

## **“RELATED PARTY TRANSACTIONS: EVALUATING AUDIT COMMITTEES’ ROLE AND ARM’S LENGTH APPLICATION IN THE ORDINARY COURSE OF BUSINESS”**

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### **ABSTRACT:**

This paper critically examines the legal framework surrounding Related Party Transactions (RPTs) in India, particularly focusing on the provisions of the Companies Act, 2013. Related Party Transactions (RPT) is defined as a ‘transaction which could be a business deal, a single or series of financial contracts, or an arrangement between two parties who are joined by a special relationship prior to the transaction would be a related party transaction’. The paper discusses the regulatory challenges posed by such transactions, highlighting their potential for exploitation and the risk they pose to minority shareholders. A key focus of this paper is on the role of audit committees, their legal mandate, and the practical challenges they face in overseeing RPTs, particularly when conflicts of interest arise due to the involvement of promoters or their families in the committee. In addition to this, the paper tries to address the ambiguity in defining “arm’s length transactions” and “ordinary course of business,” which creates loopholes that may lead to misuse. The paper also draws inference from a data driven study which highlighted the Audit risk attached to RPTs. By critically evaluating these provisions, the paper suggests reforms aimed at improving transparency, accountability, and corporate governance in India.

### **Introduction:**

Corporate ownership in India is predominantly concentrated in the hands of domestic individuals and promoter groups, multinational parents, or the state.<sup>302</sup> Much of the family and other domestic holdings could be traced back to the days of the British Managing Agencies arguably unique to India that enabled essentially British merchants and some Indian businessmen to spawn and nurture different enterprises which eventually grew into giant corporations in their own right.<sup>303</sup> In other words, not only are most firms effectively controlled by a promoter group, but the same promoter group often controls a large number of firms.<sup>304</sup> This pattern of ownership gives rise to serious

potential for conflicts of interest between the promoter group and the minority investors.<sup>305</sup>

Related Party Transactions (RPT) is defined as a ‘transaction which could be a business deal, a single or series of financial contracts, or an arrangement between two parties who are joined by a special relationship prior to the transaction would be a related party transaction’.<sup>306</sup>

Section 188 of the Companies Act, 2013, has introduced the concept of self-regulation and enjoined upon the companies to deal with the RPTs through its audit committee, board of directors and shareholders and has thereby outlined fresh accountability norms to be followed by them.<sup>307</sup>

<sup>302</sup> Bala N. Balasubramanian & R. Anand, Ownership Trends in Corporate India 2001–2011: Evidence and Implications, IIM Bangalore Research Paper No. 419, at 6 (July 30, 2013), <https://ssrn.com/abstract=2303684>.

<sup>303</sup> *ibid*

<sup>304</sup> Ami Galani & Nathan Rehn, Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses, 22 Nat’l L. Sch. India Rev. 29, 29–57 (2010), <https://www.jstor.org/stable/44283790>

<sup>305</sup> *ibid*

<sup>306</sup> Pratip Kar, Fighting Abusive Related Party Transactions in Asia: Workshop on Implementation – Background Document, Asia Roundtable on Corporate Governance, Global Corp. Governance Forum, at 2 (Oct. 25–26, 2010), <https://www.ifc.org/content/dam/ifc/doc/mgmt/46435512.pdf>.

<sup>307</sup> *ibid*

### Identification of Research Gap

- Lack of robust analysis on the practical challenges faced by audit committees.
- Ambiguity and misuse of arm's length and ordinary course principles within the Companies Act.

### Central Argument:

- The central argument critiques the role of audit committees in managing related party transactions (RPTs), focusing on conflicts of interest and insufficient oversight. It advocates for stronger safeguards, such as excluding related parties from audit committees and implementing more transparent processes for transaction approval.
- Additionally, it emphasizes the need for clearer definitions and regulations to prevent the misuse of arm's length transactions in the ordinary course of business.

### Research Questions

- How can role of audit committees be augmented to its actual potential rather than putting them in managerial shoes?
- What are the practical flaws in the arm's length and ordinary course standards, and how can these be rectified?

### Methodology of research

- A theoretical analysis of the relevant sections of the Companies Act, 2013, research papers, articles, blogs, and interviews of Corporate Lawyers.

### Related Party Transactions

Various jurisdictions have adopted standard approaches to address the challenges posed by abuses in Related Party Transactions (RPTs). However, most emphasize the responsibility of the board of directors and independent directors to safeguard minority shareholders from exploitative RPTs. Most RPT regulations principally cover three important aspects –

(a) Definition of a related party;

(b) Approval of transactions by the board of directors or the audit committee and, in certain exceptional circumstances, by the shareholders; and

(c) Disclosure of the RPTs as prescribed.

Against the above backdrop, the Indian legal infrastructure offers a response to RPTs, which sounds quite stringent by global standards. It comprises three sources of regulation addressing RPTs in India: The Companies Act, 2013, SEBI LODR Regulations, 2015, Accounting Standard – 18 and the Indian Accounting Standard – 24.<sup>308</sup>

***This paper will however critically examine the provisions under the companies act 2013 alone and more specifically two aspects ie, the practical challenges faced by audit committees and the ambiguity and misuse of the arm's length in the ordinary course of business principles within the Companies Act.***

### Legal Framework and Regulatory Challenges

#### A). Evolution of RPT Regulation in India:

Corporate governance is maximising the shareholder value in a corporation while ensuring fairness to all stakeholders—customers, employees, investors, vendors, the government and society-at-large. Corporate governance is about transparency and raising the trust and confidence of stakeholders in the way the company is run.<sup>309</sup> The path of a successful corporate governance regime is almost always rocky and needs deftness to overcome impediments. In the Indian corporate law space, Related Party Transaction ("RPT") has emerged as one such phenomenon that has the potential of vitiating corporate hygiene beyond repair if not appropriately regulated.<sup>310</sup>

Related Party Transactions (RPT) is defined as a 'transaction which could be a business deal, a

<sup>308</sup> Ibid

<sup>309</sup> N.R. Narayana Murthy, Corporate Governance and Its Relevance to India, 38 India Int'l Centre Q. 280, 280–88 (2011–2012), <https://www.jstor.org/stable/41803985>.

<sup>310</sup> Kirthana Singh Khurana, *Related Party Transactions in India – The Need for a Regulatory Revamp*, in *Changing Paradigm of Corporate and Commercial Laws* 59 (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021)

single or series of financial contracts, or an arrangement between two parties who are joined by a special relationship prior to the transaction would be a related party transaction'.<sup>311</sup> According to US Security Exchange Commission' RPT Policy, **Related Party Transaction** means any transaction, arrangement or relationship, or any series of similar transactions, arrangements or relationships, in which (i) the Company or any of its subsidiaries is or will be a participant, and (ii) any Related Party has or will have a direct or indirect interest.<sup>312</sup> While RPTs can be value enhancing in nature, they can also be potentially abusive in nature by transferring value from companies (such as listed companies with a significant number of minority shareholders) to other companies that are privately owned by the controlling shareholders.<sup>313</sup>

The J J Irani Committee, formed for making recommendations for improving the corporate governance regime in India, in its report discussed whether corporate transactions with directors or their families should be governed under a "government permission-based framework" or should involve the participation of shareholders through an approval and disclosure process. It analysed similar provisions in other jurisdictions and decided that the latter would be more appropriate for Indian companies.<sup>314</sup>

From the perspective of fairness, justice, and accountability, Related Party Transactions (RPTs) must be governed by specific legal constraints and stringent disclosure standards.

<sup>315</sup>This is particularly crucial in a country like

India, where promoters or promoter-led groups dominate most large corporations and make key decisions on their behalf. Therefore, the imperative for guarding against the possible misuse of RPTs, calls for robust procedural safeguards without stifling the value enhancing transactions.<sup>316</sup>

Section 188 of the Companies Act, 2013, has introduced the concept of self-regulation and enjoined upon the companies to deal with the RPTs through its audit committee, board of directors and shareholders and has thereby outlined fresh accountability norms to be followed by them.<sup>317</sup> In this manner, the Act has introduced a much-needed reform in the laws governing Related Party Transactions (RPTs), incorporating a multi-tiered approval system based on defined thresholds and stricter disclosure requirements.

The definition of 'related party' needs to be widened to go beyond familial relationships and cover economic interests comprehensively. This way, the gap that exists between the definition under the SEBI LODR Regulations, 2015, a more comprehensive definition, and that under the Act can be bridged.<sup>318</sup>

### B). Audit Committees: Legal Mandate and Practical Challenges

The Audit Committee of a company has the authority to approve RPTs and any subsequent modification of such transactions. The Act mentions that any RPT undertaken by the company be first reviewed and approved by the Audit Committee even if the transaction is not subject to the approval of the board or the shareholders. Such a committee also has the power to make a blanket approval for RPTs undertaken by the company by adhering to Rule 6A of the Companies (Meetings of Board and its Powers) Rules, 2014. The committee shall consider factors such as the repetitiveness of the transactions and the justification for the

<sup>311</sup> Pratip Kar, Fighting Abusive Related Party Transactions in Asia: Workshop on Implementation – Background Document, Asia Roundtable on Corp. Governance, Global Corp. Governance Forum, at 2 (Oct. 25–26, 2010), <https://www.ifc.org/content/dam/ifc/doc/mgmt/46435512.pdf>.

<sup>312</sup> Exhibit 14.2: Code of Ethics, SEC EDGAR, <https://www.sec.gov/Archives/edgar/data/1437517/000101054917000418/exc142.htm>.

<sup>313</sup> Umakanth Varottil, Corporate Governance in India: Law and Practice, in India: The Business Opportunity 35 (Linda Spedding ed., E. Book Co. 2016), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2951705](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2951705).

<sup>314</sup> Kirthana Singh Khurana, *Related Party Transactions in India – The Need for a Regulatory Revamp*, in *Changing Paradigm of Corporate and Commercial Laws* 59 (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021).

<sup>315</sup> Ibid

<sup>316</sup> Ibid

<sup>317</sup> Ibid

<sup>318</sup> Kirthana Singh Khurana, *Related Party Transactions in India – The Need for a Regulatory Revamp*, in *Changing Paradigm of Corporate and Commercial Laws* 59 (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021).



need for omnibus approval before giving a blanket approval in this regard.<sup>319</sup>

Audit committees typically follow the promoter or the promoter group. While the audit committee consists of a majority of independent directors, the influence of the promoter group or controlling shareholders holds the sway and may weaken the independence of non-executive directors in supervising RPTs and the misdemeanours of controlling shareholders.<sup>320</sup>

Audit committees face several practical challenges, particularly in sectors like EPC (Engineering, Procurement, and Construction) contracts, where determining arm's length transactions can be complex. Often, a member from the promoter's family is part of the audit committee, which can create conflicts of interest and undermine the committee's effectiveness. In some cases, unscrupulous promoters shift the responsibility of approving contentious or questionable transactions to the audit committee, thereby evading accountability. This is especially prevalent in real estate transactions, where audit committees are pressured into approving deals, effectively allowing promoters to evade scrutiny. Consequently, the burden of approving such transactions often places audit committees in a managerial role, compromising their independence and objectivity.<sup>321</sup>

### C). Issues Related to Arm's Length Transactions in the Ordinary Course of Business

The Companies Act defines the expression "arm's length transaction" to mean a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.<sup>322</sup> Corporates do

not adhere to the IT Act's definition of the arm's length principle, making it challenging in this regard, especially when the Companies Act provides a vague definition.

Generally, the term 'ordinary course of business' refers to transactions that form part of a company's regular business activities, rather than being incidental or exceptional. However, the lack of a clear definition allows for differing interpretations. Even when a policy is developed on this matter, it is usually broad and heavily reliant on the audit committee's approval. Such policies often become rigid, leaving little room for scrutiny. Consequently, almost any transaction undertaken by a company can be justified as being within the ordinary course of business, creating potential for misuse. On the flip side, this ambiguity can lead to differing value judgments between the company and the regulator, exposing directors to increased risks.<sup>323</sup>

The concept of "ordinary course of business" is typically broad and has not been clearly defined by the Companies Act. The issue arises when determining whether a transaction qualifies as part of the ordinary course of business. However, this becomes challenging in practice, particularly in industries like hospitality, where the boundaries of what constitutes the ordinary course are less clear.<sup>324</sup> Given that the company's objectives are defined in broad terms, the argument often arises that a transaction falls within the ordinary course of business.

### Analysis and Arguments

#### A) Reimagining the Role of Audit Committees

Audit Committees are crucial to the assessment of RPTs. Considering the salience of greater control and the complexity in many transactions, it is highly desirable that at least

<sup>319</sup> *The Companies Act, 2013*, § 177(4)(iv) (India).

<sup>320</sup> Kirthana Singh Khurana, *Related Party Transactions in India – The Need for a Regulatory Revamp*, in *Changing Paradigm of Corporate and Commercial Laws 59* (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021).

<sup>321</sup> Bharat Vasani, *India Inc and Related Party Transactions*, YouTube (July 23, 2019), <https://www.youtube.com/watch?v=NqA1-sYug6k>.

<sup>322</sup> *Companies Act, 2013*, § 188(1) *expl. (b)* (India).

<sup>323</sup> Kirthana Singh Khurana, *Related Party Transactions in India – The Need for a Regulatory Revamp*, in *Changing Paradigm of Corporate and Commercial Laws 59* (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021).

<sup>324</sup> Bharat Vasani, *India Inc and Related Party Transactions*, YouTube, CAM Partner Bharat (July 23, 2019), <https://www.youtube.com/watch?v=NqA1-sYug6k>.

one of the members of the company's audit committee has solid industry experience and domain knowledge. Such addition can be vital for better appraisal of both ordinary course of business and arm's length cases.<sup>325</sup>

One criticism is that audit committees often include a member from the promoter's family or a related party. While Rule 15 of the Companies Act prohibits related parties from being physically present during voting by the audit committee, this is often viewed as a superficial measure that does not effectively address the issue, given the complexities of real-world scenarios. Therefore, the solution would be to mandate that no member from the promoter's family or related parties be part of the audit committee.<sup>326</sup>

A study conducted on the relationship between Related Party Transactions (RPTs) and audit risk in India, using a sample of 1,182 firms from 31 March 2011 to 31 March 2018, reveals that RPTs increase audit risk, which in turn leads to higher audit fees.<sup>327</sup> The research also investigates the impact of the 2014 RPT regulations, introduced through the Companies Act, 2013, and the revised Clause 49 of the SEBI listing agreement, and finds that these regulations heighten the complexity of auditing RPTs.<sup>328</sup>

Audit committees often face challenges in conducting thorough documentary scrutiny due to the lack of a robust company framework that clearly defines related party transactions (RPTs). As a result, they tend to rely on the directors' declarations. It is crucial, however, that the audit committee does not shoulder this responsibility alone. In some instances, unscrupulous promoters shift the burden of approving contentious or questionable transactions to the audit committee, thereby

evading accountability. This is particularly common in real estate transactions, where audit committees are pressured into approving deals, effectively allowing promoters to bypass scrutiny. A potential solution could be for the audit committee to act solely as an oversight body, avoiding the approval of transactions altogether.<sup>329</sup>

### **B) Transactions carried out at arm's length in the ordinary course of business**

While deciphering the meaning of arm's length basis, the definition and methods provided in the Income Tax Act, 1961 are often resorted to by the companies owing to the lack of a proper definition or method in the Act.<sup>330</sup> It would, therefore, be extremely useful if the Act either defines the term or provides a proper method to be followed in order to determine whether a transaction is carried out at an arm's length basis by the company or not.<sup>331</sup>

One practical issue with related party transactions is that they are often portrayed as competitively priced, when in reality, they may be nothing more than superficial appearances with little real value. To address arm's length dealings, there are a few potential solutions, such as benchmarking (the most common approach) or ensuring that a project is bid on by a minimum of 10 to 15 parties, which could help prevent the misuse of RPTs.

The term "ordinary course of business" is not defined in the Companies Act, making it difficult to clearly determine what falls within this scope. Typically, a company's objectives are referred to in the background to assess whether a transaction is part of the ordinary course. This becomes problematic when, for instance, an aviation company claims that the purchase of uniforms is part of its ordinary course of

<sup>325</sup> Kirthana Singh Khurana, Related Party Transactions in India – The Need for a Regulatory Revamp, in Changing Paradigm of Corporate and Commercial Laws 59 (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021)

<sup>326</sup> Bharat Vasani, India Inc and Related Party Transactions, YouTube (CAM Partner Bharat, July 23, 2019), <https://www.youtube.com/watch?v=NqA1-sYug6k>.

<sup>327</sup> Abdul Rasheed P.C., Iqbal Thonse Hawaldar & Mallikarjunappa T., Related Party Transactions and Audit Risk, 8 Cogent Bus. & Mgmt. 1888669 (2021), <https://doi.org/10.1080/23311975.2021.1888669>.

<sup>328</sup> *ibid*

<sup>329</sup> Ep#12: Related Party Transactions (Bharat Vasani of Tata Group, VS Parthasarathy of M&M & Dolphy D'Souza of EY Companies), YouTube (Oct. 10, 2020), <https://www.youtube.com/watch?v=n83QeNN6bGk>.

<sup>330</sup> Bharat Vasani & CAM Corporate Team, Arm's Length Pricing – Navigational Tools for the Audit Committee, Cyril Amarchand Mangaldas (Nov. 10, 2020), <https://corporate.cyrilamarchandblogs.com/2020/11/arms-length-pricing-navigational-tools-for-the-audit-committee/>.

<sup>331</sup> *ibid*

business, with the promoter's company acting as a related party, all without the knowledge of shareholders or others involved.<sup>332</sup>

Since the judgment and rationale suggest that transactions conducted at arm's length in the ordinary course of business are not subject to further scrutiny, the broad discretion granted in such cases can sometimes be misused. Additionally, this discretion may encourage related parties to structure these contracts in a way that benefits themselves, potentially harming the interests of the company.<sup>333</sup> Thus, it is important that some safeguards are brought in to curb the misuse.

### **Conclusion:**

The biggest challenge to law makers is to check abusive RPTs which can have serious implications on the overall corporate governance in the country. India has adopted the utmost stringency in its country's approval requirements for all related party transactions.<sup>334</sup> Despite the clarity in the law regarding Related Party Transactions (RPTs), breaches continue to occur frequently. To mitigate such instances, several measures can be implemented. First, strengthening internal control mechanisms is crucial, with independent directors on the Audit Committee playing a pivotal role in monitoring RPT proposals.<sup>335</sup>

In conclusion, this paper has examined the intricate landscape of Related Party Transactions (RPTs) within India's corporate governance framework, with particular emphasis on the role of audit committees and the ambiguities surrounding the terms "arm's

length" and "ordinary course of business." Despite the legal reforms aimed at enhancing transparency and accountability, the prevalence of conflicts of interest, particularly in companies dominated by promoter groups, poses significant risks to the effectiveness of audit committees.

The ambiguity in the definitions of "arm's length" and "ordinary course of business" further exacerbates the challenges in enforcing fair practices and safeguarding minority shareholders. To address these issues, the paper suggests key reforms, including the exclusion of related parties from audit committees and the establishment of more explicit guidelines for determining arm's length transactions. Strengthening the independence and expertise of audit committees, as well as clarifying the legal definitions, can contribute to greater accountability and trust in corporate governance. Ultimately, while the legal framework has made significant strides, continuous refinement and stricter enforcement are essential to ensure that RPTs serve the interests of all stakeholders and prevent potential abuses in corporate practices.

Additionally, benchmarking RPTs can help ensure they are conducted on an arm's length basis. Finally, companies should undertake periodic compliance audits to verify that their RPTs align with applicable laws and regulations.<sup>336</sup>

### **Limitations of the Paper**

- Focus solely on the Companies Act, excluding other regulations like SEBI and global frameworks.
- Limited comparative analysis due to the doctrinal methodology and not empirical due to limited resources.

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<sup>332</sup> Ep#12: Related Party Transactions (Bharat Vasani of Tata Group, VS Parthasarathy of M&M & Dolphy D'Souza of EY Companies), YouTube (IndiaBizLaw, Oct. 10, 2020), <https://www.youtube.com/watch?v=n83QeNN6bGk>.

<sup>333</sup> Kirthana Singh Khurana, Related Party Transactions in India – The Need for a Regulatory Revamp, in Changing Paradigm of Corporate and Commercial Laws 59 (Yogendra Kumar Srivastava & Ankit Singh eds., Taxmann Publications, 2021).

<sup>334</sup> K. Brahma, Legal Analysis of Related Party Transactions in the BRICS Countries, 11 BRICS L.J. 4, 4–31 (2024), <https://doi.org/10.21684/2412-2343-2024-11-1-4-31>.

<sup>335</sup> Anand and Anand, Growing Need for Compliance with the Related Party Transaction Norms, Lexology (Nov. 4, 2020), <https://www.lexology.com/library/detail.aspx?g=fa37a743-1674-4389-94cc-04a7bbd10f92>.

<sup>336</sup> Ibid



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