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A Framework to Define ‘Ordinary Course of Business’

The Companies Act 2013 (Act) requires that companies get board and shareholder approval for related party transactions, unless these are in the ‘ordinary course of business’. But, the Act has not defined what constitutes ‘ordinary course of business’. Therefore, companies differ in their interpretation of the term.

The objective of this document is to help boards arrive at a framework to define the term ‘ordinary course of business.’ We hope these principles will provide a framework to companies and their boards as they debate and approve related party transactions.

The Companies Act, 2013 allows companies to undertake related party transactions (RPT) without the need of any approval, if these are in the ‘ordinary course of business’. If a related-party transaction is not in the ‘ordinary course of business’, it will need to be approved by the board/audit committee of the company. The requirements become more stringent if the transactions cross certain pre-determined ‘materiality’ thresholds. In such cases, the company will require the consent of 75% of the minority (non-related) shareholders.¹

Box 1: Regulation Snapshot: Section 188(1) of Companies Act, 2013

Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to:

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

Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a special resolution:

Provided further that no member of the company shall vote on such special resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party:

Provided also that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis.

¹ This requirement has been recently amended – going forward, companies will need approval from 50 per cent of minority shareholders. The amendment has been cleared by the Indian Parliament and is awaiting the final assent of the President before it is notified.

Given this backdrop, having a framework to decide what constitutes 'ordinary course of business' is important, especially for listed companies which tend to have a large and diverse set of activities.

However, IiAS observes that only 9 out of the S&P BSE SENSEX 30 companies have a defined framework for identifying 'ordinary' activities (See Table 1 below).

Table 1: S&P BSE SENSEX 30 companies – if they have defined 'Ordinary Course of Business' in their RPT Policy

Sl. No	Company	Definition of Ordinary Course of Business ¹	Sl. No	Company	Definition of Ordinary Course of Business ¹
1.	Axis Bank	×	16.	ITC	×
2.	Bajaj Auto	×	17.	L&T	×
3.	Bharti Airtel	×	18.	M&M	×
4.	BHEL	×	19.	Maruti Suzuki	✓
5.	Cipla	×	20.	NTPC	✓
6.	Coal India	×	21.	ONGC	×
7.	Dr Reddy	✓	22.	Reliance	×
8.	GAIL	✓	23.	SBI	×
9.	HDFC	✓	24.	Sun Pharma	×
10.	HDFC Bank	×	25.	Tata Motors	✓
11.	Hero Motocorp	×	26.	Tata Power	✓
12.	Hindalco	✓	27.	Tata Steel	×
13.	HUL	×	28.	TCS	×
14.	ICICI Bank	×	29.	Vedanta	✓
15.	Infosys	×	30.	Wipro	×

[1] In the above analysis, IiAS has considered companies that have attempted to define the term 'ordinary course of business' in some degree of granularity – either through a framework or through a negative / exception list.

The lack of a definition or a framework leaves a lot to the discretion of the board, particularly the audit committee. IiAS has often argued that the crux of strong internal controls lies in the objectivity of the board. Given the sensitivity and potential conflict of interest in RPTs, IiAS believes companies must develop and publish a set of guiding principles which will help their boards decide on what constitutes 'ordinary course of business'. Adherence to these pre-approved guidelines will then ensure fairness and neutrality on the part of the sanctioning authorities.

The objective of this document is to provide clarity to companies and their boards in developing such a policy framework for debating and approving related party transactions.

Framework for deciding which activities are part of the 'Ordinary Course of Business'

Any activity which is routine and in accordance with the usual customs and practices of a particular business can be described to be 'in the ordinary course of business'. For a company, the interpretation needs to be contextual, taking into account the nature of the activity and its relevance in the overall scope of company's businesses.

In order to test for this definition, the following factors must be taken into account:

a. Objects Clause

An activity is more likely to be considered in the ordinary course of business, if it features in the 'Main Objects' clause of the company's Memorandum of Association. This will typically not include activities which are incidental or ancillary to the main objects.

In other words, the more the importance of the activity in terms of the company's business, the more the likelihood of it being considered to be ordinary. This will cover the amount of resources dedicated, capital outlay, revenues generated, the time spent, the manpower involved, etc.

b. Nature of Business and Industry

On occasions, the nature of the business carried out and industry practice in accordance with well settled customs and usages would help determining whether an activity is in the 'ordinary course of business' or not.

For example, in a software company, exporting information technology products will be considered to be in the ordinary course of business; however, constructing residential colonies for its employees will not fit this classification.

c. Precedence

Activities in the ordinary course of business are likely to have a well-established precedence in the company history. If an activity is being conducted for the first time, it is likely not part of the ordinary course of business.

d. Periodicity

Regular and frequently occurring activities will typically be considered to be unremarkable and in the ordinary course of business. Transactions which are infrequent and occur only once in a while are not to be classified as 'ordinary'. We are assuming periodicity to be once every 18 months, but boards are free to determine this gap between recurrences of the activity.

e. Uniformity

This test will account for:

- i. Predictability: Activities whose nature is predictable
- ii. Consistency: Activities where the quantum of transactions are consistent with past history.

For example, in an automobile company, any purchase of auto ancillaries will be considered to be in the ordinary course of business. However, if the quantum of transactions is hiked threefold in a particular year, without a commensurate increase in production, it will cease to be classified as ordinary.

One size will clearly not fit all. Before taking a judgement call, the board must review the above factors in unison: each factor by itself may not be definitive. For example, a textile company may enter into the e-commerce business for the first time, but it will still be tagged as 'ordinary' if the MoA has the relevant clause incorporated as part of its Main Objects.

Negative List

Notwithstanding the above, for any company, the following activities will generally not be considered as part of the ordinary course of business:

- Corporate Restructurings and Schemes of Arrangement between related entities
- Slump Sales or Hive-Offs to related entities
- Purchase of securities of related entities (other than for pure investment companies)
- Royalty fees paid or received from related entities
- Providing capital support to group entities (other than wholly-owned subsidiaries)

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