

INTERFACE OF RPTS, ESG, AND M&A TRANSACTIONS: NAVIGATING THE CONFLUENCE FOR SUSTAINABLE DEVELOPMENT

*Subhasish Pamegam and Hrishikesh Goswami**

The interplay between Related Party Transactions (RPTs), Environmental, Social, and Governance (ESG) considerations, and Mergers & Acquisitions (M&A) has gained prominence in shaping sustainable investments. In this backdrop, this article seeks to explore how RPTs function as a key indicator of corporate governance standards within an entity under the ESG Rating framework formulated by the Securities Exchange Board of India (SEBI) in its Master Circular dated July 12, 2023. First, the article examines how RPTs function as a key indicator of corporate governance standards under the ESG Rating framework introduced by the Securities and Exchange Board of India (SEBI) in its Master Circular dated July 12, 2023. Secondly, it explores the implications of SEBI's emphasis on RPT transparency for investor confidence and M&A transactions. The article also highlights RPTs' utility in assessing promoter influence and their role in identifying potential conflicts of interest within listed entities, thereby informing due diligence and valuation in M&A deals. Thirdly, it addresses challenges arising from opaque RPT structures, particularly in family-owned businesses, and their detrimental effects on transaction valuations and shareholder confidence. Case studies, including the Sony-Zee merger termination and DieselGate ESG controversy, are analysed to underscore these issues. Fourthly, the article further explores the integration of ESG clauses into transaction documents and the rise of ESG-focused investors, such as impact investors, in reshaping regulatory compliance and investment strategies. Finally, the recommendations include enhanced RPT disclosure frameworks, independent reviews of RPTs, and the introduction of minority shareholders' veto power to mitigate governance risks and promote sustainable investment practices in M&A. This study offers a comprehensive framework for addressing governance gaps, emphasizing transparency and ESG-driven reforms to ensure equitable and sustainable outcomes in M&A transactions.

* Third-Year Students, Gujarat National Law University, Gandhinagar.

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I. INTRODUCTION

The Securities Exchange Board of India (‘SEBI’), in its latest Master Circular dated 12th July 2023, has taken significant strides in regulating the evolving industry of Environmental, Social, and Governance (‘ESG’) ratings.¹ This circular, directed towards ESG Rating Providers (‘ERPs’), outlines 14 parameters categorized into three pillars: Environmental (E), Social (S), and Governance (G), each containing various factors and data points. A thorough examination of the circular reveals a clear emphasis on Related Party Transactions (‘RPTs’) as a key determinant of robust governance within listed entities, particularly in the context of Mergers & Acquisitions (‘M&A’) transactions.

This regulatory focus highlights the convergence of ESG considerations with M&A transactions, which has emerged as a critical focal point in contemporary corporate discourse, shaping corporate governance and

¹ Securities Exchange Board of India, ‘Master Circular for ESG Rating Providers 2023’, [1]-[3].

investment decision-making. Against the backdrop of this evolving landscape, this article embarks on a comprehensive exploration of three interconnected themes: the significance of RPTs as an ESG metric, the interface between ESG considerations and M&A activities, and the challenges posed by abusive RPTs in family-run businesses within the Indian context.

Firstly, this article aims to delve into the rationale behind prioritizing RPTs as a key ESG consideration within listed entities, and its relevance to M&A transactions. It is found that RPTs serve as quantifiable indicators of promoter influence and potential conflicts of interest, extending their significance beyond mere regulatory compliance to inform investor decision-making processes and risk assessments. *Secondly*, we examine the intricate interface between ESG considerations and M&A transactions, elucidating the transformative impact of ESG frameworks on investment decisions and due diligence practices. From the introduction of Principles of Responsible Investments ('PRI') to the emergence of impact investors and the incorporation of ESG clauses in transaction documents, we elucidate the evolving landscape of ESG integration in M&A activities, providing insights into its implications for valuation methodologies, regulatory compliance, and stakeholder engagement. *Thirdly*, we analyse the challenges posed by opaque transaction structures, inadequate disclosures, and regulatory loopholes, highlighting their profound effects on investor confidence, market stability, and regulatory scrutiny. By exploring instances of abusive RPTs in India and their potential impact on M&A transactions, we aim to pinpoint deficiencies in the current RPT framework and propose relevant reforms to address concerns surrounding the impact of RPTs on M&A. Ultimately, our goal is to enhance the efficacy of RPT disclosures as a reliable gauge of corporate governance standards and empower investors to make more informed investment decisions.

II. UNDERSTATING RPTs AND ITS RELEVANCE AS AN ESG CONSIDERATION IN CORPORATE INVESTMENTS

Under section 2(76) of the Companies Act, 2013 (CA), 'Related Parties' with reference to a company, include a director and their relatives, relatives of key managerial personnel, entities where a director, manager, or their relatives are members or directors, a public company where a director or manager is a director and, along with their relatives, holds more than 2% of its paid-up share capital or any corporate body whose Board of Directors, managing director, or

manager acts in accordance with the advice, directions, or instructions of a director or manager². Section 2(zb) of the SEBI Listing Obligations and Disclosure Requirements ('LODR'), which refers to the regulations established by the SEBI that set out the obligations and disclosure requirements for listed companies in India, further states that a 'related party' includes any person or entity that is part of the promoter or promoter group of the listed entity. Furthermore, any individual or entity holding 10% or more of the equity shares in the listed company, either directly or indirectly with any beneficial interest, is categorized as a related party. Any transaction, including the transfer of resources, services, or obligations entered into by a listed entity with these parties is categorized as RPTs under Section 188 of the CA³ and is, thus, required to comply with the disclosure standards specified under LODR to ensure transparency and approval standards.⁴

RPTs, over the years, have become relevant from both an investment as well as corporate governance perspective. This significance arises in the background of several RPT scandals in the early 2000s as well as due to the fact that there is an active trend towards more concentrated ownership of companies. This trend is contrary to established practice in advanced economies where most listed companies are characterized by dispersed ownership, whereas, in most emerging economies, such as India, the ownership in corporate structures is concentrated in the hands of a few.⁵ With a surge in listing in these economies, public money flows into the hands of these controlling shareholders, known as promoters in India,⁶ which is defined as an individual named as such in a prospectus or identified as a promoter in the company's annual return, a person who exercises direct or indirect control over the company's affairs, whether as a shareholder, director, or otherwise, or an individual whose advice, directions, or instructions customarily influence the actions of the Board of Directors.⁷ This can be attributed to the significant role played by prominent personalities,

² Companies Act 2013, s 2(76).

³ Companies Act 2013, s 188.

⁴ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 2(1)(zc).

⁵ OECD, 'Ownership Structure of Listed Companies in India' (*OECD Publishing*, 2020) <<http://www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf>> accessed 07 March 2024.

⁶ NV Nogueira and LR Kabbach de Castro 'Effects of ownership structure on the mergers and acquisitions decisions in Brazilian firms' [2019] *Ribeirão Preto School of Business Management Journal* 227–245.

⁷ Companies Act 2013, s 2(69).

particularly during IPOs, where companies with a strong representation or face, often embodied by the promoters, attract shareholders.

Owing to such trends, the proportion of listed companies wherein promoter stakes exceed 50% has increased significantly.⁸ These shareholding patterns are further examined through three panels that present a detailed breakdown of the shareholding trends:

Panel A shows the average shareholding of promoters and non-promoters at the company level for the top 500 listed companies. Panel B shows how the concentration of promoters' shareholdings has shifted over time. For both Panel A and Panel B, the proportion of shareholdings by promoters and non-promoters are based on the number of shares that they hold. Panel C shows the aggregate shareholdings by promoters and non-promoters in terms of market value of shares for the top 500 listed companies.



⁸ Nogueira (n 6).

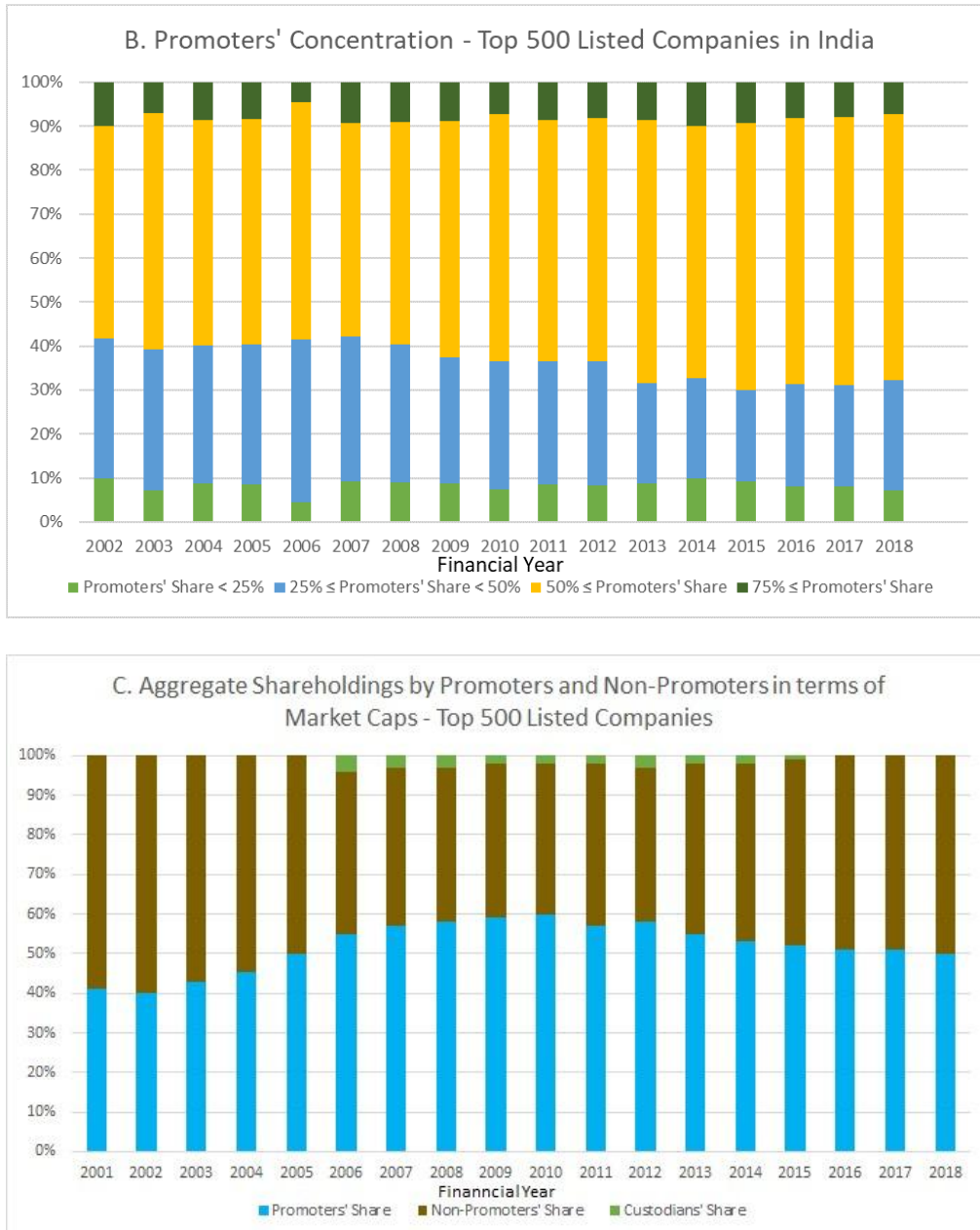


Figure (A)⁹

Given the significant impact of these trends on listed entities in India, the regulatory authorities were prompted to institute stricter disclosure requirements and oversight mechanisms to mitigate the governance risks associated with increased RPTs, considering the predominance of promoter-oriented models of companies in India. Consequently, investors have become increasingly vigilant about scrutinizing RPTs as part of their due diligence process, recognizing the potential impact of these transactions on shareholder value and corporate reputation. SEBI's Master Circular for ESG Rating Providers

⁹ ibid 7.

classifies RPTs as a key parameter under the Governance pillar of ESG ratings,¹⁰ subjecting them to the regulatory standards specified in the SEBI LODR. LODR also lays unequivocal focus on the factor that the Indian market is dominated by businesses that are often established as inherently close-knit group entities, which effectively operate as a single economic unit, with a promoter or promoter group exercising control over these companies. It was this realization that led to the classification of *'the promoter and the promoter group of a listed entity, holding over 20% of shareholding'* as a related party under the LODR.¹¹ It is on this background that RPTs have been given significant importance as an indicator of sound governance within a listed entity in the master circular for ERPs.¹²

ESG Rating in India is mostly premised on ERPs assigning ratings onto entities based on their standard of implementation of ESG parameters prescribed by SEBI in a manner that can help stakeholders easily decipher the past, present, and future performance of the entity on these standards. This objective necessitated the devising of a mechanism of scoring entities in a manner that could adequately quantify its performance on these grounds over a period of time.¹³ It is thus that the Master Circular for ERPs prescribed two different classes of scores, the *Core score*, that evaluates a company's current performance¹⁴ and a *Transition score*, which measure the progress made by the company in adhering to the prescribed parameters over time.¹⁵ RPTs, being a key parameter under the 'Governance' pillar of ESG ratings, as prescribed by SEBI, are thus also to be evaluated in terms of both the Core and Transition scores.¹⁶ This should, in principle, shed light on the manner in which the company engages in RPTs in the present time (Core score), while also letting investors and regulators know whether the standard employed by the company in this regard has seen improvements or has seen worsening over a relevant time period (Transition score). Such a nuanced dataset permits investors to conduct an in-depth examination of RPTs and for them to accurately judge a company's governance structure and understand the extent of influence exercised by the

¹⁰ Securities Exchange Board of India, *Master Circular for ESG Rating Providers 2023*, para 3.3.

¹¹ Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, Reg. 2(1)(zb).

¹² Consultation Paper on Regulatory Framework for ESG Rating Providers (ERPs) in Securities Market 2023.

¹³ *ibid*.

¹⁴ Securities Exchange Board of India, *Master Circular for ESG Rating Providers 2023*, para 5.7.

¹⁵ Securities Exchange Board of India, *Master Circular for ESG Rating Providers 2023*, para 5.6.

¹⁶ *ibid* 13, Annexure III.

promoters and also base their investment decisions on calculated predictions of possible conflict between controlling shareholders and small shareholders.¹⁷ By identifying patterns of RPTs that prioritize the interests of controlling shareholders over minority shareholders, investors can mitigate ESG risks and make informed investment decisions.¹⁸

III. M&A BEYOND NUMBERS: INCORPORATING ESG VALUES IN CORPORATE TRANSACTIONS

The interface between ESG considerations and M&As have become increasingly prominent in the contemporary business environment.¹⁹ This prominence can be attributed to several factors such as:

1. *Principles of Responsible Investments*: The introduction of Principles of Responsible Investments ('PRI'), which is a group constituted by several of the world's largest institutional investors willing to self-regulate their investment activity and align their investments with six major principles covering various aspects, including a commitment to require ESG compliance by entities they have invested in and the commitment to promote global acceptance of ESG standards among investors, set internationally accepted standards for the integration of ESG considerations into investment decisions.²⁰ Since the advent of PRI, investors have shifted their focus towards ESG disclosures as a crucial aspect of mandatory due diligence conducted prior to investing in a business. Moreover, PRI's introduction has led to the normalization of reporting on institutional investors' progress in implementing these principles, thus fostering greater transparency and accountability in investment practices.²¹ This global shift towards ESG-driven investments has significantly impacted the Indian market, with ESG-compliant investments growing 2.4 times in deal value from 2021 to 2022.²² The increasing emphasis on ESG compliance stems from its role

¹⁷ OECD, 'The Role of Institutional Investors in Promoting Good Corporate Governance' (*OECD Publishing*, 2011) <<https://doi.org/10.1787/9789264128750-en>> accessed 07 March 2024.

¹⁸ *ibid* 13.

¹⁹ Tanay Shah and Brian Lightle, 'ESG Considerations in M&A' (*Deloitte*, 2023) <<https://www2.deloitte.com/us/en/pages/mergers-and-acquisitions/articles/esg-in-m-and-a.html>> accessed 07 March 2024.

²⁰ PRI, 'What are the principles for responsible investment?' (*UN Principles of Responsible Investment*, 2022) <<https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment>> accessed 09 March 2024.

²¹ *ibid* 17.

²² Sanjay Bhatia and Colin Shah, 'ESG Investing in India: Navigating Key Factors' (*India Brand Equity Foundation*, 13 June 2024) <<https://www.ibef.org/blogs/esg-investing-in-india>>

as a key indicator of lower investment risk and the potential for long-term value creation. Such enhanced investor confidence and associated advantages have been quite pronounced in the Indian securities markets as well.²³ One such prominent example is Adani Green Energies, whose shares appreciated by over 7000% over five years till 2023. As per analysts, such a massive gain in value was majorly driven by the alignment of Adani Green Energy's business with ESG goals pursued by investors.²⁴

2. *ESG Ratings and Supply-Chain Due Diligence*: In recent times, with the introduction of ESG ratings and ESG rating providers in the securities market, most investors have access to quantitative metrics that allow them to determine the compatibility of an entity's ESG standards with their expectations. With the introduction of the ERP Master Circular in India, investors now have access to a standardized rating system for Indian-listed entities as well.²⁵ In light of this development, it is also crucial to note that these parameters, which are now a part of the ESG rating mechanism are also quite pronounced as due diligence considerations.²⁶ One of the most notable effects of such a change is the emergence of supply-chain due diligence, wherein investors look at wider ESG compliances and qualitative factors within a company's overall business model and supply chains.²⁷ A key point that we must focus on is the inclusion of parameters like '*percentage of input material*', which takes into account the source of inputs utilized by a listed entity, under the 'S' pillar of ESG Ratings.²⁸ These serve as a formal indication of the growing importance of such factors for investors, which were largely ignored in the past, and their relevance as a quantitative indicator of the level of ESG-compliance achieved by an entity,

navigating-environmental-social-and-governance-factors-for-sustainable-growth> accessed 26 June 2024.

²³ Dayal G, Chauhan P, Sawhney S, 'Impact of ESG on M&A in India' (*Lexology*, 2023) <<https://www.lexology.com/commentary/corporate-financema/india/lakshmikumaran-sridharan/impact-of-esg-on-m&a-in-india>> accessed 09 March 2024.

²⁴ R Ramani, 'Adani Green Ranks First In Asia And Among Top 10 RE Companies Globally For ESG Performance' *Outlook Planet* (New Delhi, 15 June 2023) <<https://planet.outlookindia.com/news/adani-green-ranks-first-in-asia-and-among-top-10-re-companies-globally-for-esg-performance-news-415503>> accessed 09 March 2024.

²⁵ *Nogueira* (n 6).

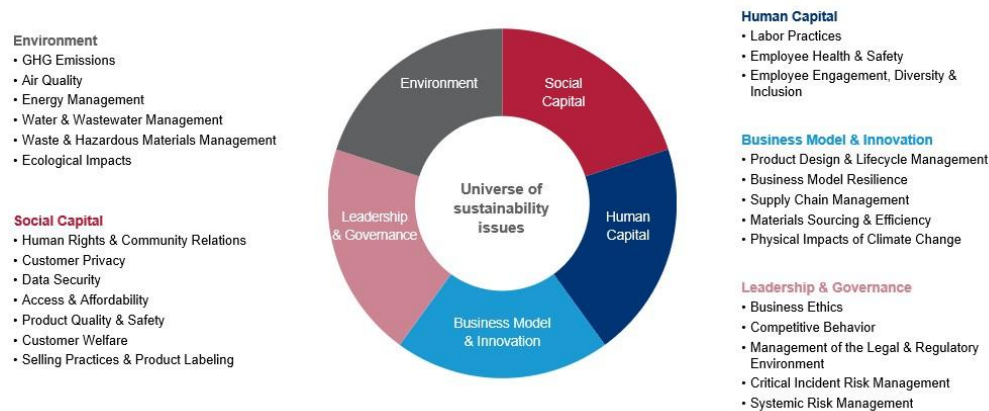
²⁶ *ibid* 19.

²⁷ Fraser E, Van Der Ven H, 'Increasing Transparency in Global Supply Chains: The Case of the Fast Fashion Industry' (*14 Sustainability*, 2022) <<https://doi.org/10.3390/su141811520>> accessed 09 March, 2024.

²⁸ Securities Exchange Board of India, *Master Circular for ESG Rating Providers 2023*, Annexure 3.

which has increasingly come to determine the prospects of a company securing investments.²⁹

3. *Emergence of Ecosystem Analysis:* With the emergence of a new class of investors, commonly termed impact investors who seek to pair profits with ESG goals and with traditional investors shifting towards this investment model, traditional due-diligence has also undergone a major course correction.³⁰ The most prominent instance of such a shift is seen through the widespread adoption of 'ecosystem analysis' in traditional practices.³¹ Such an analysis often entails a deep-dive into elements like the potential impact of future plans of a company on the climate as well as the degree of stakeholder engagement achieved by companies working in ecologically sensitive environments, which were previously considered immaterial in judging the viability of a transaction. This approach is also adopted by SEBI's master circular on ERPs, which details the parameters underlying ESG ratings and expands the horizon of corporate compliances to subject-matters previously overlooked by both investors and corporates alike.³²



²⁹ G Dayal, P Chauhan, S Sawhney, 'Impact of ESG on M&A in India' (*Lexology*, 2023) <<https://www.lexology.com/commentary/corporate-fincema/india/lakshmikumaran-sridharan/impact-of-esg-on-m&a-in-india>> accessed 09 March 2024.

³⁰ 'What You Need to Know About Impact Investing' (*GIIN*, 1 January 2023) <<https://thegiin.org/publication/post/about-impact-investing/>> accessed 26 June 2024.

³¹ 'The Role of Due Diligence in Nature-Based Investments' (*Xilva*, 26 October 2023) <<https://www.xilva.global/news-and-blog/the-role-of-due-diligence-in-nature-based-investments>> accessed 09 March 2024.

³² *Nogueira* (n 6).

*Figure (B)*³³

The ESG risks are gaining prominence in due diligence during M&A transactions to avoid negative consequences post-merger, such as damage to reputation, market value and financial loss. For instance, the DieselGate³⁴ scandal involving Volkswagen serves as a relevant case study highlighting the regulatory, financial, and reputational risks stemming from poor adoption of ESG practices by companies. The scandal was exposed in 2015 when reports revealed that Volkswagen had employed software manipulation to deceive emission tests conducted on its vehicles. This resulted in severe repercussions and loss for Volkswagen. Volkswagen faced severe consequences such as tarnished reputation, fines of billions of dollars, and substantial market value depreciation. For potential acquirers, such ESG risks highlight the ever-increasing importance of conducting comprehensive ESG due diligence to identify and avoid investing in any M&A transaction with businesses plagued by ESG risks.

The systemic failure of regulatory oversight as seen in the DieselGate scandal concerning the ESG Risks extends beyond the automotive industry. While the scandal primarily revolved around emissions testing and compliance in the automotive sector, its implications reverberate across industries, including those with RPTs. To mitigate these challenges, regulators and industry stakeholders must prioritize the development of more robust and comprehensive regulatory frameworks for monitoring ESG risks. The emergence of ESG rating agencies and specialized ESG research firms presents an opportunity to complement regulatory oversight with independent third-party assessments of companies' ESG performance, including their management of RPTs. By incorporating ESG ratings and analyses into M&A due diligence, investors can gain valuable insights into companies' governance practices, risk management strategies, and overall sustainability performance.

4. *ESG Clauses in Transaction Documents:* Beyond due diligence, ESG-oriented clauses have also become increasingly common in transaction

³³ J Sinha and T Chandra, 'Getting to the Green Frontier Faster: The Case for a Green Frontier Superfund' (*Observer Research Foundation*, 4 December 2023) <<https://www.orfonline.org/research/the-case-for-a-green-frontier-superfund>> accessed 26 June 2024.

³⁴ Russel Hotten, 'Volkswagen: The scandal explained' *BBC News* (London, 1 December 2015) <<https://www.bbc.com/news/business-34324772>> accessed 11 March 2024.

documents, with a prime example being their inclusion in representations and warranties.³⁵ Nowadays, facets like the maintenance of ESG-compliant supply chains, which require the incorporation of elements like adequate representation of SMEs in the supply chain and ensuring that a significant share of raw materials and other inputs are procured from within India, have become increasingly commonplace in negotiations and have also been found to influence valuations greatly. It is quite striking to note that the same parameters are included in ESG ratings, and are thus, used as accurate predictors of the viability of any investments investors make in certain entities. This observation only strengthens the relevance of ESG ratings, more specifically, the parameters relied upon to arrive at such a composite rating from a transactional perspective.

5. ESG-Driven Exits as an Investment Strategy: Further, ESG considerations have also significantly influenced exits from investments for various investors. Traditionally, exits (divestment of investment from a particular company) by institutional investors have predominantly been driven by financial considerations. However, recent instances highlight a shift towards exits motivated by ESG concerns. For instance, the exit of KLP, which divested its investment worth USD 1.05 million dollars in Adani Ports³⁶ and Special Economic Zone Limited ('APSEZ') was solely premised on the fact that APSEZ's partnership with Myanmar's armed forces violated its responsible investing principles under PRI.³⁷ A similar example emerged when Bharat Heavy Electricals Limited ('BHEL') was excluded from the portfolio of a Norwegian sovereign wealth fund as a result of BHEL building a coal-fired power plant in an environmentally sensitive area and the associated risk of pollution.³⁸

³⁵ R Jhunjhunwala, B Anand, and A Dadoo, 'Public M&A in India' (*Lexology*, 6 July 2021) <<https://www.khaitanco.com/sites/default/files/2021-07/Public-Mergers-and-acquisitions.pdf>> accessed 09 March 2024.

³⁶ M Muneer and R Ward, 'The Adani Affair Revealed Gaping Holes in Governance' *Mint* (New Delhi, 23 March 2023) <<https://www.livemint.com/opinion/columns/the-adani-affair-revealed-gaping-holes-in-governance-11679593117188.html>> accessed 02 March 2024.

³⁷ J Jagannath, 'Norway's \$1.35-trn wealth fund says it has no exposure left in Adani Group companies' *Business Today* (New Delhi, 9 February 2023) <<https://www.businesstoday.in/latest/corporate/story/norway-wealth-fund-says-it-has-no-exposure-left-to-adani-groups-companies-369657-2023-02-09>> accessed 09 March 2024.

³⁸ G Fouche, N Adomaitis, 'Norway Wealth Fund Excludes India's BHEL Due to Environment Rules' *Reuters* (London, 5 May 2017) <<https://www.reuters.com/article/idUSKBN1811DA>> accessed 09 March 2024.

IV. RPTS AS AN ESG METRIC: ASSESSING GOVERNANCE RISKS IN M&A TRANSACTIONS

RPTs as an ESG metric in M&A transactions is increasingly recognized in corporate governance discussions. This established relevance of RPTs as an ESG rating parameter is primarily hedged on two factors. First, their ability to demonstrate the extent of influence exercised by the promoter and promoter group in a listed entity using a quantifiable metric. Second, their ability to predict the potential for promoter-shareholder conflict in a listed entity and the failure of independent directors to address these concerns effectively.³⁹

These circumstances, apart from being mere catalysts that elevate the importance of RPTs as an indicator of sound corporate governance in a listed entity,⁴⁰ also bear a lot of significance in the world of M&A.

Understanding the ownership structure of a listed entity is crucial for assessing the quality of business decisions being made by the directors and managers as it can significantly influence the prospect of a successful M&A.⁴¹ In entities with concentrated ownership or promoter-dominated models, RPTs can be used as a means for controlling shareholders to further their personal interests at the expense of minority shareholders. For example, RPTs may involve transactions that benefit the controlling shareholders or their related entities disproportionately, leading to potential conflicts of interest and the diversion of company resources away from maximizing shareholder value. Herein, one must take into consideration the fact that investors often pay higher prices for shares of listed entities in situations where the interests of minority shareholders are strictly protected by law as they feel a sense of security with respect to the fact that there would be a higher possibility of them being able to recoup their investment in the form of dividends as they feel protected against the possibility of expropriation by managers and promoters. This preference for legal

³⁹ Carlos Esparcia and Mariya Gubareva, 'ESG rating changes and portfolio returns: A wavelet analysis across market caps' (2024) 63 *Finance Research Letters* 105306 <<https://doi.org/10.1016/j.frl.2024.105306>> accessed 26 June 2024.

⁴⁰ 'Securities Exchange Board of India Consultation Paper on ESG Disclosures, Ratings and Investing' (KPMG, 23 March 2023) <<https://assets.kpmg.com/content/dam/kpmg/in/pdf/2023/03/firstnotes-esg-sebi-supply-chain-disclosure.pdf>> accessed 09 March 2024.

⁴¹ OECD, 'Ownership Structure of Listed Companies in India' (*OECD Publishing*, 2020) <<http://www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf>> accessed 07 March 2024.

protection often also reflects in the form of investors preferring to pay higher value for shares of entities that have a dispersed ownership structure rather than one where promoters control an overwhelming majority.⁴²

In a stricter business sense, an entity with a concentrated ownership model (or promoter-dominated model) is affected by the phenomenon called incentive effect, which tends to incentivize controlling shareholders to hedge investments on behalf of the entity in better-performing projects that would directly benefit such controlling shareholders economically.⁴³ However, it is also postulated that such controlling shareholders often exercise disproportionate control over the votes and capital of such entities, which aligns their interest towards ensuring that the executives of the company make decisions that align with their own goals, stifling such executive's interest in innovating and taking risks for the entity. With such a reduced appetite for risk, the situation often gets skewed into one that is unfavourable for M&A activity as executives tend to focus solely on investments preferred by the controlling shareholders and not on riskier investments like M&A, which also carry the potential of exponentially higher long-term gains.⁴⁴

Another phenomenon called the entrenchment effect also impacts such entities with concentrated ownerships, which postulates that majority shareholders have an affinity towards expropriating the entity's funds for private benefits. The playing out of such phenomena in a listed entity jeopardizes the prospects of M&A as the risk of any such transaction overwhelmingly shifts onto minority shareholders.⁴⁵ Such shifting of risk is often facilitated through mechanisms like the issuance of various classes of shares (such as shares with differential voting rights) and the creation of pyramidal corporate structures within an entity. Such mechanisms often allow controlling shareholders to benefit disproportionately from M&A transactions as they often end up having excessive control over the voting patterns and cash flow of the company. The creation of such a disadvantageous position for minority shareholders gives rise to complex legal compliances and attracts enhanced regulatory scrutiny of M&A transactions, making the process time consuming and excessively expensive.⁴⁶

⁴² *ibid.*

⁴³ *ibid.*

⁴⁴ *G Dayal, P Chauhan, S Sawhney* (n 30).

⁴⁵ *supra* 5.

⁴⁶ *ibid.*

Further, the concerns that have emerged in recent times as to whether independent directors ('IDs') are truly independent also have a significant impact on the prospects of a successful M&A transaction. Over the years, in various jurisdictions around the world, a correlation has been observed between the active involvement of IDs in a firm's functioning and the valuation and stock market performance. A significantly pronounced example emanated out of China, wherein it was observed that companies with preoccupied IDs who attended fewer meetings experienced declining valuations, and also exhibited weaker profitability and accounting quality following mergers and acquisitions. Additionally, IDs also play a crucial role in regulating the dissemination of unpublished price-sensitive information ('UPSI'),⁴⁷ which is any information of a company, not generally available to the public, but which, if released in public domain, can impact the price of the company's securities, to promoters or members of the promoter group. Such dissemination can greatly impact a transaction, considering how dependent the valuation of a target is on the price of its securities in the market, and the fact that M&A transactions that adopt mechanisms such as share-swaps can fall apart upon drastic changes in the prices of an entity's securities listed in public markets due to dissemination of any kind of UPSI.⁴⁸

In India, RPTs in listed entities can only be approved by the audit committee,⁴⁹ which requires at least two-thirds of its members to be IDs. Further, the Nomination and Remuneration Committee ('NRC') of a listed entity,⁵⁰ which is responsible for recommending, appointing as well as removing directors and for regulating their remuneration, is also to have IDs for at least two-thirds of its members. With such crucial powers being vested in IDs, a closer look at the manner in which RPTs have been regulated within an entity can also be indicative of the nature in which IDs function, which would become a key

⁴⁷ Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 1992, reg 2(1)(n).

⁴⁸ Yu-Hsin Lin, 'Weak Independent Directors, Strong Controlling Shareholders: Do Independent Directors Constrain Tunneling in Taiwan?' (JSD Dissertation, Stanford Law School 2010) <<https://law.stanford.edu/wp-content/uploads/2015/03/Yu-HsinLin-dft2010.pdf>> accessed 09 March 2024.

⁴⁹ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 18.

⁵⁰ *ibid* reg 19.

factor in any transaction as they compose crucial committees within the listed entity and thus decide the market-readiness of any listed entity.⁵¹

V. OPAQUE ALLIANCES: NAVIGATING M&A CHALLENGES AMIDST ABUSIVE RPTS IN INDIA

In India, about 85% of businesses are family-owned businesses, constituting over 50% of total employment in the country.⁵² The prevalence of family-run businesses in India has exacerbated the issue, as these businesses often engage in RPTs that prioritize personal interests over those of minority shareholders.⁵³ This close-knit nature of family-run businesses often creates unique corporate governance challenges, leading to opaque transaction structures and inadequate disclosures, further complicating M&A negotiations and valuations. Family-run businesses often operate with a high degree of confidentiality, with key decision-making processes confined to a select group of family members or closely associated individuals. This lack of transparency can extend to financial transactions, including RPTs, where the terms and details may not be fully disclosed to external stakeholders, including potential acquirers in M&A negotiations. The family members may engage in can transactions that are not conducted in the ordinary course of business at arm's length terms⁵⁴ (i.e. transactions conducted as if the parties were unrelated, ensuring fairness), diverting company resources for personal benefit, siphoning off shareholders' funds, or engaging in undisclosed conflicts of interest. Furthermore, the concentration of ownership and management within the family can lead to a lack of independent oversight. This can negatively impact the foreign perception of Indian businesses and affect the Foreign Direct Investments ('FDI') and Foreign Portfolio Investments ('FPI') coming into India, ultimately impacting

⁵¹ 'SEBI Amends Provisions Related to Independent Directors' (KPMG, 8 September 2021) <<https://assets.kpmg.com/content/dam/kpmg/in/pdf/2021/09/firstnotes-lodr-independent-directors-audit-committee-nrc.pdf>> accessed 09 March 2024.

⁵² EK Satheesh, KP Muraleedharan, AC Fernando, *Corporate Governance, Principles, Policies and Practices* (2017) (1st supp, 3rd ed, Pearson India 2017).

⁵³ A Nekhili, & M Cherif, 'Related Parties Transactions and Firm's Market Value: The French Case' (2011) *Review of Accounting and Finance*, 10(3), 291-315.

⁵⁴ Saurav Kumar, Neha Balodhi, and Asma Arora, 'Related Party Transactions: Interplay Between The Companies Act And The SEBI Listing Regulations' (*Mondaq*, 24 February 2024) <<https://www.mondaq.com/india/shareholders/1165080/related-party-transactions-interplay-between-the-companies-act-and-the-sebi-listing-regulations>> accessed 11 March 2024.

M&As. This can affect the confidence of the public in the economy which is reflected by the slow growth in the equity market.⁵⁵

The transactions that are entered by the controlling shareholders of these family-run enterprises at the expense of the interests of the minority shareholders are known as abusive RPTs. When RPTs are exploited by controlling shareholders for self-enrichment, they become abusive.⁵⁶ Abusive RPTs often involve transactions that are not conducted at arm's length or are priced above fair market value. These transactions can artificially inflate the target company's financial performance, making it appear more profitable or valuable than it is. As a result, the acquirer may overestimate the target's worth during the valuation process, leading to an inflated purchase price.⁵⁷

Despite India's extensive regulatory framework aimed at preventing abusive RPTs, the country still struggles to strike a balance between investor protection and facilitating '*ease of doing business*' by reducing overregulation. Recognizing the shortcomings, SEBI established a Working Group ('WG') Committee to reassess RPT regulations and propose practical solutions to curb schemes involving shell companies or seemingly unrelated entities that have been utilized to divert substantial funds by evading the current regulatory framework governing RPTs.⁵⁸ The committee found that companies were exploiting loopholes by conducting RPTs through subsidiaries, as evidenced by the case of Assam Co. India Ltd. ('ACIL') investing in Mexia Resources Ltd. without proper documentation, misleading investors about the company's financial health.⁵⁹ Another concerning trend identified by the WG Committee is the diversion of shareholder funds into promoter groups for risky investments instead of safer, ethical ventures. For instance, in FY 2017-2018, an infrastructure company

⁵⁵ Padmini Srinivasan, 'An Analysis of Related-Party Transactions in India' (2013) 1 Indian Institute of Management Bangalore Working Paper No 402, 3 <https://www.iimb.ac.in/sites/default/files/2018-07/WP_No_402_0.pdf> accessed 01 December 2024.

⁵⁶ AK Bhattacharyya, 'Related Party Transactions - Scepticism All around: Business Law & Taxation Articles' *Business Standard* (New Delhi, 31 August 2014) <https://www.business-standard.com/article/opinion/related-party-transactions-scepticism-all-around-114083100739_1.html> accessed 02 March 2024.

⁵⁷ Institute of Company Secretaries of India, 'ICSI Guidance Note on Related Party Transactions' (1 May 2018) <www.icsi.edu/media/webmodules/Guidance_Note_on_RPTs_4-4-2019.pdf> accessed 29 February 2024.

⁵⁸ Securities Exchange Board of India, 'Working Group on Related Party Transactions' (27 January 2020) ch 3.

⁵⁹ *Assam Company India Ltd and Ors v The Union of India and Ors*, (1973) 4 SCC 225.

borrowed a significant sum, repaying it before year-end to avoid disclosure in the balance sheet.⁶⁰ Moreover, RPT disclosures often lack transparency, with transactions grouped under vague headings like 'Associates' or 'Joint Ventures,' leaving potential acquirers uninformed and hampering the acquirer's ability to conduct thorough due diligence and assess the true financial position of the target. The inadequacy of information disclosure undermines shareholder trust and confidence.⁶¹ Shareholders may become apprehensive about the deal, leading to increased scrutiny, resistance, or even legal challenges. This can delay or derail the M&A process, causing uncertainty and disruption for both the acquirer and the target company.

The most recent example of abusive RPTs negatively impacting an M&A transaction is the termination of the *Sony-Zee Merger*.⁶² The inquiry initiated by SEBI against Punit Goenka, CEO of Zee Entertainment Enterprises Ltd., for allegedly misappropriating funds to the detriment of minority shareholders and diverting company funds for the benefit of related parties, profoundly impacted investor confidence and the market reputation of Zee. The failure to disclose these RPTs and the corporate governance scandal, resulting in a substantial decline in shareholder wealth, culminated in the termination of the merger by Sony to protect its reputation in the market. The merger between ZEE and Sony had significant potential to drive profits, expand market presence, and enhance service offerings. However, the realisation of these benefits hinges on diligent oversight from the board of directors throughout the merger process, particularly during the due diligence. Failure to maintain regular communication and updates with the board represents a breach of fiduciary duty and undermines corporate governance practices. The lack of ongoing communication between the board and shareholders led to confusion and uncertainty among investors, which was not in the best interests of the shareholders. This case highlights the repercussions of abusive RPTs, not only

⁶⁰ Securities Exchange Board of India, *Working Group on Related Party Transactions* (Report, 27 January 2020) ch 3

⁶¹ L Chaturvedi and P Dixit, 'Related Party Transactions and Corporate Governance in India' (*SCC Online*, 2 November 2021) .<https://www.sconline.com/blog/post/2021/11/02/related-party-transactions/#_ftn20> accessed 02 March 2024.

⁶² S Sahyaja, 'Zee-Sony Merger Can't Go Through In Its Present Form, Say Experts' *NDTV Profit* (Mumbai, 23 May 2024) <<https://www.ndtvprofit.com/law-and-policy/zee-sony-merger-cant-go-through-in-its-present-form-say-experts>> accessed 23 May 2024.

on the corporate governance of the entities directly involved but also on potential M&A transactions and broader market sentiments.

VI. BRIDGING REGULATORY GAPS: CHALLENGES IN RPT GOVERNANCE AND RECOMMENDATIONS

Abusive RPTs can introduce undisclosed risks and liabilities, which may impact the valuation of the target company and the overall success of the M&A transaction. To address the issue of increasing number of abusive RPTs, both the SEBI and the Ministry of Corporate Affairs ('MCA') have brought periodic amendments to the SEBI LODR⁶³ and regulations under the Companies Act to make the legal framework governing the RPTs more robust.

However, despite the ongoing efforts to address the increasing number of abusive RPTs through regulations, certain shortcomings persist. The problems that have been pervasive in the governance of RPT disclosures are as follows: First, the blurring of the distinction between transactions that come under the exception of 'ordinary transaction' at arm's length and abusive related party transactions. Second, the non-uniformity of RPT disclosure reports among various companies. Third, the passivity of minority shareholder voting in approval of RPTs.

A. THE BLURRING OF THE DISTINCTION BETWEEN TRANSACTIONS WHICH COME UNDER THE EXCEPTION OF 'ORDINARY TRANSACTION' AT ARM'S LENGTH BASIS AND ABUSIVE RPTS

In M&A agreements, the expression '*transactions entered into by the company in the ordinary course of business*' is pervasive. These agreements outline the conduct of the target companies between the signing and closing of the deal in the following manner:

1. *Affirmative covenant on ordinary course conduct*: Sellers agree that during the interim period, the target company will operate in the ordinary course.

2. *Requirement for buyer consent for non-ordinary course transactions*: M&A agreements stipulate that the target company must obtain prior written

⁶³ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015.

consent from the buyer for specific actions outside its ordinary course of business between signing and closing.

M&A agreements typically include a warranty asserting that after a defined date ('the Accounts Date'), the target company has entered into transactions in the ordinary course of business. This provision aims to ensure that after conducting due diligence and agreeing on a valuation, the buyer receives what was negotiated. Breach of an ordinary course covenant often triggers remedies given in the conditions precedent and termination sections of the acquisition agreement. Hence, if the target company fails to comply with the ordinary course of business covenant, the buyer may have the right to refuse the closing of the transaction or terminate the acquisition agreement.⁶⁴

In this context, Section 188 of the Companies Act⁶⁵ ensures that any transaction that is outside the ordinary course of business is approved by the board. Section 188 of the CA provides exemptions for transactions entered into by the company in its ordinary course of business and at arm's length from seeking approval from the board or shareholders. The provisions govern any RPTs conducted by the target companies by mandating disclosure and board approval for any transaction that does not fall under this exemption. During due diligence in an M&A transaction, thorough scrutiny of the target company's RPTs, including reviewing transaction documentation, financial statements, and board approvals, can help identify any transactions conducted outside the ordinary business practices. This ensures that only transactions entered into in the ordinary course of business at arm's length are included in the M&A agreement. Therefore, by exercising the necessary due diligence to ensure compliance with RPT regulations under section 188 in M&A agreements, parties can mitigate the risk of regulatory scrutiny or legal challenges post-closing.

However, this provision lacks clarity and specificity in defining what constitutes transactions entered into in the ordinary course of business and how to differentiate between transactions conducted on an arm's length basis and abusive RPTs. This lack of clarity presents several challenges and complexities.

⁶⁴ R Sethi and O Chari, 'Decoding "Ordinary Course of Business" in M&A Transactions' (*IndiaCorpLaw*, 29 August 2023) <<https://indiacorplaw.in/2023/08/decoding-ordinary-course-of-business-in-ma-transactions.html>> accessed 08 March 2024.

⁶⁵ Companies Act 2013, s 188(1).

Firstly, determining whether a transaction qualifies as ‘ordinary’ and is conducted at arm's length involves assessing various factors, such as pricing, terms, and conditions, to ensure fairness and the absence of undue influence. However, in practice, it can be difficult to objectively ascertain the true nature of the transaction, especially in cases where related parties have close personal or business relationships with the independent directors and the audit committee. The independence of the audit committee is compromised in such circumstances and it creates a situation where the ID approves RPTs in haste without conducting the requisite due diligence.⁶⁶ This can adversely affect both parties in a merger or an acquisition.

The ID-focused model was a result of the realization that directors often tend to be well-acquainted with business transactions, which allows them to make a well-informed analysis of RPTs within entities. However, the fairness factor associated with this mechanism, has, over the years, been significantly diluted as is evident from the emerging practice of controlling shareholders being able to appoint their representatives as IDs. This has led to a situation wherein the review by IDs can no longer be assumed to be independent.⁶⁷ One of the first examples of such non-independence of independent directors in India is the Satyam fiasco, wherein IDs on the board failed to regulate RPTs being entered by the company, wherein one of their shareholders was the majority shareholder in one of Satyam’s acquisition targets and the sole objective behind this acquisition, as discovered subsequently, was to mask financial irregularities within Satyam, including instances of overstatement of assets and understatement of debt accrued by it.⁶⁸

Secondly, the absence of clear statutory guidelines or standardized criteria for defining and evaluating ‘ordinary transactions’ further complicates the matter. Different companies may interpret and apply the concept

⁶⁶ Kinshuk Saurabh, ‘Separating Abusive from Efficient Related-Party Transactions: Evidence from India’ (2013) 31 *Asian Review of Accounting* 631 <<https://doi.org/10.1108/ARA-06-2022-0136>> accessed 02 March 2024.

⁶⁷ Aron Almeida, ‘Satyam Scam - The Story of India’s Biggest Corporate Fraud’ (*Trade Brains*, 14 November 2023) <<https://tradebrains.in/satyam-scam/#:~:text=The%20Satyam%20Scam%20was%20a,manipulating%20the%20company's%20financial%20health.>> accessed 02 March 2024.

⁶⁸ Ashish K Bhattacharyya, ‘Satyam: How Guilty Are the Independent Directors?’ *Business Standard* (New Delhi, 29 January 2013) <https://www.business-standard.com/article/economy-policy/satyam-how-guilty-are-the-independent-directors-109011201009_1.html> accessed 09 March 2024.

differently, leading to inconsistencies and potential loopholes in regulatory compliance. Without clear guidelines, companies may exploit this ambiguity to justify transactions that may not genuinely fall within the ordinary course of business.

Thirdly, there exists a notable disparity in the threshold criteria between the Companies Act and SEBI LODR concerning the approval of RPTs. While the Companies Act exempts transactions conducted in the ordinary course of business at arm's length from board or shareholder approval, LODR necessitates shareholder approval for 'material' RPTs, which classifies transactions as RPTs based on the materiality of the transaction entered into by the listed entity. This disparity can lead to inconsistent treatment of RPTs. It can lead to the exploitation of these regulatory inconsistencies by the companies to take advantage of favourable legislation by engaging in regulatory arbitrage. As a result, similar transactions may receive different treatment depending on the regulatory framework followed by each company.

Proposed Recommendations

The proposed recommendations for the abovementioned problem can be three-fold:

1. The definition of RPT under Regulation 2(1)(zc) should entail a more exhaustive enumeration of legitimate business transactions that are conducted in the ordinary course of business and at arm's length. This can help distinguish between transactions conducted on an arm's length basis and those that are not, thereby assessing whether such transactions are free from conflict or not⁶⁹. India could also adopt the list of examples provided under the *International Standard on Auditing (ISA) 550 – Related Parties*.⁷⁰ which enumerates the list of transactions deemed to be conducted outside the ordinary course of business. The guidance note on RPTs⁷¹ published by the Institute of Company Secretaries

⁶⁹ Divyam Kandhari, 'Abusive Related Party Transactions: Safeguarding the Interests of Shareholders Through Strengthened Corporate Governance' (2024) II(7) International Journal of Law and Regulation in Asia 2, 27.

⁷⁰ International Auditing and Assurance Standards Board, 'Proposed Revised and Redrafted International Standard on Auditing International Standard on Auditing 550, Related Parties' (2007), [50]-[53].

⁷¹ 'Guidance note on related party transactions' (ICSI, 2020) <<https://www.icsi.edu/media/webmodules/publications/A20ChapterPages.pdf>> accessed 08 March 2024.

of India can also be used as a reference for understanding the criteria to determine whether a transaction falls within the scope of the 'ordinary course of business'.

2. The scope of the definition of 'RPT' in Regulation 2(1)(zc)⁷² of LODR can also be expanded to cover transactions at the subsidiary level, aiming to enhance oversight. However, it's essential to ensure that legitimate business dealings between holding, subsidiary, and associate companies within a large business conglomerate, conducted at arm's length and in the ordinary course of business, still undergo scrutiny and approval by the audit committee.

3. The *Asian Roundtable Guide on Related Party Transactions*⁷³ recommends a comprehensive legal definition of 'related parties' based on the concept of control, encompassing transactions with potential abuse risks. This definition should be harmonized across various legal frameworks such as the CA, SEBI LODR, and Indian Accounting Standards within each jurisdiction to prevent confusion and reduce regulatory complexities and cost burdens on the companies, facilitating more effective implementation and enforcement efforts.

B. NON-UNIFORMITY OF RPT DISCLOSURE REPORTS AMONG VARIOUS COMPANIES

During the due diligence process in an M&A transaction, despite the disclosure of RPTs by companies, there has been little scrutiny regarding the content, format, and transparency of these disclosures.⁷⁴ *Firstly*, without rigorous scrutiny, there is a risk that companies may not fully disclose all relevant information about RPTs, potentially hiding conflicts of interest or transactions that could impact potential acquirers negatively. *Secondly*, the absence of uniformity in RPT disclosures among companies can create disparities in the perceived value of the target company, leading to unfair advantages for certain parties involved in the transaction. For instance, it can create an uneven playing field for the acquiring company in terms of assessing the true financial relationships and performance of the target company. *Thirdly*, the absence of

⁷² Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 2(1)(zc).

⁷³ OECD, 'The Asian Roundtable Guide on Related Party Transactions' (2009). <<https://www.oecd.org/daf/ca/corporategovernanceprinciples/asianroundtabletaskforceonrelatedpartytransactions.htm>> accessed 02 March 2024.

⁷⁴ M Jian & TJ Wong, 'Propping through Related Party Transactions' (2010) 15(1) Review of Accounting Studies 70.

thorough scrutiny can perpetuate a culture of non-compliance or lax oversight regarding RPTs. Companies may perceive RPT disclosures as merely a regulatory requirement to fulfil, rather than an opportunity to enhance transparency and accountability. This mindset can foster a complacent attitude towards RPT disclosures, allowing potentially abusive transactions to go unchecked.

The lack of uniformity in the disclosure of RPTs in annual reports poses significant challenges to the analysis and evaluation of RPT disclosures during due-diligence. Various discrepancies were noted among companies regarding the inclusion of key information such as the names of related parties, the nature of transactions, and transaction amounts.⁷⁵ Some companies provided comprehensive details including the relationship type while others lacked consistency in reporting these relationships.⁷⁶ Additionally, inconsistencies were observed in the reporting of transaction types, with some companies failing to specify crucial details such as whether loans were given or received.⁷⁷

Proposed Recommendations

By drawing from the model which is practised in Singapore, the authors advocate in favour of the mandatory appointment of Independent Financial Advisors ('IFAs') to verify and provide fair opinions on RPTs. IFAs are professionals with expertise in financial matters who can offer impartial assessments of RPTs, ensuring transparency and fairness in the evaluation process. By involving IFAs, companies can mitigate the risk of undervaluing transactions, as these advisors can independently assess the true value and materiality of RPTs.⁷⁸ Additionally, IFAs can supplement the expertise of audit committee members, particularly independent directors, by providing specialized insights and recommendations for informed decision-making.

⁷⁵ CP Abdul Rasheed, 'Do Board Characteristics and Ownership Structure Influence Related Party Transactions Evidence from India' (2018) 27(4) Institute of Public Enterprises Journal of Applied Finance 5, 15.

⁷⁶ Mark Kohlbeck and Brian W Mayhew, 'Valuation of Firms That Disclose Related Party Transactions' (2010) 29(2) Journal of Accounting and Public Policy 115.

⁷⁷ SK Sachdeva, GS Batra, and N Walia, 'Corporate Disclosure Practices in Selected Indian Companies' (2015) 3(10) International Journal of Management 31.

⁷⁸ OECD, 'Improving Corporate Governance in India: Related Party Transactions and Minority Shareholder Protection' (2014) <<https://indiacorplaw.in/wp-content/uploads/2016/12/Improving-Corporate-Governance-India.pdf>> accessed 02 March 2024.

Indian Accounting Standards ('IAS') could provide specific guidelines and principles for reporting RPTs, addressing aspects such as identification, measurement, and disclosure requirements. These guidelines could clarify what constitutes a related party, the types of transactions that should be disclosed, and the appropriate valuation methods.

There should be a standardized reporting format under LODR for RPTs to ensure transparency in RPT reporting across companies. This should include explanations to why certain high-value transactions couldn't be conducted with unrelated entities. This would ensure consistency in the presentation of information, making it easier for investors to compare RPTs across different companies and industries.

C. PASSIVITY OF MINORITY SHAREHOLDER VOTING IN APPROVAL OF RPTs

The passivity among minority shareholders in voting on RPTs pose significant implications for M&A transactions, particularly transactions concerning squeeze-outs of such shareholders during takeovers. In M&A transactions where controlling shareholders may seek to squeeze out minority shareholders, the passivity of minority shareholders in voting on RPTs can exacerbate governance risks. Since a squeeze-out essentially involves expropriating minority shareholders which escalates conflicts between controlling and minority shareholders, corporate governance requires the transaction to be scrutinized under relevant provisions governing RPT.⁷⁹ By mandating approval by the minority shareholders, RPT governance ensures that decisions are made in the best interests of the company and all its shareholders, rather than serving the interests of a particular group or individual.⁸⁰

The concept of majority of the minority ('MOM') approval in RPTs is aimed at protecting the interests of minority shareholders by ensuring that significant transactions involving related parties are approved by disinterested shareholders.⁸¹ While MOM approval can serve as a safeguard against potential

⁷⁹ *Sandvik Asia Ltd v Bharat Kumar Padamsi*, 111(4) Bom LR 1421.

⁸⁰ Securities and Exchange Board of India, 'Recommendation to MCA on related party transactions' (MCA, 7 February 2011) <<https://www.mca.gov.in/content/mca/global/en/data-and-reports/reports/other-reports/report-company-law/related-party-transactions.html>> accessed 12 March 2024.

⁸¹ Ananth Kini, 'Protection of Minority Shareholders and Related Party Transactions' *Live Law* (New Delhi, 16 February 2023) <<https://www.livelaw.in/columns/protection-of-minority-shareholders-and-related-party-transactions-221704>> accessed 02 March 2024.

abuses of power by controlling shareholders or related parties, its effectiveness hinges on the active participation and informed decision-making of institutional shareholders.⁸² Institutional investors, such as mutual funds, pension funds, and other large financial institutions, often have significant shareholdings in public companies and can play a crucial role in monitoring corporate governance practices, including RPTs. However, institutional shareholders may lack sufficient incentives to closely scrutinize RPTs and cast informed votes.⁸³ They may prioritize short-term financial interests or focus on broader investment strategies over the long-term interests of the target company or the interests of the minority shareholders of such company. Institutional investors may also face conflicts of interest, particularly if they have existing relationships with the company or its management, potentially influencing their decision-making and creating tensions during negotiations during an M&A transaction.⁸⁴

However, the disclosure of RPTs has little influence on minority shareholders' voting behaviours mainly for two reasons. *Firstly*, shareholders, particularly in markets characterized by concentrated corporate ownership and limited influence of minority shareholders, often exhibit passive engagement in voting on corporate matters, giving them little opportunity to oppose proposals initiated by controlling shareholders.⁸⁵ The minority shareholders may choose not to vote because they believe their individual vote won't make a difference, leading to a collective action problem where the perception that individual votes are inconsequential results in overall voter apathy and ultimately compromises the effectiveness of minority shareholder votes.⁸⁶ *Secondly*, the presence of

⁸² Alperen Afşin Gözlügöl, 'Majority of The Minority Approval of Related Party Transactions: The Analysis of Institutional Shareholder Voting' (2021) 820(3) *European Company and Financial Law Review* <<https://www.degruyter.com/document/doi/10.1515/ecfr-2021-0029/html>> accessed 02 March 2024.

⁸³ Alperen Afşin Gözlügöl, 'How to Design an Effective and Efficient Related Party Transactions Regulation' (*Oxford Business Blog*, 15 November 2021) <<https://blogs.law.ox.ac.uk/business-law-blog/blog/2021/11/how-design-effective-and-efficient-related-party-transactions>> accessed 02 March 2024.

⁸⁴ Vladimir A Atanasov, Bernard S Black, and Conrad S Ciccotello, 'Law and Tunneling' (2011) *European Corporate Governance Institute (ECGI) - Law Working Paper No 178/2011* <<https://www.ecgi.global/publications/working-papers/law-and-tunneling>> accessed 01 December 2024.

⁸⁵ Nan Li, 'Do Greater Shareholder Voting Rights Reduce Expropriation? Evidence from Related Party Transactions' (2018) 113 *Columbia Business School* 30, 65.

⁸⁶ Bernard S Black, 'Shareholder Passivity Re-Examined' (1990) 89 *Michigan Law Review* 520–560.

mandatory RPT disclosure prompts insiders to only present reasonable transactions for voting, hiding RPTs which are made to expropriate the shareholders' funds.⁸⁷

Proposed Recommendations

Addressing this collective action problem requires coordination among shareholders, such as through collective organizations or proxy advisors.⁸⁸ and a voting rule that gives minority shareholders a fair chance to influence the outcome. Introducing the veto power of minority shareholders with regard to RPTs enhances the corporate governance of RPTs. Chen et al. (2013) discovered that a regulatory policy in China empowering minority shareholders with increased authority to veto proposals leads to substantial enhancements in proposals initiated by controlling shareholders.⁸⁹ This suggests that enforcing provisions allowing minority shareholders to veto abusive RPTs can serve as an effective solution to address governance issues related to RPTs, as it empowers minority shareholders to actively participate in decision-making processes.

The 'mandatory minority-shareholders voting' will lead to heightened transparency in RPT disclosures for two primary reasons. *Firstly*, to garner shareholder approval for their proposed RPTs, controlling shareholders will feel compelled to provide more comprehensive disclosures. Opaque disclosures could be interpreted by voters as indicative of expropriation RPTs, potentially leading to their veto. This increased transparency is beneficial for M&A transactions, as it allows buyers to conduct more thorough due diligence and make informed decisions regarding the target company's financial health and risk exposure.⁹⁰ *Secondly*, given that expropriation RPTs are discouraged by

⁸⁷ Jesse Fried, Ehud Kamar, and Yishay Yafeh, 'The Effect Of Minority Veto Rights On Controller Tunneling' (2018) European Corporate Governance Institute (ECGI) - Law Working Paper No 385/2018, 70-76 <<https://www.ecgi.global/publications/working-papers/the-effect-of-minority-veto-rights-on-controller-pay-tunneling>> accessed 01 December 2024.

⁸⁸ Yonca Ertimur, Fabrizio Ferri, and David Oesch, 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay' (2013) 51(5) Journal of Accounting Research <<https://onlinelibrary.wiley.com/doi/abs/10.1111/1475-679X.12024>> accessed 01 December 2024.

⁸⁹ Zhihong Chen, Bin Ke, and Zhifeng Yang, 'Minority Shareholders' Control Rights and the Quality of Corporate Decisions in Weak Investor Protection Countries: A Natural Experiment from China' (2013) 88(4) The Accounting Review <<https://doi.org/10.2308/accr-50424>> accessed 26 June 2024.

⁹⁰ B Vasani and V Kannan, 'RPT Regulations – Some Suggestions for SEBI's Consideration' (Cyril Amarchand Blogs, 7 July 2022)

mandatory voting, controlling shareholders will likely engage in legitimate RPTs, reducing their incentives to conceal information. Consequently, it is anticipated that firms will disclose more RPT details in their annual reports following the implementation of mandatory shareholder voting on RPTs.

With the introduction of direct listing in the international stock exchanges of GIFT IFSC, governance of RPTs with respect to cross-border M&As would likely improve significantly.⁹¹ Foreign investors, including foreign institutional investors ('FIIs') such as investment funds, mutual funds, or pension funds that are registered in a country outside of the one in which they invest, and holders of American and Global Depository Receipts, play a crucial role in monitoring companies in emerging markets like India. They tend to prefer investing in companies with less concentrated ownership to avoid monitoring challenges.⁹² However, when they do invest in group companies, they prioritize transparency, which can serve as a form of validation for RPTs. Hence, companies listed on international stock exchanges will face heightened pressures for disclosure, which acts as a deterrent for engaging in RPTs.

VII. CONCLUSION AND THE WAY FORWARD

While the complex interplay between RPTs as an indicator of corporate governance standards and its direct and indirect impact on transactions like M&A sheds light on various pertinent challenges, they also direct toward the possibilities that arise out of a calculated redressal of these issues. Going forward, implementation of progressive changes in the current regime would majorly include a focus on compliance with established laws at advantageous timings and on the part of the regulators, improvement of the regime in a manner that would provide for standardized and easy-to-comply, yet stringent regulations.

<https://corporate.cyrilamarchandblogs.com/2022/07/rpt-regulations-some-suggestions-for-sebis-consideration/#_ftn5> accessed 02 March 2024.

⁹¹ 'Modi Govt Allows Direct Listing of Securities by Indian Companies on GIFT IFSC' *Business Today* (New Delhi, 24 January 2024) <<https://www.businesstoday.in/markets/top-story/story/modi-govt-allows-direct-listing-of-securities-by-indian-companies-on-gift-ifsc-414740-2024-01-24>> accessed 02 March 2024.

⁹² Christian Leuz, Karl V Lins, and Francis E Warnock, 'Do Foreigners Invest Less In Poorly Governed Firms?' (2008) 22(8) *The Review of Financial Studies* 3245.

One of the key prospects in the future would certainly be the introduction of clearly defined standards defining the ambit of transitions covered and excluded under the various laws and regulations governing RPTs. However, one must keep in mind the fact that standardization doesn't always protect against the exploitation of loopholes. A glaring example lies in the dilution of the protection potentially envisioned under the regime that shifted power into the hands of IDs, as has already been discussed at length in this paper. To protect against such challenges, regular updating of these standards and incorporating sufficient flexibility within such regulations for them to be able to adapt to changing business landscapes is of crucial importance.

Additionally, the world of M&A as well as investing has been majorly revolutionized by technology. Aides like 'virtual data rooms', designed and maintained by the acquirer or the target (or outsourced to a company equipped with maintaining such data rooms) to make data readily available to either party as well as to regulate and streamline the data flow between the parties to facilitate the due-diligence process in M&A transactions, have ensured that the age-old dependence on regulatory requirements for data to be disclosed has been done away with. These data rooms allow much more stringent and well-monitored due diligence procedures, with an added element of security, all of which are extremely important in today's day and age.⁹³ While looking to revolutionize the regulatory landscape, one will have to keep such developments as well as future technological breakthroughs in mind.

The development of a future-ready regulatory regime, which takes into account newer business considerations like ESG and keeps a stringent check on well-established pain points like abusive RPTs, will be key to enhance India's attractiveness as an investment destination. This would not only facilitate cross-border M&As but will also ensure transparency and integrity in RPT governance, boosting investor confidence in general. In essence, good governance of RPT disclosures fosters an environment conducive to foreign investments and cross-border M&As, ultimately driving sustainable economic growth and development.

⁹³ K Patel, 'What is a Due Diligence Virtual Data Room?' (*Dealroom*, 28 April 2022) <<https://dealroom.net/blog/what-is-a-due-diligence-virtual-data-room>> accessed 11 March 2024.