



Interpreting "Contract or Arrangement" under Section 188 vs. "Related Party Transaction" under SEBI LODR: Scope, Overlaps, and Approval Mechanics

Transactions with Related Parties or Related Party Transactions ("RPTs") are governed by both Companies Act, 2013 ("the Act") & the SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 ("LODR"). Although both regimes seek to regulate transactions involving related parties and protect the interests of shareholders and stakeholders, they differ in their statutory language, scope, triggering conditions and approval mechanisms. There are also overlaps in both the regimes relating to RPT provisions and also certain distinct points which make these regimes different from one another. Consequently, while the two regimes substantially overlap, compliance with one regime cannot ordinarily be treated as a substitute for compliance with the other.

Scope:

Section 188 of the Act uses the words "contracts or arrangements" which specifically deals with seven types of transactions viz.:

- (a) sale, purchase or supply of any goods or materials;
- (b) selling or otherwise disposing of, or buying, property of any kind;
- (c) leasing of property of any kind;
- (d) availing or rendering of any services;
- (e) appointment of any agent for purchase or sale of goods, materials, services or property;
- (f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
- (g) underwriting the subscription of any securities or derivatives thereof, of the company:

Whereas, under the purview of LODR, RPTs have a broader meaning. Regulation 2(1)(zc) of LODR defines RPT as "RPT means a transaction involving a transfer of resources, services or obligations between:

- (i) a listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or
- (ii) a listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries"

The scope of section 188 of the Act is narrower than Regulation 23 of SEBI LODR. Section 188 is principally concerned with contracts or arrangements entered into by the company with its related parties, whereas regulation 23 expressly extends the RPT approval framework to

specified transactions in which a subsidiary of the listed entity is a party, even where the listed entity itself is not a party. Under LODR, monitoring of transactions of the subsidiaries of the listed entity is also necessary to ensure compliance with the regulatory requirements. The audit committee of listed entity shall give approvals for transactions where the subsidiary of the listed entity is a party, but the listed entity is not a party subject to the value of transaction crossing the thresholds as mentioned in regulation 23(2)(b) & (c) of LODR. Further, any transaction which is an RPT would be subject to the provisions of LODR unlike the specific nature of transactions provided for in the Companies Act. Transactions which are in the ordinary course of business & on an arm's length basis are excluded from the requirement of approval of the Board of Directors under Companies Act. However, any transaction, irrespective of it being in the ordinary course of business or not and on an arm's length basis or not is subject to approval of Audit Committee under LODR.

Overlaps:

Section 188 of the Act and Regulation 23 of LODR regulate substantially overlapping categories of related-party dealings, particularly goods, property, leases and services, and both impose governance, approval, voting and disclosure safeguards. Even though there are significant distinctions between both the regimes, primarily the object is same and therefore certain provisions overlap each other. As per regulation 2(1)(zb) of LODR, "related party means a related party as defined under sub-section (76) of section 2 of the Companies Act, 2013 or under the applicable accounting standards:

Provided that:

- (a) any person or entity forming a part of the promoter or promoter group of the listed entity; or
 - (b) any person or any entity, holding equity shares:
 - (i) of twenty per cent or more; or
 - (ii) of ten per cent or more, with effect from April 1, 2023;
- in the listed entity either directly or on a beneficial interest basis as provided under section 89 of the Companies Act, 2013, at any time, during the immediate preceding financial year; shall be deemed to be a related party."

The overlap between these two regimes starts from the definition of related party itself. The most prima facie overlap is regarding the nature of transactions. Even though LODR is not exclusive regarding the transactions, all types of contracts or arrangements u/s 188 of the Act can be covered under LODR. Both the regimes require shareholders' approval for entering into RPTs which are above a specified threshold which are known as material RPTs. There are different mechanisms under the Act and LODR for determining which transactions are material. Rule 15(3) of Chapter XII of the Act specifies which transactions will be classified as material. Similarly, Schedule XII of LODR specifies the turnover based thresholds for determining material RPTs.

Both the regimes have provisions granting omnibus approval for transactions which are repetitive in nature. The omnibus approval is valid for a period of one financial year. Where the transaction is unforeseeable, Audit Committee has power to grant omnibus approval subject to the limit of ₹1 Crore per transaction. Where, the Company enters into a transaction which was not approved prior to entering such transaction, the Board or the shareholders as the case may be, have the power to ratify the transaction within a period of 3 months of entering into a contract or arrangement under Section 188. Otherwise, such contract or arrangement shall be voidable at the option of the Board or as the case may be, of the shareholders and if the contract or arrangement is with a related party to any director, or is

authorised by any other director, the Directors concerned shall indemnify the company against any loss incurred by it. Similarly, failure to seek ratification of the Audit Committee within three months from the date of transaction or in the immediate next Audit Committee meeting subject to some other conditions shall render the transaction voidable at the option of the audit committee and if the transaction is with a related party to any director, or is authorised by any other director, the director(s) concerned shall indemnify the listed entity against any loss incurred by it as per provisions of LODR.

Both regimes restrict the participation of interested related parties in shareholder approvals. Section 188 restricts a related-party member from voting on the resolution approving the relevant contract or arrangement, while Regulation 23 restricts related parties from voting on resolutions approving material RPTs. Also, both the regimes expressly mention that while determining whether a RPT is actually material, the value of transaction should be determined either on the basis of individual transactions or transactions taken together with the previous transactions during a financial year.

In Linde India Limited v. SEBI, Securities Appellate Tribunal (SAT), the key issue was whether, for determining the materiality threshold under Regulation 23(1) of the LODR, transactions with a related party should be assessed contract-by-contract or by aggregating all transactions with that related party during the financial year. SAT held that all transactions with the relevant related party during the financial year must be aggregated for determining whether the materiality threshold is crossed. Similarly, Companies Act uses the words “transactions to be entered into either individually or taken together with the previous transactions during a financial year.” This clearly highlights that the provisions of Section 188 & the provisions of Regulation 23 are somewhat overlapping with one another.

Approval Mechanics:

Companies Act, 2013:

Beginning with Companies Act, 2013, section 188(1) of the Act starts with “Except with the consent of the Board of Directors given by a resolution at a meeting of the Board”. It means that if a Company has to enter into any contract or arrangement as specified in section 188, with a related party, approval of the Board of Directors is mandatory. Further, the approval of the members may also be required if the proposed RPT is material in terms of rule 15(3) of Chapter XII. The fourth proviso to section 188(1) provides exemption for transactions which are in ordinary course of business and on an arm’s length basis. Also, any material transaction 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 is exempt from obtaining shareholders’ approval as per fifth proviso to section 188(1).

Section 188 does not mention anything about approval of audit committee for entering into RPTs. However, as per section 177(4)(iv) of the Act, the audit committee has to approve any transaction or subsequent modification thereof to the transactions with related parties. Also, it is the audit committee who has the power to grant omnibus approval for RPTs.

As a result, approval of audit committee is mandatory for all RPTs. Approval of Board is required for entering into any contract or arrangement u/s 188(1) which are not in ordinary course of business and not on arm’s length basis and approval of shareholders is required only for material RPTs. Rule 6A & rule 15 of Chapter XII specify the information required to be placed before the audit committee, the Board of Directors and the shareholders while

placing the RPT for approval. In case of companies where the constitution of audit committee is not applicable, then the duties may be discharged by the Board of Directors.

SEBI LODR, 2015:

Moving on to LODR, as per provisions of regulation 23(2) all related party transactions and subsequent modifications shall require prior approval of the audit committee of the listed entity and only those members of the audit committee who are Independent Directors shall approve the RPTs. Transactions where the subsidiary of the listed entity is a party but the listed entity is not a party and the transaction is above the prescribed thresholds of regulation 23, it shall also be approved by the audit committee of the listed entity unless and until the provisions of regulation 23 also apply to the subsidiary which is also a listed entity.

Any RPT which is material as per the turnover based thresholds mentioned in the Schedule XII of LODR, has to be approved by the shareholders of the listed entity. This applies to any sort of RPT and is not exclusive to specific transactions like section 188. Under LODR, there is no provision requiring the approval of Board of Directors for RPTs. It means that the audit committee is the only authority for giving approvals for RPT including omnibus approvals except in the cases of material RPT.

Regulation 23(2)(e) states that “remuneration and sitting fees paid by the listed entity or its subsidiary to its director, key managerial personnel or senior management, except who is part of promoter or promoter group, shall not require approval of the audit committee provided that the same is not material in terms of the provisions of sub-regulation (1) of this regulation.” Accordingly, if remuneration or sitting fees is to be paid to any director or key managerial personnel or member of senior management who is a part of promoter or promoter group, then audit committee approval is mandatory. **Now whether approval of audit committee would be required if remuneration or sitting fees is being paid to someone who is not a part of promoter or promoter group?** After plain reading of LODR, it would be inferred that approval of audit committee wouldn't be required. However, when reading LODR & Companies Act together, the transaction must separately be examined under Section 177(4)(iv) of the Companies Act, which independently requires Audit Committee approval of transactions with related parties. An exemption under LODR does not necessarily eliminate a Companies Act obligation.

Similar to how under the Companies Act, 2013, the rules under Chapter XII provide for the minimum information to be placed while approving RPTs, for listed entities, there are Industry Standards on “Minimum information to be provided to the Audit Committee and Shareholders for approval of Related Party Transactions” (ISF). Where the value of transactions is above ₹1 Crore, then minimum information as per the ISF Circular shall be placed before the audit committee. The ISF Circular contains minimum information to be placed for all types of RPTs, specific types of RPTs and material RPTs. Transactions falling below the applicable threshold are not thereby exempt from all RPT compliance; the underlying requirements of the Companies Act and LODR must continue to be examined independently.

Conclusion:

Section 188 of the Companies Act, 2013 and the SEBI LODR Regulations operate in overlapping but distinct fields. The two regimes therefore share common objectives and several approval and governance mechanisms, but their scope, thresholds, exemptions and consequences are not identical. In particular, the ordinary-course and arm's-length exclusion

under Section 188 cannot, by itself, remove a transaction from the ambit of Regulation 23. Similarly, compliance with the approval requirements under one regime should not be regarded as automatically satisfying the requirements of the other. the appropriate approach is to undertake a parallel analysis under both the statutory regimes rather than treating either framework as a substitute for the other.

- Shubham S. Pathak

References:

1. Linde India Limited v. SEBI, Securities Appellate Tribunal (SAT).
2. The Companies Act, 2013.
3. Securities and Exchange Board of India (Listing Obligations & Disclosure Requirements) Regulations, 2015.