Related Party Transactions-Adopting a Fresh Regulatory Approach

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Related party transactions are one of the most common tunnelling strategies on which much ink has been spilled both in academia and in regulatory world. Various dimensions are investigated in different jurisdictions around the globe from multiple standpoints like corporate governance, law and economics, and taxation. Such a massive amount of literature would give an impression of a well-researched area. However, there is always a chance of not seeing the wood for the trees in such cases and an inspection from a distant vantage point, especially so in the Indian context, leads to identification of some issues contributing to the abusive tunnelling practices. Some of the like issues are sought to be introduced in this article. Due to wider net of applicability, the main focus is maintained on the provisions of the Companies Act, 2013.

Understanding the psyche of the transactions

Since the evolution of divestiture in ownership and management in business forms and information asymmetry arising therefrom, the tunnelling transactions have increased as a part of the obvious agency cost. Additionally, though the legal transplant of the Company Legislations has changed into legal autochthony with the passage of the Companies Act, 2013, the Indian companies continue to have concentrated ownership and control. The promoters continue to have a disproportionate say in the management decisions. It is observed by the authors, though anecdotally, that the promoters have not fully implemented the implications of separate legal status of the Company and continue to view the Company as an extension of themselves. Such transactions are often entered with a perceived view of drawing 'just remuneration' for the efforts and time spent.

A deeper study of the motives and nature of the transactions may hold some behavioural insights regarding the same. While the gamut of legislative actions are wide enough, such actions can be made more efficacious through the tools offered by behavioural law and economics.

Regulation of related party transactions

The first part of the regulation is the definition itself. The definition under the Companies Act, 2013 as well as Securities Laws, though quite wide, does not cast the net far enough. The recent changes brought through the 'Significant Beneficial Owners' ('SBO') are not yet fully captured under the definition of 'related party'. RP & SBO are sailing together in the current corporate context. While RP deals with transactions, SBO deals with ownership. The end effect of both ultimately leads to ownership and control of majority on the company and its wealth creation ability.

On the second part related to approvals, the current provisions of the Companies Act, 2013 deal with different related party transactions like investments, loans, sales, issue of securities, managerial remuneration under different sections situated under different chapters. The approval procedures and thresholds are quite distinct as well. Instead of having such pigeon-holes, it is more apposite to consider all related party transactions in totality and institute a 'majority of the minority' prior approval procedure for same.

One welcome step under the current Companies Act, 2013 is the reliance on self-governance and removing the need to obtain the approval of the Central Government for effecting related party transactions.

Lack of express duties on the controlling shareholders

The Companies Act, 2013 provides for various routes like making an application for oppression or mismanagement, complaint for fraud in the Company, filing class action suit for redressal of grievance regarding abusive related party transactions. Perhaps such abundance of the remedies has helped the country in consistently scoring higher in 'Protecting Minority Investor' criteria in Ease of Doing Business Indexes over the years as compared to its overall rank. However, there is no express duty placed upon the controlling majority to take care of interests of the minority.

To restate the obvious, controlling majority have payoffs linked to the voting rights while the only benefit of the minority is monetary in nature. Such statutory recognition of the duty to take care of the interests of the minority may help the minority in bringing more meaningful actions. At the same time, it is also to be understood that usually in Indian context and due to lack of explicit segregation of ownership and management, majority runs and manages business. Hence, such statutory recognition to the minority has to be crafted out very carefully so as to not prove an obstacle to run business and create wealth.

Better enforcement of existing provisions

Section 166 of the Companies Act, 2013 codified the duties of the Directors for the first time. These duties included duties to avoid conflict of interest and to exercise independent judgment. However, the jurisprudence regarding the same is yet to effectively develop. This situation remains despite the overarching test of fairness to minority (and even fairness to the interest of the Company) being deployed by the Courts in the spirit of a common law country. The current practice of regulators of enhancing the shareholder powers without any inherent change in other governance mechanisms is unlikely to significantly change the corporate governance practice as evidenced by some scholarly works in that area.

Uniform approach in corporate and revenue legislations

Companies Act, 2013 grants the freedom to commence a business, Competition Act, 2002 regulates the freedom to compete, and finally, the freedom to exit is given by the Insolvency and Bankruptcy Code, 2016. General investors are protected by the Securities and Exchange Board of India Act, 1992. The way these legislations define and treat the term 'related party' is different and perhaps holds certain rationale at the respective vantage point. However, a more uniform approach may be adopted in dealing with the related party transactions to reduce the unintentional regulatory arbitrage being created at certain levels. Such uniformity is sure to be beneficial in developing more harmonised practices, jurisprudence, and better enforcement as well.

Revenue legislations have certain provisions like 'deemed dividend' which are based on the principle of neutral treatment of the transaction. A similar unification of tax treatment may be adopted to make the transactions tax neutral for the beneficiary and remove the incentives for adopting different kinds of transactions for reaping the benefits in taxation.

Differential treatment for corporate groups

With the passage of time, India has seen emergence of vast diversified conglomerates operating through complex group structures. Such conglomerates should not be treated like standalone companies. Their regulation needs to take care of both the interests of the shareholders in the parent company by requiring their approval for shifting the surplus economic value as well as doing away with the repetitive and mechanical approval related compliances. An example for the first approach would be requiring approval for giving guarantee for loans to a group company which essentially transfers the credit risk. An example of relaxation would be making the constitution of Board of Directors in case of wholly-owned subsidiaries optional. Such group concepts are recognised and enforced under different legislations in different manners and this area also calls for uniformity.

Entity-agnostic provisions

The provisions regulating the related party transactions are considered only in the context of companies. The entities like partnership firm, limited liability partnership etc. are recognised only as a 'Related Party' of the Company. However, regulation of related party transactions needs to travel through the entity type and must percolate in all entities, preferably via a common minimum governance code.

Rather, the corporate regulatory laws like Companies Act, Securities Laws should identify and regulate the businesses on their capacity of earn money, control, ownership, public exposure and not on the basis of their registration (Public Limited & Private) or listing status (Listed/ Debt Listed/ Unlisted). Concept of 'small company' (vis-avis a 'Non-small company') which emerged in the Companies Act 2013, needs to be strengthened to provide stricter regulations to Non-Small Companies requiring them to exhibit fairness, transparency, minority care, segregation of ownership and management etc.

To summarise, the suggestions made above need not be all encompassing. Further, they need not be all conclusive. To some, they may even be akin to presenting diametrically opposite rationales in a flagrant violation of the basic tenet of uniformity. The idea is to start a healthy debate, build a publicly available database of all related party transactions, test the suggestions against the actual data, and then, legislate. Legislation must always be an ongoing activity and cannot be a static one. Many prudent regulatory and legislative practices have seen the landscape evolve to what it is today. Similarly, future gains can be made. There are of course further challenges like the optimum specificity of the legislation, fiduciary duties of the activist shareholders, class structures in corporate control and the like which are likely to arise from ushering in the new reforms and economic developments. To make sure that we are able to tackle them, we need to clean the Augean stables today.