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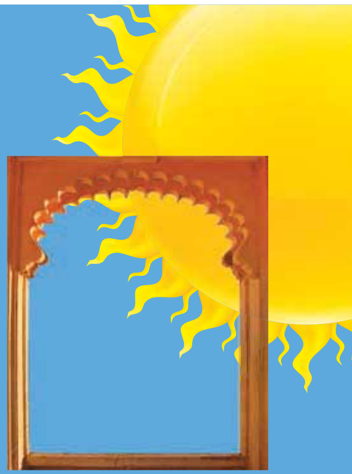

Related Party Transactions

Chief Contributor: Vikramaditya Khanna*

Executive Summary

- Related Party Transactions (RPTs) are a topic of increasing interest around the world, especially as some of them have been associated with quite well known frauds.
- Boards, shareholders and other governance actors can play an important role in preventing value-decreasing RPTs while not dissuading many value-enhancing RPTs.
- Commonplace in India, RPTs occur in varying ways, and can have a large impact on financial performance.
- Prior to 2013, India's regulatory regime focused primarily on disclosure of RPTs (although there were some explicit limits on RPTs), but did not, by and large, require approval of RPTs by disinterested or independent parties.
- The Companies Act 2013 created a new regime that required disinterested or independent approval for many RPTs bringing India into alignment with global standards.
- There remain concerns with the Companies Act 2013 - in particular, some RPTs are not covered by the new law, the selection of independent directors may raise concerns, and enforcement mechanisms are not very efficacious.
- The success of the new RPT regulation in India may also depend on the degree of shareholder activism in India.

* Member, NSE CECG and William W. Cook Professor of Law, University of Michigan Law School.

Introduction

RPTs have attracted a great deal of attention across the world. Some of the largest corporate frauds of the last 20 years have been connected to the use of RPTs, such as Satyam, Enron, Adelphia, Worldcom and many more. In India, RPTs have attracted particular interest because of the predominance of family business structures where RPTs are common place.

What are RPTs and when do they become problematic? Related Party transactions (RPTs) of a company are transactions between the company and a person related to the company such as a subsidiary, large shareholder, director, executive, or their relatives (or business organisations controlled by any of them).

Some RPTs can be problematic because they can be potentially value destroying transactions such as tunneling and squeeze outs.[1] Not all RPTs however are bad. Some RPTs can be value enhancing in the sense that such transactions may represent the best deal that can be struck. For example, a director of a company may run her own business that is considered the best in the world at making car engines. If the company buys engines from the director's business then that is an RPT, but it is likely to be value enhancing. Indeed, research suggests that RPTs can be valuable in emerging markets; can help to reduce the bankruptcy risk faced by some group firms; and may aid in capital raising (see Khanna and Yafeh 2007; Lincoln, Gerlach and Ahmaddijan 1996).

Given that RPTs can take on many different shades, the regulation of them is targeted at deterring the harmful RPTs, but not the beneficial ones. Striking this balance is not easy and is something that attracts a great deal of practical, policy and scholarly interest. Moreover, the sheer breadth and variety of RPTs belies easy categorization or regulation. The need for context and nuance in the regulation of RPTs has led to many different ways of regulating RPTs (see below). Indeed, India has been in the throes of changing its regulation of RPTs leading to the new scheme of RPT regulation in the Companies Act 2013. In light of this, it is an opportune moment to explore the issue of RPT regulation in India.

RPTs in India and their regulation

In India, according to a recent study, the most common types of RPTs take on the following forms: income, expenses, and loans and deposits (see Box 1). Some studies indicate that RPTs are very common at Indian companies.

Box 1: Common Types of RPTs at Indian Firms

- Income related transactions - such as from sale of goods and materials to or interest income or dividend income from a related party represented around 21% (by size) of all RPTs in India (Srinivasan, 2013)
- Expense related transactions - such as purchase of goods and materials from a related party represented around 18% (by size) of all RPTs in India (Srinivasan, 2013)
- Loans and Deposits - represented around 24% (by size) of all RPTs in India (Srinivasan, 2013)
- Studies suggest that although RPTs are common, they are often disclosed quite regularly. However, few firms voluntarily obtained disinterested or independent party approval. See Balasubramanian, Black and Khanna (2010)

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[1]Tunneling covers transactions where a controlling shareholder or important insider transacts with the firm for personal gain. Examples include asset sales, shares sales or purchases, executive perquisites, and personal loan guarantees. In such transactions, the usual concern is that minority shareholders lose value, or opportunities, while the controller or important insider gains. Squeeze outs are a type of merger where a controlled firm is acquired by its controller. For example, a squeeze out would arise if Mr. V owned 55% of ABC firm and forced a merger of ABC with XYZ firm (owned 100% by V). Here, some potential harms to ABC's minority shareholders could be that they receive a low price for their shares or are bought out just before ABC becomes more valuable.

As regards the regulatory regime, prior to the advent of Companies Act, 2013, most of the requirements targeted disclosure of RPTs (and in the case of some rules even the method or format of disclosure) as well as imposing limits on certain kinds of RPTs (see Box 2).

Box 2: Regulation prior to Companies Act, 2013

- Companies Act 1956 – limits on certain RPTs were imposed via sections 372 and 372A (with some exceptions in section 81(1) (a)). Disclosure and approval by the Board was required via sections 297, 299, 300 and 314(1A)
- Clause 49 – requires that the details of material RPTs that are not in normal activity of business, be disclosed. General information about RPTs should be placed before the audit committee
- Indian Accounting Standard AS18 – defines (i) related party relationship and (ii) RPT and lays out the disclosure requirements pertaining to both. Usually disclosure is in aggregate form unless the transaction is greater than 10% of the total value of all transactions of a similar kind
- Income Tax Act 1961 – addresses transfer pricing matters for RPTs

Thus, India's situation before the Companies Act, 2013 could be described as one requiring disclosure of RPTs in some format, but not requiring approval by an independent organ of the corporation (i.e., independent board members or disinterested shareholders). This meant that India was not meeting global standards on RPTs (please see below).

Global standards on RPTs

The OECD published an important report on "Related Party Transactions and Minority Shareholder Rights" in 2012, which catalogued the oversight of RPTs across 30 countries. It is observed that the board, in many jurisdictions, is responsible for making decisions about related parties in the interest of all shareholders. In this process of decision making, independent board members play a key role in terms of reviewing the terms and conditions of RPTs, often as a member of the audit committee. In some jurisdictions, an independent formal valuation is required. Shareholder approval for the RPTs can be regarded as an alternative or complement to the board approval procedure. Table 1 provides a glimpse of the approval requirements of RPTs in select jurisdictions.

Table 1: Approval regime for RPTs in select jurisdictions

Jurisdiction	Board approval for non-routine RPTs	Abstention of related directors	Requirement of Shareholders' approval	RPTs for shareholder approval
U.K.	-	Required	Yes	Non-routine transactions
Canada	Required	-	Yes	Not on market terms; >25% of market cap
Italy	Required	Required	Yes	Disapproved by the committee of independent directors
Singapore	Required	-	Yes	>5% of net tangible asset

'-' = absence of a specific requirement or recommendation

Source: *OECD, 2014*

An important point to note is that although virtually all countries require disclosure of important RPTs, there are variations in approval standards. For example, in the United Kingdom firms are required to have material RPTs reviewed by independent financial experts and to obtain a favorable vote from the majority of the minority shareholders. The United States does not require these steps, but provides much more favorable judicial scrutiny to parties that have taken these sorts of steps. The United States also imposes fiduciary duties upon controlling shareholders. Canada follows closely the approach in the United Kingdom, but Italy only requires disinterested shareholder approval if a transaction is rejected by independent directors and the board still wishes to pursue it. Other countries provide yet other variations. For example, Brazil requires shareholder approval only for some types of transactions such as corporate restructuring.

Recent reforms in India

Against this background of global interest in RPT regulation, India enacted the Companies Act 2013, which brought India into closer alignment with global standards on RPTs (see Box 3). Now most RPTs are required not only to be disclosed, but also approved by a disinterested organ of the company. This is a sea change in RPT regulation in India.

Box 3: Companies Act 2013 and RPTs – Summary

- Related party transactions are subject to approval by Audit Committee comprised of majority independent directors
- Interested/concerned directors not to participate and vote
- Approval of RPTs by majority of minority shareholders i.e. majority of disinterested or independent organ
- Possibility of suit under the soon to be constituted National Company Law Tribunals

Meanwhile, SEBI has made several changes to Clause 49 of the listing agreement to align with the provisions of the Companies Act, 2013, adopt best practices on corporate governance and to make the corporate governance framework more effective (see Box 4).

Box 4: Key features of RPT regulation in Clause 49

- While all RPTs shall require prior approval of the Audit Committee, the Audit Committee may grant 'omnibus approval' for maximum of a year in case of repetitive RPTs
- All material RPTs shall require approval of the shareholders through special resolution. [RPT(s) exceeding 10% of annual turnover are considered material]
- The related parties shall abstain from voting on such resolutions

Although these changes suggest greater scrutiny of RPTs in India, there are still a number of issues that cause concerns.

Lingering issues

Squeeze-outs have been excluded. There are still some RPTs that appear not to be caught by the provisions of the new Companies Act. For example, squeeze-out transactions (however conducted) do not appear to require approval by a disinterested group. (See Khanna and Varottil, 2015). Given that squeeze outs are large transactions where the prospect of minority expropriation is palpably large, one would have hoped for some greater protection for minorities.

Concern regarding definition of "independent" or "disinterested" directors and their selection. Prior to the 2013 Act, the definition of independence in India was largely negative – that is, what features would make someone not independent (e.g., a financial interest). After the 2013 Act, the definition has become more positive with more qualifications being expected so that celebrity or friendly independent directors are less likely. However, the key concern is that these directors are selected by a majority vote of all shareholders – including the controlling shareholder. Although the 2013 Act requires a nominating committee composed of a majority of independent directors to put forward independent directors for the board, those directors can only be elected if the controller also votes in their favour. To the extent that independent directors are expected to protect the minority against the controller, this structure may weaken the prospect of such protection.

Enforcement of RPT regulation is fractured across SEBI, the judiciary, and special tribunals (the Company Law Board under the 1956 Act and now the National Company Law Tribunal under 2013 Act). In addition to concerns about transactions slipping between the cracks, there are also concerns that the judicial and tribunal enforcement structures are too slow and cumbersome.

Finally, *higher shareholder activism is necessary*. For a disclosure and approval system to work we must be fairly confident that at least some shareholders will be willing to vote against approval where it seems something is amiss, but grant approval where transactions appear to be value increasing. Shareholder activism in India is still nascent, but the early indications are that it is picking up. Both in the Satyam matter and more recently with United Spirits Ltd, shareholders have shown that they can take action. Moreover, if the extent of foreign portfolio investment were to increase in India (as it appears to be doing) and if Hedge Funds were a likely part of that, then we might expect to see even more activism in the future.

Moving ahead

These concerns indicate where reform may be most useful to explore in India. First, including squeeze outs within the types of RPTs under the new Companies Act 2013 would be a useful step. This may enhance protection for minorities against a transaction that can substantially reduce value for them.

Second, the selection of independent directors may benefit from some strengthening. One could consider implementing something like cumulative voting (as seen in some states in the United States) or requiring that some board seats be voted on only by minority shareholders. Associated with this it may prove useful to clarify the definitions of "independence" and "related party" in the Indian context to reflect business and institutional realities.

Third, to strengthen enforcement, the regulator (e.g., SEBI) may be granted greater powers to monitor RPTs. One might also grant minority shareholders greater ability to sue (e.g., fiduciary duties owed by controllers to minorities, class actions); but given the frequent delays in the adjudicative processes in India it may prove more helpful to enhance regulatory scrutiny and perhaps devise some "early warning signals" that might alert shareholders and others to some questionable transactions. For example, requiring very prompt disclosure of RPTs above a certain threshold of revenue, the presence of off balance sheet transactions, resignations of independent directors, the pledging of shares by controllers, and so forth may greatly enhance the ability of shareholders and others to prevent the worst types of value destroying RPTs.

Fourth, enhancing the ability of shareholders to become more active in the process of monitoring RPTs will also be important. This may be through making it easier for shareholders to obtain information about RPTs, communicate with each other, contact independent experts and initiate various legal or regulatory actions. An earlier quarterly briefing in this series discusses shareholder activism in India and contains useful proposals to consider for enhancing the ability of shareholders to take on a monitoring role for RPTs in India. These types of reforms, and perhaps others suggested in the literature, when combined with the reforms in the Companies Act 2013 and Clause 49 suggest promise for the future regulation of RPTs in India.

Partial Checklist for Reducing Value Destroying RPTs

- Amending selection process for independent directors to allow for greater minority voice (e.g., cumulative voting); clarifying definitions of independence and related party
- Including 'squeeze outs' within the protections granted to minorities for RPTs (e.g., requiring majority of minority vote to allow 'squeeze outs' to proceed)
- Granting SEBI or other market regulator greater powers to monitor RPTs; if one wishes to enhance the ability of minorities to sue, then consider (a) more reforms to class action mechanism and (b) expanding fiduciary duties from controllers to minority shareholders
- Developing early warning signals for regulators and investors to alert them to possible value destroying RPTs
- Enhancing the ability of minority shareholders to act against RPTs they consider value destroying (e.g., making it easier for minority shareholders to act collectively and consult experts)

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