

CONTENTS

Related Party Transactions: Striking the Balance

	Introduction	2
1.	Sanction of Board.....	2
2.	Disclosure of interest by director.....	3
2.1	Consequences of failure to disclose.....	4
3.	Interested Director to abstain from the proceedings of the Board.....	4
4.	Maintenance of register.....	4
	Conclusion	5

Related Party Transactions: Striking the Balance

INTRODUCTION

A company is an artificial juridical person not capable of taking its own decisions. The board of directors (**“Board”**) of a company primarily takes the decisions, though a few actions also require the approval of the members of the company. Thus, the directors exercise a fiduciary relationship and need to act *bona fide* in the interests of the company. However, as ‘power corrupts and absolute power corrupts absolutely’, it is important that the powers of the Board do not remain unfettered.

The law recognizes the fact that it is human to be tempted towards personal gains and the directors are no different. A person’s view or opinion on an issue may get skewed in the light of his own personal interest. The law embodies the general rule of equity that no person who has to discharge duties on behalf of a corporate body shall be allowed to enter into engagements in which he has a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect.

The Companies Act, 1956 (**“the Act”**) provides the guiding principles to resolve the conflict of interest situations, which may be faced by directors of a company. The concept of interested director is ingrained in the Act itself, by virtue of Sections 297 to 301. These provisions obligate a director having personal interest in a contract or arrangement to disclose his interest to the Board and to abstain from the proceedings of the Board in relation to that particular contract or arrangement. As a general rule of exception, the provisions of Sections 297 to 301 are not applicable in the dealings between an Indian company and a foreign company.

As companies establish multiple operations in India, it is not uncommon to have the same individuals as directors of different entities of the same group. Frequently, these companies are private limited since they are easy to run in operational terms. Group companies also tend to do business with each other and while they have common directors, different issues may emerge. An overview of the mechanism of disclosure and how such contracts have to be dealt by the Board is described below.

1. Sanction of Board

Under Section 297 of the Act, a company is restricted to execute a contract with the following parties (**“the Parties”**), unless the Board approves such a contract by way of a Board resolution.

- (i) **director** of the company or his **relative**¹,
- (ii) a **firm** in which the director or his relative is a partner,
- (iii) any other **partner** in the aforesaid firm,
- (iv) a **private company** in which the director is a member or director.

However, the domain of such restricted contracts is limited to sale, purchase or supply of any goods, materials or services, or underwriting the subscription of any shares or debentures of the company.

¹ Section 6 of the Act read with Schedule IA of the Act provides an exhaustive list of persons who shall be termed as relatives. The list includes spouse, parents, grandparents, siblings, children, grandchildren and their respective spouses.

It is important to bear in mind that the provisions of Section 297 do not apply to contracts between two public companies. The section does not apply in a transaction relating to immovable property, since an immovable property does not fall under goods, materials or services.

The law provides limited grounds in which the consent of the Board may **not** be required. The consent of the Board is not needed in a contract for purchase or sale of goods or materials from the Parties, if the transaction is for cash at the prevailing market price. However, in case of a contract for service, the consent of the Board is still required. Further, a company may, without seeking the consent of the Board, contract with the Parties for those goods, materials or services, which are regularly traded either by the company or the Parties. However, the combined value of such contracts should not exceed INR 5,000 (US\$ 122) in a year. A special exception is carved for banking and insurance companies which are exempt from seeking consent of the Board in relation to transactions with the Parties in the former's ordinary course of business.

The approval of the Board has to be obtained either prior to or within three months of entering into the contract. The Board cannot grant a general consent but has to grant a specific consent for each contract.³ However, the law allows that in case of urgency, prior consent of the Board may be dispensed with, even if the value of contract exceeds INR 5,000, but the consent necessarily needs to be obtained within a period of three months from the date of execution of that contract. In case the consent is not obtained in due time in accordance with the stated procedure, the contract becomes voidable at the option of the Board, though the Board may at its discretion, condone the defect or delay for seeking consent and pass a resolution providing *ex-post facto* affirmation to the contract.

The law makes it mandatory for a company with a paid-up capital of at least INR 10 million (US\$ 243,902) to obtain a prior consent⁴ of the Central Government⁵ before entering into such a contract.

² 1 USD = 41 INR.

³ *Walchandnagar Industries Ltd. v Ratanbhai Khimband Motishaw* (AIR 1953 Bombay 285).

⁴ The consent has to be obtained in Form 24A.

⁵ The powers have been delegated to Regional Directors.

This consent cannot at all be dispensed with, and the contract shall be void if the Central Government's approval is not obtained.

2. Disclosure of interest by director

Section 299 of the Act, applicable to both private and public companies, imposes an obligation on every director⁶ including an alternate director, who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement, entered into, or proposed to be entered into, with the company, to disclose by way of a general notice⁷, the nature of his interest or concern, to the company's Board at its meeting. Such a disclosure needs to be made in the very first meeting when the director becomes concerned or interested. Therefore, if the director is concerned or interested in a proposed contract or arrangement, he needs to make his disclosure in the first meeting itself when the contract is taken into consideration by the Board. Further, if the interest or concern of the director arises later in time, after entering into the contract or arrangement, then the director shall at the very first meeting, after becoming concerned or interested, make such a disclosure.

The general notice for disclosure expires at the end of financial year and may be further renewed for the subsequent financial year, by a fresh notice, to be given in the last month of the financial year when the existing notice lapses. However, the notice shall be deemed to be effective only when it is given in the Board meeting or is considered in the first meeting after its issuance. The notice given by an interested director has to be recorded in the minutes of the meeting in which it is given or read.

Though there is a duty of disclosure by the directors under both Sections 297 and 299, the provisions of section 299 have a wider import than those contained in Section 297, since the latter takes into account specific nature of contracts from Parties, while the former ensures that every direct or indirect

⁶ A director would not be considered to be an interested director under Section 299, if he holds less than 2% of the paid-up share capital of the other company with which the contract or arrangement is entered or proposed to be entered.

⁷ The disclosure needs to be made in Form 24AA.

interest in a contract or arrangement is disclosed to the Board.

2.1 Consequences of failure to disclose

Failure to make disclosure of his interest or variation from the prescribed procedure of disclosure of interest, as mentioned above, constitutes an offence and the director may be punished with a fine, which may extend to INR 50,000 (US\$ 1,219). Further, such a director would be liable to cease office⁸ and failure to do so may subject him to prosecution⁹ and, additionally, he would also have to refund his remuneration received after cessation of his directorship.¹⁰

A non-disclosure required to be made under Section 299 does not invalidate the contract, but it becomes voidable at the option of the Board.

3. Interested Director to abstain from the proceedings of the Board

A director, under Section 300 of the Act, is prohibited to take part in the discussions and vote in the matter relating to a contract or arrangement in which he is interested. Further, an interested director shall not be counted for constituting the quorum at the time of such discussion and voting. If such a director votes in a matter in which he is interested, his vote shall be void. A deliberate contravention of this provision is punishable with a fine, which may extend to INR 50,000. However, these prohibitions are not absolute in nature and are not applicable under certain exceptional circumstances. Even in such exceptional circumstances, it is important for an interested director to disclose his interest, but he is allowed to participate in the discussions and vote on those matters where he has personal interest.

Following are the exceptional situations¹¹ wherein the directors even though being personally interested, may participate and vote on those matters:

- (i) Contracts or arrangements executed by a private company, which is neither a subsidiary or a holding company of a public company with any other company,
- (ii) Contracts or arrangements between a private company and its holding company, if the latter is a public company,
- (iii) If a director is surety for the company in a contract of indemnity that the company enters into, with any third party,
- (iv) Contract or arrangement with another public or private company, which is a subsidiary of a public company in which the director's interest solely consists of:
 - (a) being a director of the other company and holding only such number of shares (qualification shares¹²), which shall entitle him to become a director of the other company, or
 - (b) holding not more than two percent of the paid up share capital of the other company.

Also, the Central Government is empowered to make allowances from the application of prohibitions relating to participation of interested directors in the proceedings of the Board. Such allowances shall be made by way of a notification for a company or companies belonging to a particular industry, business or trade in order to promote that industry, business or trade. These special provisions may be for both, a public company or a private company that is a subsidiary of a public company.

4. Maintenance of register

Every company has to maintain a register at its registered office in the format prescribed and as per the procedure laid down in Section 301 of the Act. The register must contain the details of contracts and arrangements which are attracted by the provisions of Sections 297 and 299. All directors must sign every entry made in the register in the subsequent Board meeting. Non-compliance of Section 301 may lead to monetary sanctions, which may be levied on the company and on every officer in default, and the fine may extend to INR 5,000 for each default.

⁸ Section 283(1)(i) of the Act.

⁹ Section 283(2A) of the Act.

¹⁰ *M O Varghese v Thomas Stephen & Co. Ltd.* [(1970) 40 Company Cases 1131 (Kerala)].

¹¹ The exemptions provided to private companies do not extend to private banking companies vide Section 49 of the Banking Regulation Act, 1949.

¹² Companies in India may impose a qualification on their directors to hold certain number of shares in order to become the director in that company.

CONCLUSION

The provisions enacted in Sections 297, 299 and 300 of the Act are founded on the principle that a director is precluded from dealing on behalf of the company as himself and from entering into engagements in which he has a personal interest conflicting or which possibly may conflict with the interest of those with whom he is bound by fiduciary duty. If a director makes a contract with the company and does not disclose his interest, he will commit a breach of trust.¹³ This concept of interested directors and related party transactions gains importance because of the growing impetus on transparency and corporate governance in the affairs of companies not only in India, but globally. This issue has also been dealt in the report¹⁴ of the Expert Committee on Company Law constituted under the Chairmanship of Dr. JJ Irani, where it has been proposed that in order to give transparency to related party transactions, transactions beyond a specific limit be subject to shareholders approval.

Directors of a company are its torch-bearer and negotiate contracts with different parties on its behalf. However, when it comes to contracts with related parties, the directors have to adopt utmost caution and walk upon a tight rope taking into account the best interest of the company. This also includes an implied obligation to ensure that the contracts should not become voidable. It is pertinent to note that if a related party transaction is challenged in a court of law, then the burden of proof lies on the interested director to prove that he had made sufficient disclosures and followed specified procedures in such a contract. The law does not forbid a director to execute a contract with the company, but the delicate relationship between the director and the company warrants that such a contract be formed at an arm's-length and in a manner which does not cast any doubt on the fairness and integrity of both the director and the company.

(Madhav Rastogi)

¹³ *Yashvardhan Saboo v. Gnoz-Bakert Saboo Ltd.* [(1995) 83 Company Cases 371 (CLB)].

¹⁴ http://dca.nic.in/report_expert_comt.htm#chap5.



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