RELATED PARTY TRANSACTIONS: EMPOWERING BOARDS AND MINORITY SHAREHOLDERS TO PREVENT ABUSES

Ami Galani* and Nathan Rehn**

Related party transactions can be legitimate and value-enhancing for a corporation, but they can also serve as a vehicle for illegitimate expropriation of corporate value by management or controlling shareholders. Related party transactions assume greater significance in a market context where there is high promoter ownership in group companies and a prevalence of listed companies under promoter-controlled groups. Abuses of related party transactions have been linked to negative consequences to minority investors in Indian companies, and have played a key part in some high-profile cases of corporate fraud. Currently, the Indian legal regime does not contain adequate safeguards for preventing abuse of related party transactions. This paper describes this problem in a comparative framework, examines disclosure regarding related party transactions contained in the annual reports of some of India's largest public companies, and makes several proposals for regulatory reform.

* Associate Attorney, Hogan Lovells US LLP; Jindal Global Teaching Fellow, Jindal Global Law School

** Assistant Professor, Jindal Global Law School.

In Part I, this paper discusses the problem of related party transactions from a theoretical perspective. Part II provides a brief overview of the Indian legal regime covering related party transactions, and Part III compares Indian law with the law in several other countries. In several key areas, Indian law comparatively provides ineffective safeguards against abuse of related party transactions. Part IV of the paper examines the disclosure about related party transactions in several annual reports from some of the largest public companies in India. Our examination reveals that disclosures do not provide adequate information, especially when compared to similar types of disclosures in other jurisdictions. Finally, in Part V the paper makes several proposals for legal reform to afford minority investors greater protection from abusive related party transactions. The paper proposes that minority investors will be more effectively protected through the adoption of clearer legal standards regarding disclosure, as well as measures requiring approval of different categories of related party transactions by the audit committee, by a special committee of disinterested directors, or by a vote of disinterested shareholders.

I. Related Party Transactions: An Introduction to the Problem

In recent years, a number of observers have noted that abuse of related party transactions is a significant concern for corporate governance reformers in Asian countries in general, and in India in particular.[1] The problem is rooted in two aspects of the ownership structure of Indian companies. First, there is high concentration of ownership, which gives particular individuals or families actual or effective control of most companies, even publicly traded companies. A 2007 study found that

> the average BSE 100 company has a promoter who owns over 48% of the company. Only ten of the BSE 100 companies have promoters holding stakes below the critical 25% threshold. Looking at the broader BSE 500 set of companies produces similar results: the average promoter owns roughly 49%, and fewer than 9% of promoters have stakes below 25%.[2]

If anything, this estimate probably represents an understatement of the degree of concentration, as a percentage of promoter ownership is "often hidden in the form of other corporate bodies or individual shareholders."[3] Second, a large number of companies in India are grouped together under the common

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1 OECD, Guide on Fighting Abusive Related Party Transactions in Asia, September 2009 [hereinafter "OECD Report"]; Asian Corporate Governance Association, ACGA White Paper on Corporate Governance in India, January 2010 [hereinafter "ACGA White Paper"].

2 Shaun Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, 3 Colum. Bus. L. Rev. 800, 833 (2007). Note that the concept of "promoter", while somewhat muddy in Indian law, has a very similar meaning to the concept of "controlling shareholder", as that term is generally used in the corporate governance literature. *See* Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) Nat. L. Sch. Ind. Rev. 1, 16 n. 76 (2009) (using words "promoter" and "controlling shareholder" interchangeably).

3 Afra Asharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 Nw. J. Int'l L. & Bus. 335, 364 (2009). *See also* K.S. Chalapati Rao & Atulan Guha, *Ownership Pattern of the Indian Corporate Sector: Implications for Corporate Governance* 1, 11, Insti. for Stud. in Indus. Dev., Working Paper No. 2006/09, 2006, *available at* http://isidev.nic.in/pdf/wp0609.pdf; Rajesh Chakrabarti, *Corporate Governance in India – Evolution and Challenges* 11 (2005), *available at* http://ssrn.com/abstract=649857.

control of a single shareholder or family.[4] 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.

This pattern of ownership gives rise to serious potential for conflicts of interest between the promoter group and the minority investors. If the firm makes profits, the promoter group is required to share the firm's profits with the minority investors. But if the promoter can divert the resources to himself, or to another firm within the promoter group in which he has a higher share of ownership, then he will be able to capture a higher share of the firm's profits. One of the primary methods of diverting resources is to engage in self-dealing transactions that have the effect of shifting value from one firm to another within the promoter group.[5] This is a particular risk in an environment with a large number of business groups, in which a number of companies are controlled by the same individual or family. This might be done by such mechanisms as having group companies "give each other high (or low) interest rate loans, manipulate transfer prices, or sell assets to each other at above or below market prices, to name just a few."[6] Such strategies are frequently described as tunnelling, because they create channels by which value can flow from one firm to another.[7] One attempt to empirically evaluate the effects of tunnelling in Indian business groups came to the striking conclusion that tunnelling enables controlling shareholders to extract more than 25% of the marginal profits that would otherwise be shared with minority investors.[8]

Anecdotal evidence also provides some indication of the problem. Several recent corporate controversies in India have been connected to related party transactions. One example involves the Subhiksha retailing firm, which, facing

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4 Marianne Bertrand et al., *Ferreting Out Tunnelling: An Application to Indian Business Groups*, 117 Q. J. Econ. 121, 126 (2002) ("[G]roup firms in India are often linked together through the ownership of equity shares. In most cases, the controlling shareholder is a family . . . .").

5 *See* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263, 1307 (2009) ("In [shareholder controlled] companies, self-dealing transactions that involve controlling shareholders or their affiliates provide a principal channel for diverting value from the firm and its outside shareholders. The risk of value diversion through self-dealing is exacerbated when dominant families control a relatively large number of public companies through pyramids and other similar structures.")

6 Marianne Bertrand et al., *supra* note 4, at 122.

7 Marianne Bertrand et al., *supra* note 4, at 122.

8 Marianne Bertrand et al., *supra* note 4, at 122.

serious liquidity problems, has been seeking amalgamation with another company with the same promoter over the objections of minority investors and creditors. Additionally, the accounting fraud at Satyam Computer Services was revealed only after an attempt to acquire two other companies that were related to Satyam's founder and chairman.

A pervasive atmosphere of related party transactions can be problematic even if most such transactions are negotiated in good faith. Even if there are no transactions at all, the existence of relationships among companies may be sufficient to affect dealings with other parties, and thus merits disclosure.[9] Moreover, if there is a general lack of transparency regarding these transactions, then the perception of potential abuse can be just as damaging as the actual abuses that may occur. Thus, related party transactions do not merely pose the potential harm of direct expropriation of value from minority investors, but they can also reinforce negative perceptions of the country's capital markets as a whole, and lead to a general discounting of equity markets.[10] There is, therefore, a strong case for mandating disclosure and transparency regardless of whether related party transactions are used abusively or even at all.

The problem of related party transactions also illustrates some of the broader pitfalls in the method of legal transplantation that has been followed in Indian corporate regulation. The structure of Indian company law has traditionally borrowed from English and American models. The Companies Act of 1956 was largely based on the English law at the time,[11] and the recent adoption of Clause 49 followed a report by the Birla Committee that explicitly relied heavily on practices in the United States.[12] Much scholarship has been written on the concept of legal transplants, especially in the area of corporate law.[13] One of the leading criticisms of legal transplantation has been that laws designed for one economic, social, and institutional context are unlikely to be well-suited to an entirely different context. A transplant that is not suited to the needs of the recipient is unlikely to be effective.

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9 *See* Indian Accounting Standard 18: Related Party Disclosures [hereinafter "AS 18"], ¶ 17 (noting how a related party relationship may affect a company's behaviour even if no transactions occur).

10 OECD Report, 11-12.

11 Afra Asharipour, *supra* note 3, at 354.

12 Afra Asharipour, *supra* note 3, at 368.

13 For a critical discussion, *see* Umakanth Varottil, *supra* note 2. *See also* Daniel Berkowitz et al., *The Transplant Effect*, Am. J. Comp. L. 163 (2003) (providing statistical analysis of global phenomenon of legal transplantation).

Related party transactions offer a particularly salient example of this problem. The two countries that have been the primary source of inspiration for India's corporate law regime—the United States and the United Kingdom—are characterized by widely dispersed shareholding and a general lack of control relationships among different public companies.[14] One would generally not expect these legal regimes to place a great emphasis on mechanisms to prevent abuse of related party transactions. Therefore, related party transactions are an area where reformers may be well-advised to look to non Anglo-American models for inspiration. Two countries with similar experiences to India that have adopted stricter regulations concerning related party transactions are Singapore and Hong Kong, and this paper will pay special attention to these models.

II. Indian Law on Related Party Transactions

There are three primary sources of regulation covering related party transactions in India: the Companies Act, 1956, as amended; Clause 49 of the Listing Agreement of the stock exchanges, and Accounting Standard 18 issued by the Institute of Chartered Accountants of India. Each of these is discussed in turn below.

A. The Companies Act

1. Sections 299 and 300: Disclosure and Abstention by Interested Director

Sections 299 and 300 of the Companies Act provide the principal restrictions on related party transactions. These sections cover all existing and proposed contracts or arrangements with the company in which a director is "in any way", "directly or indirectly" interested or concerned.[15] Section 299 requires disclosure to the board of directors of a director's interest in a contract or arrangement, and section 300 requires an interested director to abstain from voting on the contract or arrangement in question. While these two sections encompass a broad array of related party transactions, the actual requirements in these sections are relatively relaxed and have significant loopholes and exceptions.

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[14] *See* Varottil, *supra* note 2, at 21:

> Any problems with regard to transplantation of these corporate governance concepts are exacerbated by the differing political, social and economic considerations that operate in these two sets of jurisdictions, namely the U.S. and U.K. (the outsider system) on the one hand, and India (an insider system) on the other.

[15] The Companies Act, 1956, No. 1 of 1956, §§ 299-300 [hereinafter "Companies Act"].

Section 299 requires any director of a company who is concerned or interested in a contract or arrangement with the company to disclose the interest to the board of directors.[16] However, section 299 only requires a "general notice" to the effect that the director is a director or member of a specified entity and should be regarded as interested in the contract or arrangement in question.[17] Section 299 expressly provides that such a general notice shall be sufficient, thus making any detailed disclosure, including the nature or extent of the concerned director's pecuniary interest, voluntary.[18]

Section 299 also exempts any contract between two companies where any of the directors of the one company hold 2% or less of the paid-up share capital in the other company.[19] The use of the word "hold" here appears to suggest only the concept of direct ownership, especially when compared to language used in other sections of the Companies Act that include a broader concept closer to "beneficial ownership."[20] The limited nature of the language here raises concerns. Considering the complex structures of promoter group ownership in India, section 299 may exempt a large body of transactions in which a director is directly or indirectly interested if the director directly owns less than 2% of the shares of the other company.

Section 300(1) of the Companies Act prohibits a director from taking part in the discussion of, or vote on, any contract or arrangement entered into by the company if he is concerned or interested in the contract or arrangement.[21] Section 300 covers the same set of related party transactions covered by section 299. Pursuant to section 300, the presence of an interested director at a meeting will not be considered for determining whether quorum has been established, and a vote of an interested director will be void.[22] The provisions of section 300 are subject to similar limitations as those in section 299. For example, section 300 does not apply to a contract with another public company—or a subsidiary of a public company—if the interest of the director consists solely of (i) his being a

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16 Companies Act, 1956, No.1 of 1956, § 299(1).

17 Companies Act, 1956, No.1 of 1956, § 299(3)(a).

18 *Id.* The notice provided expires annually and may be renewed annually. Companies Act, 1956, No.1 of 1956, § 299(3)(b).

19 Companies Act, 1956, No.1 of 1956, § 299(6).

20 *See, e.g.*, § 247, describing ownership of a company as being "financially interested in the success or failure" of the company, or "able to control or materially to influence the policy of the company". Companies Act, 1956, No.1 of 1956, § 247.

21 Companies Act, 1956, No.1 of 1956, § 300(1).

22 *Id.*

director of such company and holder of not more than the requisite number of shares to qualify him for a directorship[23] or (ii) in his holding not more than 2% of its paid-up share capital.[24] As with section 299, this language potentially exempts a variety of transactions in which the director or his family have large interests at stake through more complicated ownership structures. The penalty for a violation of section 299 or section 300 is a fine of up to fifty thousand rupees.

2. Additional Relevant Provisions of the Companies Act

In addition to sections 299 and 300, several other provisions of the Companies Act address related party transactions. Section 297 requires that the board of directors approve certain transactions, subject to a few exceptions.[25] This section requires board consent to any contract for the sale, purchase or supply of any goods, material or services between the company, and a director, a director's relative, or an entity in which such director or relative may have a directorship, partnership or membership.[26]

Section 295 prohibits a public company from providing a loan, a guarantee, or any security in connection with a loan made by or to any of the parties governed by section 297, as well as any entity in which a director or two or more directors of the concerned company exercise or control at least 25% of the total voting power; and any entity the board of directors, the managing director or manager of which is accustomed to act in accordance with the directions of the board of directors, or any director(s), of the concerned company.[27]

The company may seek prior approval from the Central Government for a transaction that would otherwise violate section 295.[28] Notice of approval is not required and presumably, public information of such approval is not available unless voluntarily provided by the company. A penalty for a violation of section 295 may include up to six months imprisonment, if any amount of the loan is still outstanding, and fifty thousand rupees.[29]

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23 Companies Act, 1956, No.1 of 1956, § 300(d)(i).

24 Companies Act, 1956, No.1 of 1956, § 300(d)(ii).

25 Companies Act, 1956, No.1 of 1956, § 297.

26 Companies Act, 1956, No.1 of 1956, § 297(b). Note that the set of related parties in s. 297 is substantially broader than the set of parties in §§ 299 and 300.

27 Companies Act, 1956, No.1 of 1956, § 295(1).

28 Companies Act, 1956, No.1 of 1956, § 295(1).

29 Companies Act, 1956, No.1 of 1956, § 295(4).

Under section 301, every company is required to keep a register of the particulars of all contracts or arrangements to which section 297 or section 299 apply. The register must be signed by the board of directors and include date of each contract or arrangement, names of the parties, the principal terms and conditions, and the names of the directors voting for or against the contract or arrangement.[30] The company must make the register available for inspection by any member of the company.[31] Defaults in maintaining the register may be penalized up to five thousand rupees.

B. Clause 49

Clause 49 of the Listing Agreement for all stock exchanges in India [hereinafter "Clause 49"] provides both requirements and suggestions regarding related party transactions by listed companies.[32] Clause 49 addresses related party transactions in four areas: role of the audit committee, disclosure of related party transactions to the audit committee, disclosure of management related party transactions to the board of directors, and suggested disclosure of related party transactions to shareholders in annual reports.

The term "related party transaction" is defined by reference to Accounting Standard 18 [hereinafter "AS 18"] issued by the Institute of Chartered Accountants of India.[33] Though discussed further below, it should be emphasized that the definition of "related party transaction" in AS 18 is limited to relationships in which one party controls the other. AS 18's definition of "related party transaction" does not include transactions between companies under common control.[34] Because Clause 49 incorporates the definitions in AS 18, the oversight and disclosure requirements of Clause 49 may not apply to a large number of transactions between sibling companies within the promoter group.[35] This

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30 Companies Act, 1956, No.1 of 1956, § 301(1)-(2).

31 *Id.*

32 Clause 49 of the Listing Agreement is required by the Securities and Exchange Board of India (SEBI), and was introduced in February 21, 2000.

33 BSE Listing Agreement Clause 49 [hereinafter "Clause 49"], § II(D), Explanation (ii).

34 AS 18, ¶ 10. *See*, *infra* note 43 and related discussion.

35 Elsewhere, the Listing Agreement uses "Promoter" and "Promoter Group" as defined in the Disclosure and Investor Protection Guidelines of 2000, as amended. BSE Listing Agreement, Clause 35 and Clause 40A. "Promoter" means "(a) the person or persons who are in over-all control of the company; (b) the person or persons who are instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public; (c) the persons or persons named in the prospectus as promoters(s)." SEBI (DIP) Guidelines of 2000 (last updated August 20, 2009) § 6.8.3.2, Explanation I.

presents a significant regulatory gap with respect to transactions between parties within a promoter group that may not be on an arm's length basis and present opportunities for promoter tunnelling of company resources from one company to another, without any oversight by the reporting company's Audit Committee.

Section II(D) of Clause 49 requires that the role of the Audit Committee include reviewing annual financial statements, with a particular reference to related party transactions, before submission to the board of directors.[36] Section II(E) also requires that the Audit Committee review a statement of significant related party transactions, a term that is defined as the Audit Committee determines, submitted by management.[37] Clause 49 does not require the Audit Committee to review related party transactions prior to entry into them, nor does it require pre-approval of related party transactions by the Audit Committee.

Section IV(A) of Clause 49, however, does require that certain related party transactions be disclosed to the Audit Committee. First, management must periodically place a statement, in summary form, of related party transactions in the ordinary course of business before the Audit Committee.[38] Second, management must provide details of material individual transactions with related parties which are not in the normal course of business.[39] Finally, management "should" provide details of material individual transactions which are not on arm's length basis to the audit committee, together with a justification of those transactions.[40] Based on the language alone, it is unclear whether this

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"Promoter Group" generally means

(a) the promoter, (b) an immediate relative of the promoter, (c) in case promoter is a company: (i) a subsidiary or holding company of that company; (ii) any company in which the promoter holds 10% or more of the equity capital or vice versa; (iii) any sibling company in which a group that holds at least 20% of the equity of the listed company also holds at least 20% of the equity, (d) in case the promoter is an individual: (i) any company in which at least 10% of the equity is held by the promoter, an immediate relative of the promoter, or a firm or Hindu Undivided Family ("HUF") in which the promoter or any one or more of his immediate relative is a member; (ii) any company in which a company specified in (d)(i) above, holds at least 10% of the equity; (iii) any HUF or firm of which the promoter and his immediate relatives own at least 10%.

SEBI (DIP) Guidelines of 2000 (last updated August 20, 2009), s. 6.8.3.2, Explanation II.

36 Clause 49, § II(D)(4)(f).

37 Clause 49, § II(E)(2).

38 Clause 49, § IV(A)(i).

39 Clause 49, § IV(A)(ii).

40 Clause 49, § IV(A)(iii).

last item is mandatory, as with the first two disclosure requirements, or simply suggested disclosure, though this item covers a category of related party transactions (material and not on arm's length) that raise particular need for independent oversight.

In addition to the Audit Committee, the Board of Directors is also entitled to certain disclosure about related party transactions pursuant to Clause 49. Section IV(F) of Clause 49 requires senior management to disclose to the board of directors all material financial and commercial transactions in which they are interested or have potential conflict of interest with the company at large.[41] Senior management does not include directors, but includes management and all functional heads. Because this section does not cover directors,[42] and no other section of Clause 49 requires directors to disclose their interest in transactions, section 299 of the Companies Act, which requires only a general notice stating that an interest exists, is the only legal requirement for a director to disclose his or her interest.

While Clause 49 does not require a company to disclose related party transactions to shareholders, section VI of Clause 49 does require that the company include a separate section on corporate governance in its annual report.[43] Annexure I C of Clause 49 provides forty-eight suggested items for inclusion in the report on corporate governance, including disclosure of materially significant related party transactions that may have potential conflict with the interests of the company at large.[44] Given the vagueness of this language, and the fact that a company may choose to disregard the suggestion altogether, one would not expect the disclosures under this section to offer much useful information to investors.

C. Accounting Standard 18

AS 18 requires a company to report related party transactions and related party relationships in its financial statements.[45] Under AS 18, parties are

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41 Clause 49, § (IV)(F)(ii).

42 Clause 49, § (IV)(F), Explanation.

43 Clause 49, §(VI)(i).

44 Companies must also submit a compliance report to the stock exchanges, identifying whether they have included a corporate governance report in their annual report. But the company satisfies this requirement by simply checking "yes" on the provided form, without any information on which of the 48 suggested items were included. BSE Listing Agreement, Clause VI(i) and Annexure- I C.

45 AS 18, ¶ 21, 23.

considered to be related if "one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions."[46] As previously mentioned in the discussion of Clause 49, this language has critical gaps. For example, consider a transaction between two companies, both within the promoter group, one a listed company in which the promoter controls 51% of the total voting power of the company, and the other a private company in which the promoter controls 80% of the total voting power of the company. This would not constitute a "related party transaction" under AS 18 unless one company had the ability to control, or exercise significant influence over, the other company.[47] As a result, no disclosure would be required of transactions between such companies.

There is another section of AS 18 that mentions enterprises under common control, which has led some observers to mistakenly suggest that AS 18 requires disclosure of transactions between related companies that do not have a control relationship.[48] But the actual disclosure required by AS 18 is limited to relationships in which one party controls or exercises significant influence over the other. In contrast, International Accounting Standard 24 [hereinafter "IAS 24"] issued by the International Accounting Standards Board includes a substantially broader definition of "related party" that would include sibling companies that do not have a control relationship between them, family members, joint venture partners, and other parties that may be related without a direct control relationship.[49] As a result, IAS 24 requires significantly greater disclosure about related party transactions than AS 18.

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46 AS 18, ¶ 10. "Control" is defined as (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

"Significant influence" is defined as "participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies." *Id*. AS 18 provides further guidance in these definitions. AS 18, ¶11-13.

47 AS 18, ¶ 10.

48 *See* AS 18, ¶ 3. This paragraph mentions both entities under common control, and entities over which a major shareholder of the reporting entity also exercises control. But ¶ 3 does not define the scope of required disclosures. The operative definition of "related party", in ¶ 10 of AS 18 that is used to determine which related party transactions must be disclosed is significantly narrower than the language in ¶ 3. For an example of the misperception, see OECD Report, 17 (mistakenly citing ¶ 3 of AS 18 for definition of "related party").

49 International Accounting Standard 24, § 9.

AS 18 requires two broad categories of disclosure: (1) disclosure of the names of related parties and the nature of the relationship, regardless of whether there are transactions with the related parties; and (2) disclosure of certain details regarding transactions between related parties, including a description of the relationship, description of the nature of the transactions, as well as any other elements of the transaction necessary for an understanding of the financial statements.[50] An example provided to give guidance on what "other elements" should be disclosed is disclosure of the transfer of a major asset at an amount materially different from that obtainable on normal commercial terms.[51] AS 18 does not require the disclosure of the pricing of transactions. As a result, unless voluntarily reported by the company, general information disclosed pursuant to AS 18 would not indicate whether the transactions reported are on fair commercial terms.

III. Law on Related Party Transactions in Other Countries

A. United States

In the United States, there are three principal sources of regulation for related party transactions: state corporation law, federal securities laws, and stock exchange listing rules. It should first be noted, however, that the problems regarding related party transactions that arise in the United States are different from those in India. Public companies in the United States are characterized by dispersed ownership, which raises different regulatory concerns than in India, where ownership is concentrated with promoters.[52] Where ownership is dispersed, as in the United States, corporate abuses have involved management, instead of promoters or controlling shareholders, and have taken forms such as excessive compensation, stock option re-pricing, and insider trading. As a result, U.S. regulation focuses on curtailing management abuses based on stock transactions rather than potential promoter abuse, such as tunnelling. There is no one single set of international best practices for regulation of the corporate entity. Rather, it is important to tailor regulations to the needs of the domestic economy. Nonetheless, a brief review of the law in the United States provides a helpful framework for comparison.

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50 AS 18, ¶ 21 and ¶ 23.

51 AS 18, ¶ 25.

52 *See* Bebchuk & Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263, 1265-66 (2009).

53 Delaware General Corporation Law, as amended, § 144.

1. State Corporation Law

The General Corporation Law of the State of Delaware [hereinafter "DGCL"], the state where most corporations are organized in the United States and with the most robust judicial development of corporate law, an interested director or officer must disclose the material facts about the interest and the contract or transaction to the board of directors or board committee, or the shareholders if they are entitled to vote on the matter.[53] The matter must be approved by a majority of the disinterested directors.[54] The most notable difference from section 300 of the Companies Act is that the DGCL requires more fulsome disclosure of the nature of the director's interest and the transaction, whereas the Companies Act only requires a statement to the effect that an interest exists.

2. U.S. Securities Laws

A public reporting company in the United States is required to disclose any transaction during the completed fiscal year and any proposed transaction involving the reporting company in which a related person has a direct or indirect interest, where the amount involved exceeds USD 120,000 (around Rs. 54 lakhs).[55] This disclosure is required annually in the company's annual report or proxy statement for the annual meeting of shareholders.

Disclosure must include the names of the related persons, the nature, including approximate dollar value of the related person's interest, dollar value of the transaction, and other information that is material to investors.[56] Related persons include directors, director nominees, officers, principal shareholders,[57] and their respective family members. Reporting companies are also required to describe the company's policies and procedures for the review and approval of related party transactions and to identify any related party transactions that were entered into outside of the those policies and procedures.[58]

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54 *Id.*

55 Regulation S-K promulgated under the Securities Exchange Act of 1934, as amended [hereinafter "Regulation S-K"], Item 404(a). *See* Form 10-K, promulgated under the Securities Exchange Act of 1934, as amended, and Form Def 14A, promulgated under the Securities Exchange Act of 1934, as amended.

56 Regulation S-K, Item 404(a).

57 Principal shareholders that are considered related persons for purposes of the disclosure requirements are shareholders who beneficially own 5% of more of any class of voting securities. Regulation S-K, Item 404(a) and Item 403(a).

58 Regulation S-K, Item 404(b)(1) and (2).

3. New York Stock Exchange Listed Company Manual

The listing rules of the New York Stock Exchange addressing related party transactions primarily focus on equity issuances to, and trading by, directors, officers and other insiders. Listed companies are required to seek shareholder approval for equity compensation plans,[59] or any issuance of common stock or other securities convertible or exercisable for common stock, to a director, officer or substantial security holder[60] of the listed company, or any of their related parties,[61] if the number of shares of common stock exceeds 1% of the total common stock or voting power of the company.

With respect to related party transactions generally, the listing rules do not require special board approval or review of related party transactions.[62] However, the New York Stock Exchange has taken the position that the Audit Committee should be considered the appropriate body to review related party transactions.[63] The New York Stock Exchange has also taken the position that it will continue to review annual reports and proxy statements for related party transactions.[64]

B. Hong Kong and Singapore

1. Hong Kong

The Stock Exchange of Hong Kong has formulated clear rules regarding related party transactions, which are referred to as "connected transactions" in the Listing Rules of the Exchange. The goal of these rules is to "ensure that the interests of shareholders as a whole are taken into account" when the company enters into related party transactions.[65] The Rule defines "connected transactions," and then subjects them to an escalating set of requirements regarding disclosure and approval by disinterested shareholders, depending on the size and significance of the transaction.

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59 New York Stock Exchange Listed Company Manual, § 303A.08

60 A party with an interest of less than 5% of the common stock or total voting power outstanding will not cause the interest holder to be considered a "substantial shareholder". New York Stock Exchange Listed Company Manual § 312.04(e).

61 New York Stock Exchange Listed Company Manual, § 312.03. Related parties include subsidiaries, closely-related persons or companies in which any of them have substantial direct or indirect interest.

62 New York Stock Exchange Listed Company Manual, § 314.00.

63 *Id.*

64 *Supra* note 62.

65 Stock Exchange of Hong Kong, Listing Rule 14A.01.

Under Listing Rule 14A, a "connected person" includes any person who is a director, chief executive, or owner of more than 10% of the voting power, as well as any "associate" of that person, and also certain non-wholly owned subsidiaries.[66] An "associate" is defined to include family members, persons or entities with whom the connected person has an agreement relating to the transaction, and any other companies in which the connected person or his family owns at least a 30% share.[67] This definition captures most entities that might control or be controlled by the reporting company, as well as the majority of sibling companies controlled by the same individual or group. A "transaction" is broadly defined to capture almost any relevant arrangement, including loans, sales or purchases of goods or services, issuance of securities, and so forth.[68]

Listing Rule 14A breaks connected transactions into three categories: those that need not be reported or approved; those that must be reported and publicly announced; and those that must be reported, announced, and approved by a majority of independent shareholders.[69] In the first category are exempt transactions. These involve very small amounts, either less than 0.1% of total assets or revenue, or less than 2.5% of assets or revenue and lower than HK$ 1,000,000 (around Rs. 60 lakhs).[70] In the second category are transactions that must be reported and announced, but do not need to be approved by the shareholders. These include transactions involving less than 2.5% of total assets and revenue, or transactions involving less than 25% of assets or revenue and lower than HK$ 10,000,000 (around Rs. 6 crores).[71] In the third category are transactions that must be reported, announced, and approved by a majority of the independent shareholders. This consists of any transaction involving more than 2.5% of total assets and revenue, or more than HK$ 10,000,000.

If a transaction is in the second or the third category, the Rule requires detailed disclosure of the date of the transaction, the identity of the parties and

66 Stock Exchange of Hong Kong, Listing Rule 14A.11.

67 Stock Exchange of Hong Kong, Listing Rule 14A.11; Stock Exchange of Hong Kong, Listing Rule 1.01.

68 Stock Exchange of Hong Kong, Listing Rule 14A.10(13).

69 There are actually five categories, with the first two categories being divided into continuing transactions and one-time transactions. For purposes of the analysis here, however, the distinction between continuing and one-time transactions is unimportant. Stock Exchange of Hong Kong, Listing Rule 14A.16.

70 Stock Exchange of Hong Kong, Listing Rule 14A.31.

71 Stock Exchange of Hong Kong, Listing Rule 14A.32.

their connection to the reporting company, a description of the transaction and its purpose, the nature of the connected person's interest in the transaction, and the terms and consideration of the transaction. These details must be reported to the exchange, publicly announced as soon as possible, and included in the company's annual report.[72] If the transaction is subject to independent shareholder approval, Rule 14A mandates that the independent directors form a committee to advise the shareholders and secure the assistance of an outside financial advisor to issue an opinion regarding the fairness of the transaction.[73]

The Hong Kong Listing Rules also have certain requirements governing disclosures in the company's annual report. A company must include in its annual report information about any contract of significance entered into with any "controlling shareholder," defined as 30% or more.[74] The company must also disclose whether any directors, officers, or holders of more than 5% of the company's shares have any interest in the company's five most significant customers or suppliers.[75]

2. Singapore

The Singapore Exchange follows a very similar model to the Hong Kong Exchange. As with Hong Kong, the Singapore Exchange defines the concepts of "interested person" and "transaction" very broadly, and then mandates either disclosure or disclosure and independent shareholder approval. Under the Singapore Listing Manual's definitions, an interested person includes the CEO, the directors, and substantial shareholders of the company, as well as associates of these persons.[76] An associate includes any family members and any other companies in which the interested person or his family owns at least a 25% interest.[77]

Under the Singapore Exchange Listing Manual, a transaction must be immediately announced if it has a value greater than 3% of the company's assets. The transaction must be immediately announced and approved by the shareholders if it has a value greater than 5% of the company's assets.[78] The

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72 Stock Exchange of Hong Kong, Listing Rule 14A.45.

73 Stock Exchange of Hong Kong, Listing Rule 14A.48.

74 Stock Exchange of Hong Kong, Listing Rule Appendix 16.

75 *Id.*

76 Singapore Exchange Listing Manual, Rule 9A05.

77 Singapore Exchange Listing Manual, Rule 1.

78 Singapore Exchange Listing Manual, Rule 9A06.

public announcement must include all the relevant details of the transaction, including the identity of the interested person, the nature of that person's interest in the transaction, the terms of the transaction and how those terms were negotiated.[79] The announcement must also include a statement by the audit committee regarding whether the transaction is on normal commercial terms and is fair to the shareholders and the company. If the transaction necessitates shareholder approval, the shareholders also must receive the opinion of an independent financial adviser regarding the fairness of the transaction.[80] Any interested shareholder or associate of any interested shareholder must abstain from voting on the transaction.[81]

A Singapore listed company may also obtain general mandate from its shareholders approving recurring transactions with related parties. The general mandate must include a list of the interested persons, the nature of the transactions and the rationale for them, and fairness opinions by the independent financial advisor and the audit committee. The company must disclose details of all transactions entered into under the general mandate in its annual report, and must have the mandate renewed annually.[82]

IV. Evidence from Actual Disclosures

As the previous sections have demonstrated, the rules governing disclosure of related party transactions in India are more relaxed than the laws in several other countries. Interestingly, a number of observers of Indian corporate law have commented on the disparity between the law on the books and the law as it is actually practised. The implicit argument has been that the real problem with corporate governance in India is a lack of observance and enforcement of the laws, rather than flaws in the law itself.[83] The analysis presented in this paper indicates that the underlying weaknesses in the laws contribute to the problem as well. A lack of enforcement would enable firms to wilfully break the law without fear of significant penalties. But under the legal regime governing related party

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79 Singapore Exchange Listing Manual, Rule 9A08.

80 Singapore Exchange Listing Manual, Rule 9A09.

81 Singapore Exchange Listing Manual, Rule 9A10.

82 *Id.*

83 *See* Afra Asharipour, *supra* note 3, at 339 (arguing that India's corporate governance regime has formally converged to the "Anglo-American model", but that this has been undermined by "lapses in the enforcement and widespread implementation of these rules").

transactions, a firm could be in technical compliance with the law, while still engaging in abusive related party transactions.[84]

This section examines disclosure from a number of Indian companies listed in the BSE 100 to evaluate whether the regulatory gaps result in poor disclosure. These comparisons are primarily made for the purpose of illustrating the problem, and this paper is not an exhaustive survey of corporate disclosures in India or in any other country. Moreover, most of these examples merely indicate an absence of information and demonstrate that minority shareholders are operating at a distinct informational disadvantage when compared to shareholders in other countries. In this section, unless otherwise noted, all annual reports cited are from the 2008-2009 fiscal year.[85]

This section begins by examining the related party disclosures made in the corporate governance reports that are recommended by Clause 49. It then proceeds to a consideration of the disclosure required by AS 18 contained in the annual reports of a selection of Indian firms. Overall, the amount and quality of the disclosure is compared with the disclosure in some representative overseas companies. Two results emerge clearly. First, the legal disclosures suggested by Clause 49 are providing virtually no useful information to shareholders in India. To the extent that any information is available, it is because of the accounting standards, not the listing agreement. Second, the nature of the information that is being reported under the accounting standards is fragmentary when compared to the nature of the information reported under legal requirements in other countries.

A. Clause 49 Reporting

As discussed above, Clause 49 of the Listing Agreement includes a suggested list of items to be included in the reporting company's corporate governance report. One of these items is disclosure of any "materially significant related party transactions that may have potential conflict with the interests of the company at large." We reviewed fifteen annual reports from companies in the BSE 100. In fourteen of those reports, the company reported that there were no material related party transactions having a potential conflict of interest with

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84 The authors are grateful to Vivek Reddy for phrasing this point in this way during discussion of this paper at the NLSIR Symposium. *See also id.* at 399 (noting that many firms in India take a "box-ticking approach" to compliance with corporate governance rules).

85 Annual reports cited here are not identified by the name of the company. For further information about research methodology, please contact the authors.

the company. The sole exception was one annual report in which the company stated that there were no transactions that conflicted with the interest of the company, but did disclose the allotment of some equity shares to preferential warrant holders.

None of the reports described the procedure by which they had evaluated whether a transaction was materially significant and posed a potential conflict of interest. Furthermore, almost none of the reports identified who had made the decision regarding whether to disclose any transactions. Rather, the reports tended to repeat the language of Clause 49 almost verbatim. A standard example is: "There has been no materially significant related party transaction with the Company Promoters, Directors, the Management, the Subsidiaries or relatives of the Directors which may have potential conflict with the interests of the Company at large."[86] Because Clause 49 does not require any detailed disclosure, it is unsurprising that virtually all companies provided nothing more than this pro forma statement.

Eight out of the fifteen corporate governance reports referred to the disclosure of related party transactions in the company's financial statements. In each case, the report simply mentioned that related party transactions were listed elsewhere pursuant to AS 18. Therefore, to the extent that an outside investor might expect to obtain any information about a company's related party transactions, the investor will almost certainly not find it in the disclosure that is currently suggested by Clause 49. Any information will have to be found in the financial disclosures.

B. Disclosure Under AS 18

All the annual reports we investigated identified a list of related parties and included a schedule that listed some financial information about transactions with related parties pursuant to AS 18. However, this information was hampered by several significant problems. First, there appears to be little consistency regarding how companies interpret what relationships and transactions need to be disclosed, and in what level of detail. Second, only minimal information is provided, especially when compared to the information that is generally provided by comparable international companies. The comparison to international standards is particularly indicative of the relatively unfriendly environment for minority shareholders in India.

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[86] Annual Report No. 5, at 52. Almost all the annual reports had language very similar to this, without further elaboration or explanation.

1. Lack of Consistency Regarding What Companies Disclose

One striking aspect of the financial disclosures that companies made under AS 18 is just how dissimilar they are from each other. For example, a number of public companies in India are part of far-flung business groups, in which one promoter or promoter group effectively controls all the businesses in the group. But the related party disclosures in the company financial statements treat these group relationships in very different ways. First, the reports use a wide variety of terminology, making it difficult to make any comparisons between different groups. One public company refers to its "Promoter Group Companies",[87] another refers to "Associate Companies",[88] and still another refers to "Enterprises over which Key Management Personnel and their relatives exercise significant influence".[89] Even in these cases, it is impossible to determine whether all group companies are disclosed, or what criteria were used to determine whether or not an entity would be disclosed. In at least one report, a public company that is part of a well-known family promoter group makes no disclosure at all of the other companies in the business group, rendering it impossible to know whether any transactions with those other companies took place.[90] In none of these cases does the financial disclosure explain what levels of ownership the controlling group exercises in each of its group companies, which is a critical piece of information in evaluating the likelihood of abuse in a transaction between related entities. Such inconsistent disclosure is unsurprising in light of the narrow definition of "related party" in AS 18.

Another area of inconsistency involves the degree to which information about transactions is disclosed. For example, in one case the company reports around Rs. 172 crores of purchased goods and services from "Enterprises over which Key Management Personnel and their relatives exercise significant influence".[91] But the report fails to disclose which other enterprises were involved in these transactions. In other cases, the company does disclose which other parties were involved in particular categories of transactions, albeit without providing details about the nature or terms of each transaction.[92]

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87 Annual Report No. 15, at 92.

88 Annual Report No. 10, at 113.

89 Annual Report No. 9, at 114.

90 Annual Report No. 13, at 177.

91 Annual Report No. 9, at 115.

92 *E.g.*, Annual Report No. 15, at 94.

2. Comparison with International Examples.

The relative inadequacy of the related party disclosures in India becomes clearer when compared with similar disclosures in other countries. Because the only useful disclosure in India is a result of an accounting standard, rather than Clause 49, the information is reduced to a column of numbers. The numbers are presented with virtually no context or explanation, leaving doubts hanging as to whether a conflict of interest is lurking behind them. This can be compared to the type of information provided in legal disclosures in countries such as the United States, Hong Kong, and Singapore, where clearer legal rules lead to clearer disclosures.

One example of this can be seen in transactions with a company's directors. Several annual reports in India indicate the presence of transactions with directors. For example, in one report, buried in the notes on the company's loans is a statement that a loan of Rs. 9 crores was given to a "Deputy Managing Director who was an officer at the time of taking the loan."[93] But this is the only information that is offered. There is no information regarding the terms of the loan, how it was negotiated and approved by the company, or anything else beyond the simple acknowledgement that the loan exists. This can be compared to a United States company that entered into a consulting arrangement with one of its directors.[94] The annual report of a United States company explains the precise terms of the agreement, including the number of years the agreement lasts, the nature of the consulting services that the director will provide, the officer responsible for requesting these services, and other terms. In addition, the United States disclosure explains that this and any other related party transactions must be approved by the company's Corporate Governance Committee. As mentioned earlier, none of these disclosures are surprising—they are mandated by United States securities law in order to provide shareholders with adequate information to evaluate the transaction, as well as reassurance regarding how such transactions are governed and approved. In the case of the Indian transaction, the outside investor is aware that a loan was given to a director, but has no information regarding the loan, its terms, or how it was approved.

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93 Annual Report No. 1, at 66. It is interesting to note that such a loan may be a violation of section 295 of the Companies Act. The company in question does not indicate whether it had Central Government approval for this loan. The inadequate disclosure leaves a shareholder unable to determine whether the provisions of section 295 have been followed, let alone to determine whether to bring an action to enforce these provisions.

94 United States Report No. 3.

Further examples can be seen by looking at other types of transactions. For example, many of the financial statements under AS 18 from Indian companies refer to agreements for the purchase or sale of goods to or from companies in the same group. In many cases, the total amount disclosed appears significant. One company disclosed a sale of goods in the amount of Rs. 79 crores to another company in its promoter group, an amount that was equivalent to around 1.4% of the company's total assets, and around 4.5% of the company's pre-tax profits.[95] Another company disclosed sales of goods to group companies of over Rs. 475 crores, equivalent to roughly 4.3% of the company's total assets, and an astonishing 24% of the company's pre-tax profits for the year.[96] Yet this company did not even identify which other group companies were involved in these transactions. These accounting disclosures provide at least some evidence of the potential for abuse, given the size of the transactions involved. But lacking further disclosure, it is nearly impossible for an investor to evaluate the fairness of the transactions or make an informed investment or voting decision with respect to the company.

Again, we compare this disclosure to disclosures in other countries. In one example, a Hong Kong company acquired a new subsidiary, which meant that a number of its subsidiaries were now under common ownership with the new subsidiary. Pursuant to Hong Kong Listing Rule 14A, the reporting company provided lengthy disclosure of all transactions among the fellow subsidiaries.[97] This included details of each transaction — the company provided a list identifying particular transactions such as construction, service or supply contracts. In each case, the company also lists the consideration, and provides a statement from the directors that the transaction was entered into on normal commercial terms and was fair and reasonable to the company as a whole. A recent example from Singapore is also illustrative.[98] In the Singapore example, the reporting company explains a lease agreement it has entered into with another entity in which the reporting company's controlling shareholder has a substantial interest. The disclosure explains the interest, and also provides detailed information about the terms and conditions of the lease, including the location of the building and the monthly rent. Moreover, the disclosure states that the rent is fair market value and explains how the Audit Committee decided on the terms of the transaction and approved it without the votes of the interested parties.

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95 Annual Report No. 15, at 94.

96 Annual Report No. 9, at 115.

97 Hong Kong Disclosure No. 2.

98 Singapore Disclosure No. 1.

The lesson from these comparisons is clear. In each case, the disclosure by the Indian company is incomplete and offers little guidance to shareholders or others seeking to gauge the risk that the transaction in question may be abusive. Meanwhile, a comparable transaction in another jurisdiction is accompanied with extensive information about three critical issues– the identity and interest of the related party, how the transaction was approved by the company; and the relevant terms of the transaction. In other words, there is at least some anecdotal information that legal rules in other jurisdictions result in better disclosures than the legal rules in India.

V. Recommendations for Reform

The regulatory gaps in the Companies Act, Clause 49, and AS 18 have resulted in inadequate disclosure to both independent board members and minority shareholders, leaving the board and shareholders unable to monitor related party transactions. The following proposals are intended to address the specific risks that are raised by the ownership structure in Indian listed companies. Specifically, the proposals seek to empower independent board members and minority shareholders to monitor and approve related party transactions. Improving oversight over related party transactions in this way would allow listed companies to engage in non-abusive related party transactions, but minimize the risk of tunnelling. Furthermore, if adopted, the following regulatory reforms would improve perceptions of India's capital markets as lacking transparency or generally being controlled by promoter groups.

A. Strengthen the Definition of "Related Party" under Clause 49 and Accounting Standard 18

The definition of "related party" under both Clause 49 and AS 18 must be expanded to improve legal and financial disclosure about related party transactions. First, the definition of "related party" should capture horizontal relationships between companies within common control, as well as other associated companies and parties. One approach would be to explicitly include the promoter and promoter group, as such terms are broadly defined in the SEBI (DIP) Guidelines of 2000[99] and all other companies in which the promoter group has a significant interest, in the definition of "related party." Doing so would extend Clause 49 to horizontally related parties, and therefore enlarge the number

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[99] *See supra* note 32 and related discussion.

of related party transactions required to be disclosed. It would also provide shareholders with a much clearer picture of the pattern of cross-holdings among a business group, highlighting potential areas of concern or conflicts of interest.

Another approach would be to incorporate the definition of "related party" from IAS 24 into AS 18. The definition under IAS 24 has been accepted as comprehensive in many jurisdictions.[100] As more jurisdictions move to International Financial Reporting Standards, requiring Indian companies to report related party transactions on the basis of IAS 24 would bring greater clarity to financial disclosure about related party transactions to both Indian and foreign shareholders.

Second, SEBI and the stock exchanges should encourage a principles-based approach in interpreting the term "related party" under Clause 49. Whether "related party" is expanded to include entities or individuals within the promoter group as under the SEBI (DIP) Guidelines, or the definition of IAS 24 is adopted, a principles-based approach would avoid an over-formulaic approach that may not capture the complexity of ownership in the Indian market context.[101]

B. *Improve Board of Director Oversight*

The board of directors is responsible for overseeing the affairs of the company. Independent and disinterested directors on the board bear primary responsibility for monitoring related party transactions. Sections 299 and 300 of the Companies Act are currently too relaxed to empower disinterested directors to make informed decisions about whether related party transactions are in the best interest of the company. Sections 299 and 300 should be revised to require interested directors to provide full disclosure of their interest, including all material facts about the nature of the interest, the basis of the pricing arrangement, and whether the terms and conditions of the proposed transactions are on arms-length terms. The exceptions to sections 299 and 300 should also be narrowed, by adopting a broader concept of ownership and by explicitly including relatives of

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100 OECD Report, at 19-20.

101 Part of adopting a principles-based approach may include developing a "beneficial ownership" concept of ownership in order to require promoters, and entities and individuals within the promoter group, to claim ownership when they have investment or voting power over the shares, though they do not have legal ownership of the shares. For example, shares subject to a voting agreement should be considered beneficially owned by the party who has power to vote the shares. *See* Rule 13d-3(a) promulgated under the U.S. Securities Exchange Act of 1934, as amended, for one formulation of beneficial ownership.

the interested director.[102] These sections should also empower independent directors to make independent inquiry about the terms of the proposed transaction, including by seeking outside advice. Finally, the Listing Agreement should require the Audit Committee to review all related party transactions prior to entry into such transactions and to adopt overall policies and procedures addressing the manner in which related party transactions will be approved.[103] The nature of this policy should be disclosed to shareholders.

C. Disclosure and Shareholder Approval Requirements

Minority shareholders can also be empowered through improved disclosure of related party transactions and approval rights over extraordinary or significant transactions.[104]

1. Improved Disclosure

Overall, disclosure of related party transactions should be significantly expanded. Shareholders in listed companies should receive enough information about related party transactions to make informed investment and voting decisions. Currently, the information provided by listed companies is so inadequate that a shareholder might not even learn that a related party transaction has occurred, let alone learn any of the material facts regarding the transaction. The need for disclosure should be balanced against the overall regulatory burden of disclosure. Requiring disclosure of every related party transaction would impose an undue regulatory burden on listed companies. Furthermore, over-disclosure may present a confusing picture to shareholders. Therefore, disclosure

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102 The Companies Bill of 2009, Bill No. 59 of 2009, moves in this direction in several key ways. The Companies Bill proposes a replacement provision for sections 299 and 300 that would require a director to disclose the "nature of his interest or concern." Companies Bill 2009, § 162. Furthermore, the proposed provision also removes many of the exceptions contained in § 299 and § 300.

103 There is a basis for empowerment in section 292A of the Companies Act, which provides that the Audit Committee's recommendations on any matter relating to financial management, including the audit report, shall be binding on the Board.

104 Some scholars have proposed more draconian measures, such as an absolute ban on transactions between a corporation and a director, officer, or controlling shareholder. *See* Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 Wm. & Mary L. Rev. 1055, 1149-50 (2004). However, such a drastic step is ill-advised. There may be a number of benefits to the firm from related party transactions, and a regime of disclosure and approval is more likely to prevent abuses while allowing companies appropriate levels of flexibility in devising corporate strategy.

requirements should be based on a mandatory materiality threshold. All related party transactions above a certain rupee threshold or above a certain percentage of the company's net assets or revenue should be disclosed. For example, as described above, in the United States, disclosure is required for all related party transactions that exceed USD 120,000 in value. And in Hong Kong, only transactions above 0.1% of total assets or total revenue are required to be disclosed.

In addition to imposing a materiality threshold for disclosure, the quality and content of disclosure must be improved. Currently, shareholders receive information about related party transactions only through AS 18 in a bare financial statement that shows parties and amounts.[105] There is no disclosure about the relationship of the parties, terms of the transactions, or even the subject matter of the transactions. Clause 49 should require at least the following disclosure items for related party transactions above the materiality threshold: the name and relationship of the parties, a description of the transaction, the amount of the transaction, a summary of the terms of the transaction, the rationale for the transaction, and whether the transaction was reviewed independently by the Audit Committee, or the responsible committee of independent directors. Providing shareholders with this information would allow them to monitor related party transactions and make informed investment and voting decisions.

2. Shareholder Approval

In order to give minority shareholders meaningful input on related party transactions, listed companies should be required to seek shareholder approval from disinterested shareholders for extraordinary or significant related party transactions, as well as for certain on-going transactions with related parties.[106]

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105 Section 166 of the Companies Bill of 2009, which would replace section 297 of the Companies Act, moves in this direction by requiring public companies to refer to any related party transactions, as defined in that section, along with a justification of entering into the related party transactions, in the director's report to shareholders. Section 166 is incomplete, however, because it does not provide details about what information must be disclosed to shareholders.

106 Some have suggested that the requirement of independent shareholder approval would not fit well with the traditional emphasis on shareholder democracy in Indian company law, because the largest shareholder in the company would generally not be able to vote on these transactions. Such a departure from shareholder democracy is most likely to be warranted in these cases, in which the controlling shareholder has such a strong potential conflict of interest with the company at large. In this situation, we would expect the subset of independent shareholders to be much more likely to make the best decision in the interest of the company than if all shareholders, including interested parties, were allowed to vote.

The stock exchanges should require[107] that all extraordinary and significant transactions with related parties be approved by the disinterested stockholders. Extraordinary transactions would include equity or preferential issuances to related parties, amalgamations with related parties, and transactions above a threshold amount or percentage of company assets.

Issuances of preferential warrants in India have been used by related parties to increase ownership at discounted prices, to dilute minority shareholders, and to transact in the company's equity based on inside information.[108] Currently section 81 of the Companies Act requires approval of shareholders at a general meeting.[109] However, the Act does not require separate approval from the disinterested shareholders. As a result, preferential issuances to promoters or entities or individuals within the promoter group are easily approved due to their controlling stake. In order to close this regulatory gap, the Listing Agreement should require the approval of the disinterested shareholders for any preferential issuances to related parties.[110] In order to allow the company some flexibility, issuances below a certain threshold can be exempt from shareholder approval. For example, the New York Stock Exchange Listed Company Manual only requires shareholder approval if the issuance exceeds 1% of the total voting power of the company. To prevent companies from segregating transactions to circumvent stockholder approval, issuances that are related or within a short period of time should be aggregated for purposes of determining whether disinterested shareholder approval is required.

In addition to approval for preferential issuances, the Listing Agreement should require that all amalgamations of companies within the promoter group, such as that proposed by Ramalinga Raju with respect to Satyam in order to cover his fraudulent overstatement of cash, should require the approval of disinterested shareholders before a petition for amalgamation is made to the High Court under the Companies Act.

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107 There may be enforcement challenges if these measures are enacted. If enacted, these recommendations would need to be actively enforced by SEBI and the applicable regulators. A discussion of these matters is beyond the scope of this article.

108 *See* ACGA White Paper, at 30-35.

109 Companies Act, 1956, No. 1 of 1956, § 81(1A)(a).

110 Ideally, a vote of the disinterested stockholders would be by poll and by proxy, but voting in India often takes place by show of hands. *See* AGCA White Paper, at 16-17. The authors recognize the shortcomings in requiring stockholder approval if votes are conducted by show of hands and by prohibiting proxies, but a discussion of voting methods is beyond the scope of this article.

Finally, the approval of disinterested shareholders should be required for all other significant transactions with related parties above a certain rupee threshold or above a certain percentage of the company's total assets or revenue. This threshold would be higher than the threshold for the disclosure of related party transactions, similar to the Hong Kong and Singapore models. In the case of ongoing or recurrent transactions with a related party, the value of these transactions should be aggregated over the course of the year to determine whether disclosure or shareholder approval is required.

When shareholder approval from the disinterested stockholders is sought for any of the circumstances described above, the shareholders should be provided sufficient disclosure to make an informed decision. The disclosure should include details regarding the terms of the transaction, the nature of the relationship between the company and the related party, the interest of the related party, whether the transaction is on commercially reasonable and fair terms for the company, whether the Audit Committee or another independent committee has reviewed the transaction, and other relevant information. The independent directors who have reviewed the transaction should provide a statement explaining the rationale for the transaction to the shareholders. Finally, the stock exchanges should require the company to obtain a fairness opinion on the valuation of the transaction from an independent financial adviser, and the opinion should be provided to the shareholders.

VI. Conclusion

Despite the fact that multiple aspects of corporate ownership in India raise special concerns about abusive related party transactions, the laws governing these transactions in India are comparatively weak by international standards. Research into the substance of corporate disclosures in India, as compared to similar disclosures elsewhere, highlights that the relative weakness of the law leads to inadequate disclosures that do not enable minority shareholders to make informed decisions. A stronger regulatory structure that increases transparency and empowers disinterested directors and shareholders to police potential abuses by controlling shareholders would lead to significant progress in the fairness and efficiency of Indian capital markets.