

Transacting by exception: Listed entities in
India give substantive carve out for RPTs
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Overview (Executive Summary)

Related Party Transactions are subject to a series of approvals due to the fact that such transactions might cause actual or potential conflict of interest between the Company and its shareholders. Accordingly, the provision of law requires all related party transactions to be specifically approved by audit committee, which is an independent committee expected to assure interest of the Company.

In this regard, while observing the general corporate practice, we see that companies specifically exempts certain transactions from approvals such as reimbursements etc. However, in this article we have analysed the appropriateness of some exemptions provided in the policies of various companies as to whether they provide any potential abuse to corporate governance norms of the Company

Table of Contents

Introduction	3
RPT Policy requirement	3
Hierarchy of approvals for RPTs	3
Exemptions under applicable law from approval of RPTs	4
Exceptions under RPT Policy	5
Analysis of exceptions under RPT Policy	6
1. Appointment and remuneration of Directors/KMPs and deputation in subsidiaries or associate companies	6
2. Transaction pursuant to interest in the securities of the company	7
3. CSR contribution	7
4. Reimbursement of expenses	7
5. Corporate restructuring activities involving related parties	8
6. Transactions approved by the Board	8
7. RPTs in OCB and ALB	8
8. Recurring/ consequential transactions	9
9. Transactions with the employees of the company	9
10. Issue of securities	9
Conclusion	9

Introduction

Related Party Transactions ('RPTs') have an element of potential conflict of interest and that is the basic reason why all RPTs, including modifications thereof, are subject to prior approval of Audit Committee ('AC') that is a committee comprising of majority Independent Directors ('IDs'). IDs *inter-alia* are entrusted with the duty to pay sufficient attention and ensure that adequate deliberations are held before approving RPTs and assure themselves that the same are in the interest of the company.

This article analyses the permissible exemption from approvals under applicable law for RPTs and appropriateness of various exceptions provided in the policy adopted by various companies; if there is any potential abuse of corporate governance norms.

RPT Policy requirement

Companies having their specified securities listed on stock exchange are required to frame a policy on materiality of RPTs and on dealing with RPTs as per Reg. 23 (1) of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('Listing Regulations'). Further, such entities are required to disclose the same in the website [Reg. 46 (2) (g)] and provide a web-link of the policy in the Corporate Governance Report every year.

Systemically important Non-Banking Financial Companies as well as Housing Finance Companies are required to frame a policy on dealing with related parties and disclose the same of the website and in the annual report. Insurance Companies are also mandated by Insurance and Regulatory Development Authority of India (IRDA) to frame policy on RPTs.

Hierarchy of approvals for RPTs

As per Listing Regulations every RPT requires prior approval of Audit Committee, which could be a specific or an omnibus approval (for foreseen and unforeseen transactions). Material RPT require approval of shareholders, with the related parties allowed to vote against the resolution but not in favor of the resolution.

Under Section 177 (4) (iv) of Companies Act, 2013 ('Act, 2013') every RPT requires approval of Audit Committee, which could be a specific or an omnibus approval (for foreseen and unforeseen transactions) or a subsequent ratification in certain cases within 3 months from the date of entering into a transaction. The Audit Committee evaluates an RPT from conflict of interest perspective as it is comprised of majority of IDs. Approval of Board for an RPT cannot exempt the requirement to obtain AC approval as the viewpoint of AC is different from that of the Board. Further, where an RPT is not approved or recommended by AC but approved by the Board, the same is required to be disclosed in the Board's report in terms of Section 177 (8) with reasons for not accepting any recommendation of the AC and even in the Corporate Governance report annexed in accordance with Listing Regulations.

Transacting by exception: Listed entities in India give substantive carve out for RPTs

Section 188 of Act, 2013 mandates prior approval of Board of Directors for items specified under clause (a) to (g) of Section 188 (1) except for RPTs entered into by the company in its Ordinary Course of Business ('OCB') and on an Arm's Length Basis ('ALB'). Where such RPTs are in excess of thresholds prescribed under Rule 15 of Companies (Meetings of the Board and its Powers) Rules, 2014 prior approval of shareholders is also required to be obtained, with the related parties allowed to vote against the resolution but not in favor of the resolution¹.

Exemptions under applicable law from approval of RPTs

Approval from	Act, 2013	Listing Regulations
AC	Transaction, other than a transaction referred to in section 188, between a holding company and its wholly owned subsidiary company.	<ul style="list-style-type: none"> • Transactions entered into between two government companies; • Transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.
Board of Directors	Transactions entered in OCB and ALB.	N.A
Shareholders	<ul style="list-style-type: none"> • Transactions entered in OCB and ALB; • Transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. • In case of a Government company, in respect of contracts or arrangements entered into by it with any other Government company, or with Central Government or any State Government or any combination thereof; • In case of a Government company, other than a listed company, in respect 	<ul style="list-style-type: none"> • Transactions entered into between two government companies; • Transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

¹ Exemption from this restriction exists for companies in which ninety per cent. or more members, in number, are relatives of promoters or are related parties.

Approval from	Act, 2013	Listing Regulations
	of contracts or arrangements other than those referred in the above item, in case such company obtains approval of the Ministry or Department of the Central Government which is administratively in charge of the company, or, as the case may be, the State Government before entering into such contract or arrangement.	

Apart from the exemptions provided in the table above, there is no exemption under applicable law for RPTs.

The Report of the Working Group on RPTs² constituted by SEBI the Working Group also considered excluding certain corporate actions which, by their very nature treat all shareholders equally, such as payment of dividend, sub-division or consolidation of securities, buy-back, rights and bonus issue of securities. Further, corporate actions which were subject to procedures specifically laid down by SEBI in its other regulations, such as preferential allotment, were also proposed to be kept outside the purview of RPTs.

Accordingly, following exemptions were proposed to be inserted in Listing Regulations:

- *the issue of specified securities on a preferential basis, subject to requirements under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 being complied with; and*
- *the following corporate actions by the listed entity which are uniformly applicable/offered to all shareholders in proportion to their shareholding:*
 - *payment of dividend;*
 - *subdivision or consolidation of securities;*
 - *issuance of securities by way of a rights issue or a bonus issue; and*
 - *buy-back of securities*

Exceptions under RPT Policy

Apart from the exemptions granted under applicable law, companies exclude certain RPTs that are perfunctory or does not include any conflict of interest from the scope of the policy so as to ensure that the Audit Committee is able to focus on critical transactions and not review trivial RPTs. Eg. reimbursement of expenses, payment of dividend etc. However, certain companies exclude RPTs that are likely to result in abuse of corporate governance.

² https://www.sebi.gov.in/reports-and-statistics/reports/jan-2020/report-of-the-working-group-on-related-party-transactions_45805.html

Analysis of exceptions under RPT Policy

We reviewed the exceptions provided in the RPT policy framed by 100 listed entities, as uploaded on its website. While majority of companies did not have any separate exclusion in the policy, several listed companies have carved out certain kinds of RPTs, as explained in *Figure 1: Exclusions provided under RPT policy*

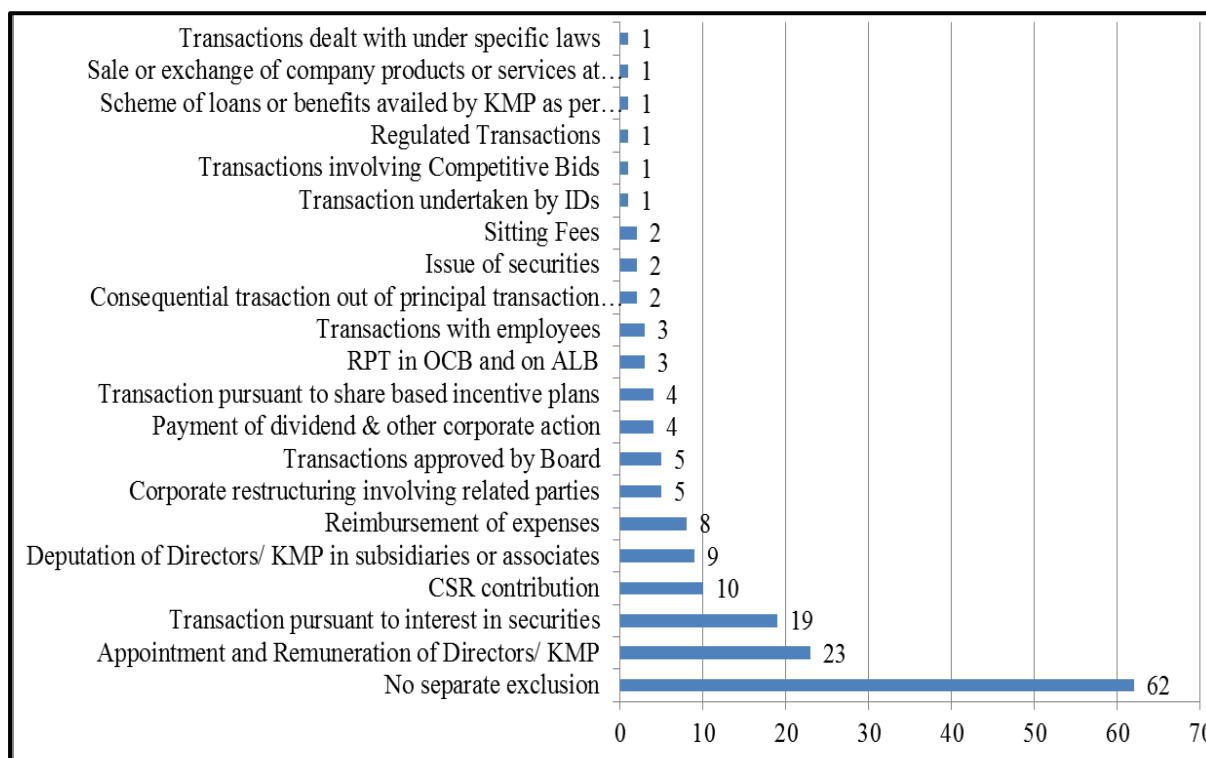


Figure 1: Exclusions provided under RPT policy

The appropriateness and suitability of the aforesaid exclusions have been reviewed hereunder in the light of provisions of law.

1. Appointment and remuneration of Directors/KMPs and deputation in subsidiaries or associate companies

Any transaction that involves providing of compensation to a director or Key Managerial Personnel, in accordance with the provisions of the Act in connection with his or her duties to the Company or any of its subsidiaries or associates, including the reimbursement of reasonable business and travel expenses incurred in the ordinary course of business.

Appointment of directors and Key Managerial Personnel ('KMP') are recommended by Nomination and Remuneration Committee ('NRC'), approved by Board of Directors and approved by shareholders in case of appointment of director and manager.

Transacting by exception: Listed entities in India give substantive carve out for RPTs

From RPT perspective, the appointee becomes a related party upon appointment as director or KMP, unless the appointee is a relative of a director or KMP. Re-appointment of the director/ KMP or variation in the terms of appointment (including remuneration) results in modification of transaction with a related party, thereby requiring approval of AC under applicable law.

The rationale for placing the RPT before AC is to enable evaluation of terms of appointment (including remuneration) from a conflict of interest and office or place of profit perspective.

Deputation of employees without any cost sharing or reimbursement, that are likely to result in burden to the Company and benefit to the subsidiaries or associates, should require sanction of Audit Committee as it results in rendering of services to the group companies on terms that may not seem to be on ALB.

2. Transaction pursuant to interest in the securities of the company

Any transaction in which the interest of Related Party arises solely from ownership of securities issued by the Company and all holders of such securities receive the same benefits pro rata as the Related Party or other pro rata interest of a Related Party included in a transaction involving generic interest of stakeholders involving one or more Related Parties as well as other parties.

This seems a valid carve out as there is no concept of interested shareholder. Right to receive dividend or interest, right to subscribe in rights issue, right to receive shares pursuant to bonus issue, split or consolidation etc, right to receive redemption amount is pursuant to holding of securities involving generic interest.

3. CSR contribution

Contribution towards Corporate Social Responsibility (CSR) within the overall limits approved by the Board that require approval of the CSR Committee.

This cannot be regarded as a valid carve out as the CSR Committee approves the spending from CSR policy perspective and a company is not mandatorily required to spend the amount through its CSR arm only. The AC is required to evaluate from conflict of interest perspective, especially in cases where the amounts are not entirely spent by the related party responsible for carrying out CSR expenditure or where the amounts are being sanctioned without furnishing of utilization or monitoring report.

4. Reimbursement of expenses

Reimbursement made of expenses incurred by a Related Party for business purpose of the Company, or reimbursement received for expenses incurred by the Company on behalf of a Related Party. Reimbursement of pre-incorporation expenses incurred by or on behalf of a Related Party.

Reimbursement of actual expenses does not have an element of income embedded in it. It is mere recovery of expenditure incurred at a common place and is merely a matter of logistic convenience. The term "reimbursement" has been provided with the following meaning in the Black's Law Dictionary: "Reimburse: To pay back, to make restoration to repay that expended; to indemnify, or make whole". Hence, reimbursement of expenses does not result in any transaction

as it does not lead to any burden or benefit and the same arises only for operational convenience and does not have any economic rationale unless reimbursement is being made with some margin on cost.

5. Corporate restructuring activities involving related parties

Transactions involving corporate restructuring, such as buy-back of shares, capital reduction, merger, demerger, hive-off etc. which are approved by the Board and carried out in accordance with specific provisions of the Companies Act, 2013 or the Listing Regulations, 2015;

This seems a valid carve out. However, as per Regulation 37 read with SEBI Circular dated March 10, 2017 in case of a scheme of arrangement, there is a need to submit report from the Audit Committee recommending the Draft Scheme, taking into consideration, inter alia, the Valuation Report. Accordingly, the information will be required to be placed before the Audit Committee irrespective of whether the same involves a related party or not.

6. Transactions approved by the Board

Transactions that have been approved by the Board under the specific provisions of the Companies Act, 2013 e.g. inter-corporate deposits, borrowings, investments etc. with or in wholly owned subsidiaries or other Related Parties;

This is not a valid carve out as the Board may grant an in-principle approval or delegate the power to committee to grant loans, make investments, make borrowings. The approval of Board is obtained under Section 179 and Section 186. However, the AC is required to evaluate from conflict of interest perspective³.

Section 177 (4) (v) mandates scrutiny of inter-corporate loans and investment by AC. Para A (21) of Part C of Schedule II to Listing Regulations further requires reviewing the utilization of loans and/ or advances from/investment by the holding company in the subsidiary exceeding rupees 100 crore or 10% of the asset size of the subsidiary, whichever is lower including existing loans / advances / investments existing as on April 1, 2019.

7. RPTs in OCB and ALB

Approval of Audit Committee/ Board of Directors/ Members under this Policy shall not be required if the transaction(s) is in the Company's ordinary course of business and the same is on an arm's length basis.

It is not recommended to have such blanket exception for all RPTs in OCB and ALB. There is no such exemption provided under Act, 2013 or Listing Regulations to such effect. It is for the AC to determine if the RPTs are in the OCB and on ALB and evaluate from conflict of interest perspective.

³ Read our article on Guidelines for review by AC at <http://vinodkothari.com/2019/03/guidelines-for-review-of-loans-and-investments-by-audit-committee/>

Transacting by exception: Listed entities in India give substantive carve out for RPTs

However, certain listed entities comprising of Banks, in hospitality business, insurance sector, may consider excluding those transactions that are undertaken in OCB and on ALB without any conflict of interest i.e. regular course retail transactions as the same may result in AC to approve perfunctory transactions thereby losing sight of critical RPTs. A company should avoid bringing unimportant and innocuous items as a part of RPT approval that may deflect attention from more substantive items.

8. Recurring/ consequential transactions

Recurring/consequential transactions flowing out of a principal transaction or arrangement for which the Audit Committee has granted its omnibus approval.

This is a valid carve out if the principal transaction has already been approved by the Audit Committee. For Eg. if approval of AC has been granted for giving to loan to a related party, separate approval is not required to be obtained for receipt of interest on loan or repayment of loan.

9. Transactions with the employees of the company

Facilities available or transaction entered into by the Company with all employees in general. This seems a widely termed carve out. The fact that similar facilities or transaction is extended to all employees provides a rationale for the RPT being in the OCB. However, the AC is still required to evaluate the transactions proposed to be undertaken from conflict of interest perspective. If the same is pursuant to share based incentive plan approved by shareholders, in accordance with Act, 2013 or SEBI (Share Based Employee Benefit) Regulations, 2014 the same may be excluded.

10. Issue of securities

Issue of shares / securities to related party.

This seems a valid carve out as Act, 2013 as well as SEBI Regulations provides the terms and conditions for issue of securities. Accordingly, issuance of securities to a related party should not require prior approval of Audit Committee if the issuance is as per the procedure provided under applicable law.

Conclusion

The requirement under applicable law to place RPTs before AC is on account of the AC comprising of majority IDs, with the responsibility to ensure under Schedule IV to Act, 2013 that such RPTs are in the interest of the Company. The said responsibility should not be diluted by providing carve out under RPT policy unless the transactions are perfunctory or innocuous items not resulting in any conflict of interest for the listed entity.

Other relevant articles-

- For more write ups on related party transactions, visit our website at: <http://vinodkothari.com/article-corner-on-related-party-transactions/>
- For more write ups on similar topics, you may visit our website at: <http://vinodkothari.com/category/corporate-laws/>

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