

CASE STUDY I - RELATED PARTY TRANSACTIONS¹

About the Company -

MB Pharma, a leading Indian pharmaceutical, is a listed public company ('Company'/'MB Pharma') incorporated under the provisions of the Companies Act, 1956, having its registered office in Mumbai, Maharashtra. The Company is engaged in the business of developing medicines to treat respiratory, cardiovascular disease, arthritis, diabetes, weight control and depression; other medical conditions.

With over 15 manufacturing units in 8 locations across India, the Company's growth and reputation have been based on its extensive research-based activities, including investment in R&D companies, in latest know-how, and its consistent business with its suppliers and customers. Over the years, growth in business has enabled the Company to establish itself in countries abroad - as on date, the Company has presence in over 10 countries, majorly in the South-East Asian region.

Ownership & Management -

Incorporated as a private company, the Company was promoted and managed by the Reddy Family. Gradually, as the business expanded, the Company introduced several industry experts as directors in its Board. Further, the shareholding was also shared with two new investors [Dalal Group and Bansal Group] who currently form part of the Promoter Group. Even after listing, the significant shareholding continues to be held by the promoter-directors. Below is the snapshot of the current shareholding pattern and directorship of the Company -

1. The shareholding pattern as on 30th June, 2021 is as follows-

Sl. No.	Name of the Shareholder	No. of shares @ Rs. 10 each	Percentage of shareholding
	Promoter & Promoter Group		
(i)	Mr. Y S Reddy	300,000	15
(ii)	Mr. Anand Dalal and Dalal group entities	500,000	25
(iii)	Mr. Anup Bansal and Bansal group entities	200,000	10

¹ All case studies are inspired by real life facts. However, we have tried our best to camouflage facts so that the case here does not represent any real life company. Names, including names of individuals, are completely imaginary. Any similarity, whether actual or contextual, is purely incidental. Should anyone have any objection to any of the names, situations or other facts used in the case study, please do contact us at corplaw@vinodkothari.com and we will take necessary action.

(iv)	Reddy Family Trust	500,000	20
	Public		
(v)	Public	500,000	30
(vi)	Non-Promoter Non-Public	-	-
Total		20,00,000	100

2. The list of Directors as per the latest quarterly disclosure, is as follows -

Sl. No.	Name of the Director	Designation
(i)	Mr. Mr. Y S Reddy (YSR)	MD & CEO
(ii)	Mr. Anand Dalal (AD)	Director
(iii)	Mr. Mr. Anup Bansal (AB)	Director
(iv)	Ms. Anita Joseph (AJ)	Independent Director
(v)	Mr. A Raja (AR)	Independent Director
(vi)	Mr. Chirs Morris	Independent Director

Group Structure -

For many years the Company operated as a standalone with its business limited to Mumbai. However, as the business flourished and opportunities were identified in different locations in and around India, the Company initiated investments in companies engaged in similar businesses as well in jurisdictions outside India. Currently, the Company has an extensive group structure comprising several subsidiaries and associate companies engaged in different aspects of the pharmaceutical business, and for geographical and jurisdictional efficiency. The group structure of the Company is as follows -

1. The company has 5 subsidiaries which are as follows-

Sl. No.	Name of Subsidiaries	% of Shareholding
(i)	OP Pharma Limited (listed company)	60
(ii)	KP Pharma Pvt. Ltd.	55
(iii)	NY Pharma Inc (USA)	100
(iv)	Sterling Pharma LLP (Malaysia)	100

(v)	MB Foundation [sec 8 company]	100
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2. The company has 2 associate companies which are as follows-

Sl. No.	Name of Associates	% of Shareholding
(i)	Olive R&D Pvt. Ltd.	25
(ii)	AZB Limited	49

Financial Performance -

The Company has witnessed consistent profits and growth over the years. Expansion across jurisdictions and investments in R&D oriented companies has further proved to give the Company an edge over its competitors. Frequent transactions with group companies has also made business operationally beneficial, at the same time, introducing complexities of inter-company deals. Group companies have also significantly benefited from their R&D ventures and transactions thereof.

Relevance extracts of financial statements of the Company, as on 31st March, 2021 and few of its group companies are given below -

1. MP Pharma Limited

Balance Sheet as on 31st March, 2021 (Relevant extracts only)

Particulars	Note	Amount (Rs. in crores)
Non-current assets		
Plant and machinery		100
Capital work-in-progress		12
Intangible assets		10
Land & buildings, including RoU assets	(i)	85
Investments	(ii)	20
Current assets		
Investments		5
Trade Receivables	(iii)	45
Cash & Cash Equivalents		5
Loans		0.5

Equity		
Equity share capital		20
Other equity		27

Notes –

(i) Land and Buildings

(a) Leasehold land (RoU assets)

The right of use asset (RoU) [Rs 15 crores] represents land and buildings taken by the Company on lease from the Reddy Family Trust. The Family Trust is a private discretionary beneficiary trust where beneficiaries are the descendants of YSR. The land & buildings have been owned by the Family Trust over the years, and are carried in the books of the trust at a zero value. However, the Company took the same on lease for a term of 20 years. The land, a prime property in the urban area, had an annual fair rental of Rs 1.50 crore; however, the Company acquired it at a much lower rental of Rs 30 lacs. The Company paid a security deposit of Rs 12 crores to the Trust. The value of the RoU asset has been stated at Rs 15 crores including the value of the security deposit, as the auditors have viewed this transaction as an integral part of the lease, and have carried out IndAS 116 valuation by including the present value of the rentals as also the security deposit.

The Audit Committee approved the lease as being arms' length, in view of the valuers' certificate stating that the fair value of the rental was much higher than Rs. 30 lacs per annum that the Company had agreed to pay.

(ii) Investments

(a) Investments in non-group companies

Particulars	Amount (Rs.) (in crores)	% of holding
Zoho Entertainment Pvt Limited - 2 lac shares @ Rs.100 each	2.0	8.5
Panorama Movies Limited - 1 lac shares @ Rs. 500 each	5.0	9
Portrait Enterprises Limited. - 10 lac shares @ Rs. 100 each	10.0	12.75

(b) Investment in Mutual Funds -

IDFC Fixed Term Plan - 30 lakh units @ Rs. 10 each - Rs. 3 crores

(iii) Trade Receivables -

Case Study on Related Party Transactions
Vinod Kothari & Company

Party	Value of goods sold (crores)	No of days outstanding	Amount Outstanding (crores)
OP Pharma Limited	20	More than 400	23
AZB Limited	18	280- 370	12
Zoho Limited (unrelated)	30	65-90	7
Other debtors (unrelated)	40	30-60	8

The sales to related parties are done at arm's length price as if they are unrelated. The general credit period for debtors ranges from 120-180 days. The Company runs a dealer financing scheme whereby a bank pays off the company within 60 days, and then the bank recovers the dues from the dealers. Sales to related parties is not covered by the scheme.

All sales to related parties are approved by the Audit Committee every year through an omnibus approval.

Statement of Profit & Loss (*relevant extracts*) (amounts in crores)

Particulars	Note	Stand-alone	CFS
Income			
Value of Sales		750	1150
Other Income		5	13
Expenses			
Cost of materials consumed		250	423
Purchase of Stock-in trade		105	102
Employee Benefit expense		113	146
Finance Cost		152	203

2. OP Pharma Limited

OP Pharma is a listed company. While 60% shares are held by M B Pharma, there is a 12% stake with a large HNI Investor (Mr. Khilonawala). The remaining 28% shares are scattered among the public.

Balance Sheet as on 31st March, 2021 (extract)

Particulars	Note	Amount (Rs. in crores)
Non-current Assets		
Plant and machinery		20
Capital work-in-progress		5
Investments		10
Current Assets		
Investments		5
Cash & Cash Equivalents		45
Equity and Liabilities		
Equity share capital		25
Other equity		15
Non-current Liabilities		
Borrowings		15
Provisions		2
Deferred tax liabilities		5
Current Liabilities		
Borrowings		2
Trade Payables (including amount due to the parent company)		40

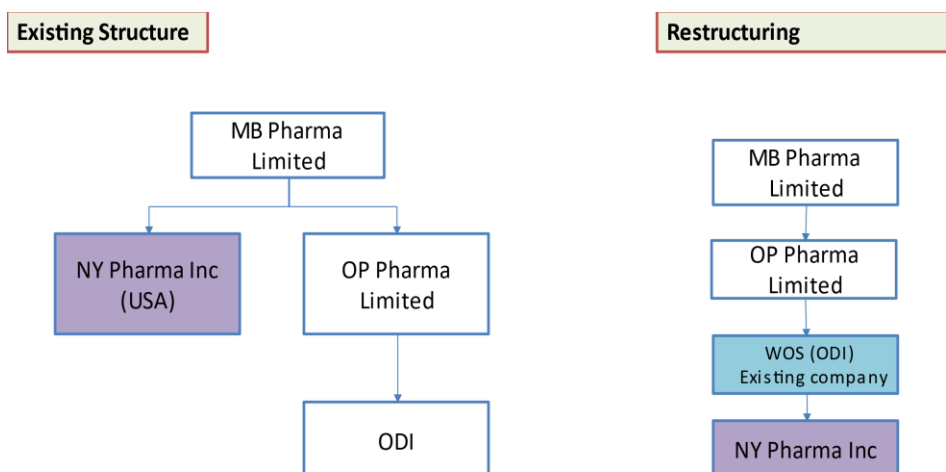
Statement of Profit & Loss (*relevant extracts*) (standalone)

Particulars	Note	Amount (Rs. in crores)	CFS (with its overseas subsidiary and associates)
Income			
Value of Sales		75	453
Other Income		5	12
Expenses			
Cost of materials consumed		25	363
Purchase of Stock-in trade		10	15
Employee Benefit expense		10	234
Finance Cost		15	108

Note: Based on the facts above, we shall be discussing six different cases with some additional facts and scenarios. Below, we discuss the first case –

Case 1 - Restructuring Arrangement

OP Pharma Limited currently has ODI (name of the company) as its subsidiary company. Now, in order to align its administration and operations, moreso to avail maximum tax efficiency on account of cross-border tax provisions, OP Pharm has proposed the following restructuring as a part of its business restructuring strategy.



This restructuring is inspired by several considerations. From the viewpoint of strategic management, MB Pharma will be able to control overseas pharma business through OP Pharma, by placing the US Company as a step down subsidiary of OP Pharma. Additionally, there is a substantial liquidity currently with OP Pharma, and as MB Pharma is continuously engaged in expansion, capital expenditure and inorganic growth plans, the proposed transaction will allow a substantial flow of liquidity from OP Pharma to M B Pharma. MB Pharma will also be able to book a capital gain on the appreciation in the shares of the US Company over time.

For the purpose of the proposed restructuring, and in accordance with the requirements under the extant provisions of the Companies Act, 2013 and SEBI (LODR) Regulations, read with the SEBI Circular on Arrangements, OP Pharma appointed a merchant banker to carry out the valuation of shares of the US Company. Accordingly, the Registered Valuer gave the following values on the basis of different methods of valuation -

- Fair Asset Value as per DCF : Rs. 368/- per share, total valuation Rs 53 crores
- Earning capitalisation value: Rs 412 per share, total valuation Rs 59 crores.

Based on the valuation, it is proposed that the transaction will be done at about Rs 54 crores, and given the book value of the investment [Rs 10 crores approx], there will be a gain on sale of Rs 44 crores.

In order to give effect to the transaction, the advisers have suggested the following modality:

- OP Pharma will infuse Rs 54 crores into the capital of ODI. The advisers have stated that this infusion, including the existing overseas investments made by OP Pharma, will be within the limits of overseas direct investments that can be made.
- The advisers have further suggested that infusion of capital into ODI, an existing WOS, is a simple exercise. There should be least regulatory obstacles in doing this.
- Once ODI gets the said infusion, ODI can buy the shares of the US company from MB Pharma. MP Pharma will get the consideration for the shares from ODI in accordance with FEMA rules.

Points of discussion

1. Whether the proposed restructuring is a related party transaction under the Act or the rules & regulations applicable thereunder?
2. If yes, whether OP Pharma is required to obtain approval of its Audit Committee & the Board, even though OP Pharma is not a party to the said transaction?
3. If MB Pharma & OP Pharma are listed companies, what would be the consequences? Note that Mr. Khilonawala can be a spoilsport, and with a view to arm twist the Reddys, he may not cooperate in case the matter has to go to shareholders.
4. If OP Pharma had acquired the NY LLC directly from MB Pharma, would the scenario change?

We invite our fellow corporate professionals to share their views on the questions raised above, in the comment section below.