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# Impact of Related Party Transaction on Corporate Governance: Indian Scenario

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## ABSTRACT

*Transaction between two or more companies, primarily where the parties have some sort of relationship with one another can be termed as a related party transaction. Contractually, such transaction is in favour of party autonomy but from company law point of view it can raise concerns as the corporate governance standards will not be followed. Companies must adhere to the corporate governance standards which ensures utmost fairness and transparency in the internal proceedings and compliance with the existing laws. Since related party transaction goes against the principle of merit-based transaction, it will most likely result in breach of stakeholders right and common interest of the company.*

*The existing law requires the companies to disclose in its Board report about the related party transaction highlighting its benefit for the company and stakeholders, thereafter it has to be ratified by the shareholders in the company's Annual General Meeting. But in practise there are several instances of suspicious transaction wherein necessary approval is not obtained and it further leads to poor corporate governance.*

*In India, there has been a rise in such transactions, mostly by the entities which are controlled by a group of family members. There is also high level of risk factor involved in it. For instance, if two companies are managed by two siblings then there is a possibility of selling and buying products below the market price, affecting other people or participants in the market.*

*This article seeks to provide an insight on related party transaction while addressing the impact and risk associated and how it violates the key principles of corporate governance. In the later part of this paper, there would be a case study analysis on the IndiGo crisis.*

**Keywords:** *Related party transaction, Stakeholders, Corporate Governance.*

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## I. INTRODUCTION

The term ‘related party’<sup>2</sup> has been defined under the Companies Act, 2013. Such person must be some way or the other related to the director, firm, key managerial personnel which includes the Board of directors. Similarly, the term ‘relative’ connotes that the parties are spouses or are members of a Hindu Undivided Family or related to each other in a certain prescribed way.<sup>3</sup> Companies indulge in various transaction, but when such exchange of goods, services, asset takes place between related parties, then it leads to exertion of control by one party over the other. No doubt that party autonomy must be upheld but, in the meantime, the principal of corporate governance reflecting transparency, disclosures, fairness gets affected. Corporate Governance being a process within the company requires continuous evaluation and commitment. Similarly, directors of the company are agents to the shareholders and are expected to represent, act on their behalf since they are appointed by the shareholders. In cases of dispersed ownership there is a conflict between directors and shareholders whereby the directors work in accordance to their personal interest, and avoid acting for the best interest of the shareholders. This can be a type of agency problem. When such conflict exists internally among the principal and agents of the company then the regulators pressurise. Related party transaction even goes against the stakeholder theory which has been codified under Companies Act of 2013. Section 166 states that it is the duty of directors to accommodate interest of all the stakeholders.

## II. ARM’S LENGHT TRANSACTION

Transaction which are entered by the parties only on basis of merit without involving any other consideration, can be termed as Arm’s length transaction. Here, the parties act in their independent capacity in order to achieve their self-interests. Unlike related party transaction, the buyer and seller do not influence one another and it ensures a fair deal without prior relation and manipulation. Corporate governance standards are not hindered in arm’s length transaction as there is prior ‘Consensus Ad Idem’ between the parties. Neither does the market expectation gets hampered as independent negotiators are involved and all the aspects of the deal have been mentioned in the report.<sup>4</sup>

## III. SECTION 188 OF COMPANIES ACT, 2013

Under Section 188, it is enshrined that consent of Board of directors given by a resolution at

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<sup>2</sup> Companies Act, 2013; S. 2(76) (hereinafter CA)

<sup>3</sup> CA, 2013; S. 2(77)

<sup>4</sup> Jean Murray, *What is an Arm’s Length Transaction?*, The Balance SMB, October 30, 2020

the Board meeting, subject to Companies (Meeting of Board and its Powers) Rules 2014, is required before the company enters into any contract or arrangement with a related party. Approval of Audit Committee has to be there. But in instances where the transaction is done on an arm's length basis during ordinary course of business, then the above requirement is not essential. Where two government companies enter into a transaction or in cases of transaction between holding company and wholly owned subsidiary, there is no obligation to pass any resolution. Apart from that, the directors shall make a disclosure regarding his interests in any company or companies, firms, body corporate or other individual associations in the first Board meeting. If any contract or arrangement is not disclosed by the director then it will be voidable at the option of the company concerned.<sup>5</sup> Further, all the details of the contract entered has to be given in the Board report and it has to be ratified in the Annual General meeting by the shareholders, keeping in mind the beneficial basis. But in reality, there is no certain prescribed format for reporting related party transaction by the company and hence the law is not followed in its entirety. It is also traced that the companies do not mention the details of the company with whom they have contracted or entered into transaction. Shareholders rely on least information while making investment or voting in matters of related party transaction which is provided to them via Annual Report. Independent advisors and their opinions are required to guide the shareholders while making a decision.

Related party transaction covers both contract and arrangement. While contract can be oral or written, arrangement need not be binding.

#### **IV. RPT FOR LISTED COMPANIES**

In listed companies, public interest and public money is at stake. With that comes higher degree of compliance with corporate governance. Substantial stakeholder interest comes first and has to be protected. Therefore, SEBI<sup>6</sup> regulates those transaction where one party to the transaction is a listed company or entity.

While transaction between two or more unlisted entities is regulated by Ministry of Corporate Affairs. Under SEBI Listing Obligation and Disclosures Requirements (LODR) Regulations, 2015, related party transaction indicates the transfer of resources, services and obligations between a listed entity and any related party.<sup>7</sup> Meanwhile, it is also a prerequisite for listed entities to form policy regarding the materiality of related party transaction, which has to be

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<sup>5</sup> CA, 2013; S. 184

<sup>6</sup> The Securities and Exchange Board of India

<sup>7</sup> LODR, 2015; Regulation 2(1)(zc)

approved by the audit committee.<sup>8</sup> In its simplest sense, a transaction is said to be material when it is good enough to draw the attention of regulators. Additionally, the Kotak Committee recommendations along with a Working Group to look over provisions of LODR Regulations regarding related party transaction were implemented by SEBI. Mainly the provisions aim towards restricting abusive related party transactions, but the regulators are in the opinion that such provision is not enough.

## **V. STAKEHOLDER CAPITALISM AND PLURALIST APPROACH**

Companies value their reputation and perception, and the Articles of Association ensures that companies are doing business while following the provisions of law. All the stakeholders add value and are associated with the company either directly or indirectly. The stakeholders theory highlights company's larger responsibility towards the stakeholder rather than just the shareholders. In India, we follow the pluralist approach wherein it is duty of the directors to act in good faith, to benefit the company and all the stakeholders.<sup>9</sup> Stakeholder capitalism can only be achieved when the Company through its directors work in good faith and practise due diligence to avoid risk of loss. Primarily, it means to take reasonable care when planning to do business with other company by conducting examination and investigation. Here, the role of Independent directors is crucial to lead a neutral and fair decision. Section 149 is the codified version of Corporate governance which mandates the companies to have Independent directors in the Board.

## **VI. THEORIES OF CORPORATE GOVERNANCE**

As discussed earlier, when agents (directors) do not work on behalf of their principal (shareholders) then it leads to agency conflict. Directors enter into related party transaction to pursue self interest, which affects the interest of the principal. In few cases, the transaction is not disclosed in proper format.

Likewise, Stewardship theory which is an alternative to agency theory provides that the company executives should work in collaboration and add value for the company and shareholders. Collaboration is preferred over competition in order to maximize shareholder's wealth and profit. But in contrary, the agents pursue their own interest under related party transaction and are influenced by the transacting company.

In Transaction cost theory, transaction of high value entered by the company calls for greater compliance.

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<sup>8</sup> LODR, 2015; Regulation 23

<sup>9</sup> CA, 2013; S. 166(2)

## **VII. INDIGO CRISIS: CASE STUDY**

Interglobe Aviation Limited, a listed company which runs the IndiGo airlines was started by two promoters of the Company namely; Rahul Bhatia and Rakesh Gangwal. A shareholding agreement was entered into by both the promoters. Soon after incorporation of the company, both of them took the position as executive directors. Business was running at a smooth pace until the company went for an Initial Public Offer in the year 2015 after which the shareholding pattern changed consequently due to business expansion.

Rakesh Gangwal made certain allegations regarding the clauses which seemed to be biased and were in favour of Rahul Bhatia, who got to appoint Managing Director, Chairman of Board and other officers. Additionally, Rahul Bhatia had also entered into related party transaction, without any approval of the audit committee and Board of directors.

Thereafter, Rakesh Gangwal approached SEBI to seek relief as Interglobe Aviation Limited was a listed entity, and notice was issued by SEBI to Rahul Bhatia and other associate companies. Ministry of Corporate affairs got involved as well under purview of Section 206 of the Companies Act, 2013.

To this, Rahul Bhatia rebutted that he obtained the consent and the transaction was continuing over the years but no objections were made. Again the policy of the company with respect to related party transaction was reviewed and settled in the Annual General Meeting.

The matter did not go for litigation and was settled internally within the company.

## **VIII. CONCLUSION**

For overall benefit of the company, related party transaction until and unless extremely crucial, must be avoided. There is a need for prescribed method and format to report such transactions and disclosure of complete identity of the parties, which will guarantee credibility and fairness. It is also advisable for each company to have a broad shareholding so that company's transaction is not influenced and controlled by dominant majority, as often is the situation in family controlled business. Strict enforcement of law can act as a deterrence mechanism to curb abusive related party transaction. Furthermore, all the transactions have to be in line with the prevailing market scenario. With that, the interest and rights of all the stakeholders should be prioritized.

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