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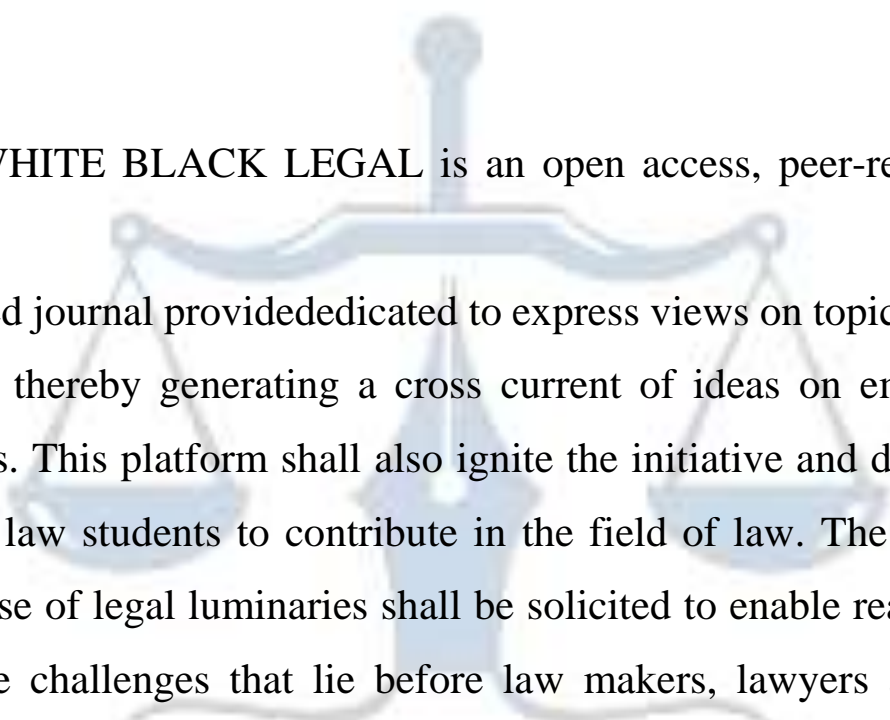


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ABOUT US



WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

CRITICAL ANALYSIS OF RELATED PARTY TRANSACTIONS AND RELATED FRAUDS WITH SPECIFIC REFERENCE TO KINGFISHER AIRLINES CASE

AUTHORED BY - SAKSHI BAKHRU & GOURI SHRIVASTAVA

Abstract

The Related Party Transaction and the fraud connected to it are discussed in the paper. It briefly discusses related party transactions and the steps taken to make them successful, much like every coin has two sides. Section 188 of the Companies Act, 2013, which deals with related party transactions, has been discussed in the paper. The paper also covers the recent amendment of 2021 by the Ministry of Corporate Affairs and how it can reduce frauds. Related party transactions also have pros and cons, and the paper tried to cover and analyse all the factors. The well-known Kingfisher Airlines case has been examined to help with the topic's knowledge.

Research Questions

1. What is Related Party Transaction?
 - 1.1 who can be a related party?
 - 1.2 What are the Repercussions of Non- Compliance?
 - 1.3 What is “arm’s lengths” transaction?
2. Analysing of Related Party Transaction Frauds with special reference to Kingfisher Airlines Case.
3. What are the Lacunas in Section 188 of Companies act, 2013.
4. What are the suggestions for smooth functioning of corporate governance (related party transaction)

Research Objective

1. To understand the concept of Related Party Transaction and other terms related to it.
2. To understand the distinction between Related Party Transaction and “arm’s length’s transaction”
3. To understand how companies do fraud by doing related party transaction

4. To understand the loopholes in the provision which defines Related party Transaction;Section188, Companies Act, 2013
5. To understand how to get away with the loopholes and the suggestion how proper functioning of Relating Transaction can happen.

Review Of Literature

1. E. Henry, E. A. Gordon, B. Reed, and T. Louwers, "The role of related party transactions in fraudulent financial reporting," *Journal of Forensic & Investigative Accounting*, vol. 4, no. 1, pp. 186-213, June 2012. – The statements concerning related party transaction scams show how a business might abuse the legal gaps at hand to perpetrate malpractice and profit personally from such transactions. The study also discusses the damage that shareholders must endure as a result of such scams.
2. E. A. Gordon, E. Henry, and D. Palia, "Related party transactions and corporate governance," in *Corporate Governance (Advances in Financial Economics)*, M. Hirschey, K. John, A. K. Makhija, Eds. Bingley, UK: Emerald Group Publishing Limited, 2005 – The paper aids in my in-depth understanding of related party transactions, which is crucial for effective corporate governance. Corporate governance is the legal framework that establishes the contractual obligations between an organization's shareholders, management teams, board of directors, and all other important stakeholders.
3. J. A. McCahery and E. P. M. Vermeulen, "Corporate governance crises and related party transactions: A post-Parmalat agenda," in *Changes of Governance in Europe, Japan and US*, K. J. Hopt et al., Eds. Oxford, UK: University Press, 2005 – The paper discusses corporate governance and compares India to other nations such as the USA and Japan to show how the systems differ. It also looks at the well-known Eron case and the fraud committed by a Japanese agriculture company, and it states and suggests preventive measures that should be taken to avoid frauds of this nature.
4. ashmin Frenandes, *Biggest Corporate Governance Failures in India*, *The CSR Journal*, April 20, 2021 – The paper gave me a clearer picture and deeper understanding of the numerous corporate scams that have occurred in India. It analyses examples including Nirav Modi, Kingfisher Airlines, Cafe Coffee Day, Satyam, and other companies. According to the publication, "Corruption in civilised

society is a sicknesslike cancer that, if not caught early, is destined to spread its malignancy across the country's polity, with devastating repercussions." I gained a thorough understanding of the scams, which supported me in my case analysis.

Introduction

A "related-party transaction" is an agreement or deal reached between two people or entities who already have a working commercial connection or have a shared interest. A corporation enters into a commercial agreement with a person that it either knows well or has a common interest with. The Companies Act, which deals with Related Party Transactions (RPTs) in the Indian context, specifies several safety precautions that must be adhered to while handling Related Party Transactions but does not outright forbid them. The notification of the transaction to the Board and shareholders is the key prerequisite as per Section 188 of the Companies Act, which lays forth basic parameters for the regulation of Related Party Transactions. SEBI modified the RPT regime this year in accordance with the Working Group Report on Related Party Transactions (which comes into force from April 1st, 2022). This article describes the significant changes made by SEBI and their potential effects on current and future transactions. Several scams that took place under the guise of a Related Party Transaction caused significant harm to not only the shareholders but also numerous banks that provided loans to the firms and the national economy.

Relating Party Transaction

Any transaction involving people or entities that have an established past relationship, such as a family member, director, or corporate management, is referred to as a "related party transaction."

The term "related party transaction" is defined under Section 188 of the Companies Act of 2013, and it refers to any transaction entered into by a corporation or other entity with another party. The transaction's nature can take many different forms, including sale, mortgage, purchase, sponsorship, investment, lease, etc. Before engaging in any transaction with a related party, the Board of Directors and Shareholders of the firm are required under Section 188 to provide their consent. Disclosure is also required when the transaction amount exceeds 10% of the company's annual revenue or net worth. Additionally, the associated party must refrain and not participate in the vote at the meeting addressing the transaction in which they have an interest. However, if the transaction is carried out as part of regular company operations, no

clearance is needed.¹

Who can be a Related Party?

The connected party is defined as a director, relative, key managerial employee, or a private firm in which a director, manager, or one of their relatives is a partner under Section 2 (76) of the Companies Act 2013 (the "2013 Act"). In summary, when there is a personal interest involved in the transaction. Additionally, a corporation that is public or private and whose management or director owns more than 2% of the stock is included in this section. The affiliate, holding, and associate companies are all covered by the term.

The Companies Act of 2013, Indian Accounting Standard (Ind AS) 24 - Related Party Transaction, 2015, and SEBI the Securities and Exchange Board of India (Listing Obligation and Disclosure Requirement) Regulations, 2015 are the regulating laws that govern related party transactions.

The Companies Act of 2013 does not define the idea of obtaining clearance prior to a related party transaction, but it does place limits on the parties, requiring them to refrain from voting in related party transactions.

Rule 15 of the companies Rules, 2014 states that during the meeting held for the decision making, the director or manager who has got a personal interest from that transaction should not be present and the details of such related party transaction should be disclosed in board report. And a special resolution should be passed by the maximum number of shareholders in addition to approval by board of director when the transaction amount exceeds more than limit prescribed by the law for instances more than 100 crore or more than 10% of total turnover or net worth.

Repercussions of non-compliance

If any agreement or related party transaction found not followed the procedure and complied the norms set up by the law then the board or the shareholders can ratify it within the time period three months and if not then it can consider as Voidable by the discretion of board.

¹ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021

And the director or manager who is related and had personal gains in such transactions should bear the losses suffered by the company because of the transaction.

According to the Companies Act any director or employee will be subject to punishment of one year of imprisonment or fine from 25000 to 5 lakh INR this is for public listed companies. For other companies, fine can be 25,000 Rs and 5 lakh Rupees.²

General Course of Business and the ‘arm’s length’ standard

Not every related party transaction is dubious and bad, some are really beneficial for companies to avail services and benefits. Each and every related party transaction done by a company cannot be flagged, there are some transactions which are genuine and done in a normal or general course of a business. Such kind of transactions don't need any approval from the board or from the shareholders by the special resolution³

Section 188 of the Companies Act, 2013 defines the 'arm's length transaction' as it's a transaction between two primary related parties who conduct a business or transaction as if they are not at all related, so there will be no conflict of interest. In short, the conditions, monetary value and everything should be standard and rational as it could be for an unrelated party this will close the rooms for fraud and personal gains.

In the case of **Mohit Kumar Surana v. Healthadda Pvt. Ltd**⁴, the petitioner accused the Respondent of committing RPT as the company's e-commerce website was sold to a related party.

In **Deccan Chronicle Holdings Ltd. v. Registrar of Companies**, certain funds were transferred by the applicant company to its related entity, without taking any approval and interest amount. The NCLT asked the applicant company to pay penalty for the offence committed by it.

² J. A. McCahery and E. P. M. Vermeulen, "Corporate governance crises and related party transactions: A post-Parmalat agenda," in *Changes of Governance in Europe, Japan and US*, K. J. Hopt et al., Eds. Oxford, UK: University Press, 2005

³ E. Henry, E. A. Gordon, B. Reed, and T. Louwers, "The role of related party transactions in fraudulent financial reporting," *Journal of Forensic & Investigative Accounting*, vol. 4, no. 1, pp. 186-213, June 2012

⁴ AIR 1997 Cal 179

Related Party Transaction Frauds

The incidence of corporate crimes in India is rising daily, which is concerning for both shareholders and the nation's economy. Corporate frauds are a developing risk to which organisations are susceptible. It not only undermines investor trust in the stock market, which causes significant losses in money, but it also harms the company's brand and goodwill. Consequently, it causes financial hardship.

The Satyam Scam, Enron Scam, Jet Airways Scam, Lehman Brothers, Kingfisher Airlines Scam, and other big scams are only a few of the numerous enormous frauds that have occurred in the past, not just in India but all around the world. In this essay, we've attempted to analyse one such fraud to better understand how these types of transactions are misused.⁵

Kingfisher Airlines case

Kingfisher Airlines fraud case, was one of its first kind in the airline industry, Which furthered to downfall of the king of good times, Kingfisher Airlines and group. The airline group was launched by Vijay Mallya and in very short period of time Kingfisher Airlines became most popular among the passengers because of its high quality services which is being provided at low prices. The Kingfisher airlines had the second highest market after Jet Airways. There were many frauds, malpractices, Diversion of funds and accounting of fake invoices practised in the company. One of them is the Fraud in related party transaction, all such frauds led the fall of the Kingfisher Airlines and Group.

Vijay Mallya, owner of Kingfisher Airlines, was named director of the racing team firm "Force India" in a filing with the UK's company registry in 2009. Other than him, one of the largest shareholders in the racing team firm Force India was Watson Ltd, a stakeholder and promoter of United Breweries Holding Ltd.⁶

Kingfisher Airlines paid a huge amount of sponsorship to racing team company Force India Formula One Team Ltd (FIFOTL), in which Vijay Mallya was the director, though it was a related party transaction still they kept the board and Shareholders of Kingfisher airlines in dark and didn't disclose this transaction, which is the violation of the Companies Act 2013,

⁵ Kashmin Frenandes, Biggest Corporate Governance Failures in India, The CSR Journal, April 20, 2021

⁶ J P Sharma, Ruchi Goyal, Corporate Governance Failure of Five-Star Accredited "Kingfisher Airlines", Journal of IMS Group, Vol. 14, No. 1, January-June 2017, pp. 10-25

Corporate Governance norms, Section 188 which deals with related party transaction and Accounting Standards.

SFIO stated in its reports that for than two years Kingfisher Airlines was paying excessive amount of Sponsorship to Force India Company which is around 30 crore, all this payment were made in the between 2008 and 2009 when the company was in debt already and was facing liquidity crunch and were unable to meet even operational expenses.

According to SFIO this was a clear diversion of the funds, all the collection the Kingfisher company received in their London based HSBC account was directly transferred to Force India Company's account. And there were no records which potrays that the Kingfisher group has taken permission from Consortium bank SBI for making such payments. SFIO also pointed out a cavity in the sponsorship agreement that in agreement it was stated that the car company will put a logo of Kingfisher airlines from where they got the sponsorship but in real they just put Kingfisher and Kingfisher group is a wide group⁷.

The King of Good Times (Vijay Mallya) and the Chief Financial Officer of Kingfisher Airlines have been accused of violating Section 211(3A) and AS18 of the Companies Act by the government investigating agency SFIO. Both clauses address disclosure of linked party transactions.⁸

Lacunas in Section 188 (Related Party Transaction) of the Companies Act, 2013

1. The Incongruity between Listing Obligations and Companies Act 2013 and Requirement for disclosure

Both The Companies Act, 2013 and The Listing Requirements apply to related party transactions in India, and it's not always possible for them to coincide. They frequently have diverse roles in related party transactions.

For instance, linked parties were not only forbidden from voting in transactions to which they were solely related but also from doing so under Section 188 of the Companies Act

⁷ E. Henry, E. A. Gordon, B. Reed, and T. Louwers, "The role of related party transactions in fraudulent financial reporting," Journal of Forensic & Investigative Accounting, vol. 4, no. 1, pp. 186-213, June 2012

⁸ J P Sharma, Ruchi Goyal, Corporate Governance Failure of Five-Star Accredited "Kingfisher Airlines", Journal of IMS Group, Vol. 14, No. 1, January-June 2017, pp. 10-25

and Regulation 23 of the Listing Requirement. Later, the Ministry of Corporate Affairs clarified that a party may only abstain from voting when it is connected to a transaction. As a result of this modification, the Act and the listing requirement take distinct positions in relation to third-party voting.

2. Requirement of High Materiality

When the transaction is more than the prescribed limit (Rule 15 of Companies Rule, 2014) then Related party transaction requires an approval⁹. Earlier the prescribed when the transaction is of more than 100 crores or more than 10% of the turnover of the company for the shareholder's approval. But, later on Ministry of Corporation removed this limit of 100 crores and the approval of the shareholders is required. Only 10 % or more of turnover is required.

This threshold set by the ministry is very high, thus many companies can perform related party transaction by keeping their amount below the set limit without the approval of shareholders. It has become an open channel for frauds and also questions the integrity of Corporate Governance.

3. Usual Course of conducting business is not defined

Not all Related Party transaction requires the approval from the shareholders and Board if the transaction is at arm's length. But the Companies Act, 2013 don't clarify much about such kind of transactions. This leaves a room for misinterpretation of the term by directors and the companies. There's no proper approach established in Act and which transaction should be considered as at Arm's length and which are not.¹⁰

4. Transaction between a Private Company and its Subsidiaries.

The major problem arising out of poor bifurcation of Section 188's implementation on public and private companies is that when there is transaction between the holding company and its subsidiary company is viewed as a related party transaction, even if the holding company holds 99% of shares and if the transaction crosses the prescribed limit it needs approval of board and share-holders and holding company will not be allowed

⁹ Section 188, The Companies Act, 2013

¹⁰ B. Gullkvist and A. Jokipii, "Perceived importance of red flags across fraud types," *Critical Perspectives on Accounting*, vol. 24, no.1, pp. 44-61, Feb. 2013.

to vote in meeting regarding that transaction. This, in turn, will result in the subsidiary's inability to achieve its goal. Furthermore, the announced regulations decrease uncertainty in referenceto totally owned subsidiaries, although they remain mute on the subject of subsidiaries thatare not wholly owned¹¹.

Suggestions

Better corporate governance requires related party transactions to operate properly. There are numerous procedures that may be done to ensure this happens. Some of the proposals are as follows:

1. To prevent fraud, a clear distinction should be made between transactions made in the ordinary course of business and transactions involving related parties. This is done by using an actual and suitable criterion to define the arm's lengths notion.
2. Because many related party transactions are excluded from the approval process and there is a risk of fraud, the bar established for related party transaction clearance shouldbe lowered.
3. It's the board's duty to check, identify and approve related party transactions, but in many cases the board get confused or take a hasty decision which leads to fraud and italso difficult to distinguish between arm's lengths transaction and related party transaction. Thus, there is a vital need for an auditing Committee, as it's an independentwing so there lie a no scope of bias and arbitrariness and will also secure the Shareholder's interest.
4. The auditing procedure has a significant impact on the RPTs. Therefore, it is recommended that the audit committee and board of directors take a proactive approachto related-party agreements. They must establish a procedure for entering into RPTs and for routinely reviewing all significant RPTs. The work of auditors is vital in exposing RPTs that are harmful to investors. This possibility, however, may bethwarted by the auditors' reliance on management for all information pertaining to RPTs. In this regard, a separate audit guideline note on RPTs would be helpful.
5. Related party transactions should be properly disclosed along with justification for thefirm's investment, including how it would benefit the company.
6. The Related Party Transaction should be regulated by the MCA and SEBI in unison

¹¹ J. A. McCahery and E. P. M. Vermeulen, "Corporate governance crises and related party transactions: A post-Parmalat agenda," in Changes of Governance in Europe, Japan and US, K. J. Hopt et al., Eds. Oxford, UK: University Press, 2005

to prevent exploitation of the clause.

7. Finally, shareholders should be made aware of the need of protecting their rights and assets.

Conclusion

This paper addresses a crucial corporate governance issue of related-party transactions—in an emerging market economy such as India by analysing Section 188 of the Companies Act 2013 and the Kingfisher Case. It was quite clear that even after many amendments the provisions governing related party transactions are being misused and loopholes still exist. Recent amendments curb it to some extent but still there is a long way to go. In a country like India, where the awareness among shareholders is very low, vigilance among the shareholders is important. Because whenever a corporate fraud happens it's the innocent shareholder's money which gets drowned and it raises the big question on the functioning of corporate governance. There should be transparency in a company for the smooth functioning of the company.

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