Committee?**
  - All companies are not required to form an Audit Committee. Therefore companies not having Audit Committees are not required to get its RPTs approved by the Audit Committee.
  - However, where a company has an Audit Committee, approval of the RPT by the Audit Committee is necessary since the Committee is required to act in accordance with its terms of reference. Once approved by the Audit Committee, the same may be recommended to the Board for its approval.

- **Does lending/guarantee to/for subsidiary come under related party contract?**
  - A subsidiary is certainly a related party as per section 2(76). However section 188 does not cover either loans or guarantees.
  - But section 177(4)(iv) will certainly cover such contracts which requires Audit Committee approval.
## Procedure to be followed for entering into RPTs - 1/2

<table>
<thead>
<tr>
<th>Serial No</th>
<th>Particulars</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mandatory Provisions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>The RPT will first need to be approved by the Audit Committee, if any.</td>
<td>As per the Rules, only: (i) listed companies, (ii) Every public company having: • paid up capital of 10 crore or more; or • turnover of Rs. 100 crore or more • in aggregate outstanding loans and borrowings, debentures or deposits exceeding Rs. 50 crore or more. are mandatorily required to form an Audit Committee.</td>
</tr>
<tr>
<td>In case the company does not have any Audit Committee, this provision will not apply.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Once approved by the Audit Committee, if any, the Board of Directors of the Company will need to pass the resolution at a meeting of the Board</td>
<td>Such resolutions cannot be passed by a resolution by circulation.</td>
</tr>
</tbody>
</table>
Procedure to be followed for entering into RPTs -2/2

<table>
<thead>
<tr>
<th>For companies with paid up capital of Rs. 1 crore or more</th>
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<tbody>
<tr>
<td><strong>3</strong></td>
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<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>RPTs entered in ordinary course of business and on an arms’ length basis</th>
</tr>
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<tbody>
<tr>
<td><strong>4</strong></td>
</tr>
</tbody>
</table>
Contravention of Sec 188

- Punishment for violation of provisions of the section
  - Listed Company
    - Imprisonment extending to 1 year or
    - Fine Rs. 25,000 – Rs. 5 lakhs or with both
  - Any other company
    - Fine Rs. 25,000 – Rs. 5 lakhs
  - Penalty on any director or employee who enters into or authorizes the contract in contravention of provisions of the section
  - Punishment levied even if no loss has been incurred by Company from such RPT.
The relation between Sec. 188 and Sec. 164

Section 164(1)(g) of Act, 2013 which pertains to “disqualification of directors” reads as follows:

he has been convicted of the offence dealing with related party transactions under section 188 at any time during the last preceding five years

S. 188 on the other hand prescribes punishment for violation by way of imprisonment or fine

Section 441(6) of Act, 2013 allows compounding of offences punishable with imprisonment or with fine or with both

• Thus, a director can compound his violation u/s 188 and not end up getting convicted at all.
  ▫ So, the director may never attract the provisions of s. 164(1)(g) of Act, 2013
Measures suggested by SEBI to curb abusive RPTs - 1/2

<table>
<thead>
<tr>
<th>Approval of shareholders while disinvestment*</th>
<th>Immediate and continuous disclosures of material RPTs*</th>
<th>Prohibiting/regulating grant of affirmative rights to certain investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Act, 1956 did not require consent of shareholders for sale of shares of major subsidiaries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• This lacuna left uncorrected in Act, 2013</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Reporting to SEs done only annually and so information dissemination happens after occurrence of the event</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Suitable threshold limits to be prescribed for reporting requirements by material RPTs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Superior rights granted to PE investors may oppress minority</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• SEBI stated that it has to be examined whether listed company should be permitted to enter into such an agreement granting superior affirmative rights to selective investors</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* These are proposed to be included in the listing agreement
Measures suggested by SEBI to curb abusive RPTs - 2/2

<table>
<thead>
<tr>
<th>Approval of major RPTs by ‘Majority of the minority’*</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Similar to section 188 of Act, 2013</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pre-approval of RPTs by Audit Committee and encouraging them to refer major RPTs for third party valuation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Act, 2013 allows audit committee to approve the RPT and to also investigate the same and seek professional advice and have full access to information provided in the records of the company</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Approval of Managerial Remuneration by disinterested shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Proposal to consider mandating approval of disinterested/minority shareholders for managerial remuneration beyond a particular limit</td>
</tr>
</tbody>
</table>

* These are proposed to be included in the listing agreement
SEBI’s consultative paper on *Review of Corporate Governance Norms in India*

- The measure to seek consent of ‘majority of minority’ for RPTs was discussed in detail in this SEBI report as well as in JJ Irani Committee report
  - The common consensus was to allow a disclosure based regime and limit the power of abusive RPTs
    - This was suggested to re-instill the faith of investors in the company
    - However, the aftermath of such a drastic measure was not foresighted
      - Approval of “majority of minority” can lead to abusive non-related parties taking upper hand, resulting in potential “hung company”
Speak to Us

Vinod Kothari & Company
Kolkata Office: 1012 Krishna
224 A JC Bose Road
Kolkata – 700017
Ph: 91-33-22817715/ 1276/ 3742

Mumbai office: 601C, Neelkanth,
98, Marine Drive,
Mumbai-400002
Phone: 022-22817427

E-Mail to: vinod@vinodkothari.com;
nidhi@vinodkothari.com

Our Websites: www.vinodkothari.com;
www.india-financing.com