

Interested Director: need for disclosure

Introduction

The directors of a company act as its agents and execute contracts and arrangements on behalf of the company. In the course of such transactions, it is likely that they may have some personal interest in the proposed transactions. Since a director occupies a fiduciary position in a company and must act *bona fide*, the Companies Act, 1956 (“**Act**”) has laid down extensive provisions under Sections 297 to 302 to prevent the misuse of rights and powers by the directors. The object of these provisions is to bring to the notice of the Board, the extent of the interest of a director, whether directly or indirectly, in any contract proposed to be executed with the company.

In India, a large number of companies are held and run by family enterprises which have common directors on the Board of such companies. As a result, there is a risk of potential conflict of interests between the promoters and the other minority shareholders of such companies. Section 297 of the Act protects such minority by requiring mandatory approval of the Board, when a director of a company is a director or a member or is related to any director or member of the other contracting entity. However, this approval is not required for contracts between two public companies.¹ In other words, the section applies where the first party is any type of company, private or public and the second party is **(a)** a director or relative of director of first party, **(b)** partnership firm in which director of first party is a partner or **(c)** a private company in which the director of the first party is a member or director. This newsletter focuses on a director’s accountability and compliance requirements when such a person is “interested.”

1. Definition of interested director

As per Section 287 of the Act, “*interested director*” means a director, who by reason of Section 300, cannot be counted for constituting a quorum and who cannot participate or vote on a contract or arrangement under consideration by the Board. Section 300 requires an interested director to abstain from voting or participation in discussions on any contract or arrangement in which he is either directly or indirectly interested. “Interest” arises if the party to the contract is: **(a)** relative² of the director; **(b)** a firm in which the director or his relative is a partner; or **(c)** a private company in which such director is a member or a director. Thus, in essence, an interested director is one who is concerned or interested in the proposed contract or arrangement to be executed with the other company of which he is a director and consequently, cannot constitute towards quorum or participate or vote on that business.

¹ Section 3(1)(iv)(c) of the Act defines a public company to include a private company which is a subsidiary of a public company

² Under Schedule I-A of Section 6 of the Act, a person is relative of another if they are members of a Hindu undivided family, they are husband or wife or related in the manner in Schedule I-A

2. Contracts in which director is interested

Sections 297, 299 and 300 of the Act focus on the requirement of Board's approval when a director is interested in a contract, and prescribe the procedure for disclosure of interest and the position of such an interested director in Board meeting. Section 297 provides that prior approval of the Board should be taken for a contract for sale, purchase or supply of any goods, materials or services between two companies having common director(s). This approval has to be provided by the Board in its meeting and not by a circular resolution. Further, in case the company's paid-up capital is INR 10 million (about *US\$ 185,000*)³ or more, prior approval of the Central Government would be necessary in addition to the approval of the Board.⁴ The terms "goods" or "services" are not defined under the Act. This has led to deliberations on the threshold issue whether a contract falls under the purview of Section 297 or not. The primary consideration while analyzing the ambit of Section 297 is whether the director is in a situation to manipulate his fiduciary position in the company, for his personal benefit. It is redundant if he has actually misused his power. The potential prospect of abuse by the interested director is sufficient to cover the contract under the scrutiny of Section 297. Thus, agreements between group enterprises with common director(s) are most susceptible to come under Section 297. For example, Company A and Company B are private limited companies with paid-up capital of INR 20 million and INR 25 million respectively and are subsidiaries of Company C, a public limited company. Mr. X is a common director in all the three companies. Company C buys the finished products from Company A and B and sells them in the open market under a common brand name. For such an arrangement, since X is a common director and the agreements will be executed between a private and a public company, consequently, Companies A and C and B and C will have to take prior approvals from Central Government for executing such agreements.

The requirement of Board and Central Government approval does not apply in the case of purchase and sale transactions of goods for cash at prevailing market prices⁵ and when a company regularly trades in the purchase and sale of such goods and services for INR 5,000 (*about US\$ 92*) in a year. Furthermore, in case of business exigencies, Section 297(3) of the Act allows a company to execute the contract without the approval of the Board, but mandates that such approval must be obtained at a meeting within 3 months of the date of the execution of the contract.

As mentioned earlier, an interested director cannot take part or be counted for the purpose of forming a quorum⁶ in the Board meeting. Any resolution passed without necessary quorum is invalid. Section 300 is not applicable to private companies and contracts between private company(s) with its holding company. A problem arises in certain closely held private companies which may have a lean Board with two directors in the two companies and who may be both related and interested. In such situations, it is necessary to obtain approval from the

³ 1 US\$= INR 54.32 approx

⁴ The approval from Central Government is delegated to the Regional Director is available online on filing of e-Form 24A

⁵ Though not defined in the Act, it means the reasonable price with respect to the market rate at the time of sale

⁶ Under Section 287 of the Act, the quorum for a Board meeting is one-third of its total strength or two directors, whichever is higher.

shareholders in a general meeting.⁷ If the interested director is also a shareholder and a resolution is put up for approval of the members, he can vote in the capacity of a shareholder in the general meeting.

3. Disclosure by interested director

Section 299 provides that directors have to disclose their interest in a contract or arrangement of the company, even for a public company. However, such disclosure of interest is not required in contracts between two companies when common director(s) is also a shareholder of the other company and holds less than 2% of the paid-up share capital in the other company. For example, Company A, executes a contract with Company B, which has paid-up capital of INR 1 million (*about US\$ 18,400*). Mr. X, a director of A holds equity shares worth INR 10,000 (*about US\$ 185*), in Company B., Mr. X does not disclose his interest to the Board of Company A as required under Section 299, since his holding in Company B is less than 2%. But if Mr. Y, who holds shares worth INR 20,000 (*about US\$ 370*) is appointed in Company A, then Mr. X and Mr. Y's joint holding in Company B exceeds 2% of its paid-up share capital and disclosure has to be made by Mr. X and Mr. Y to Company A.

The method of disclosure is provided under Section 299 of the Act as follows:

(a) *In case of proposed contract/arrangement:* Disclosure by a director has to be made at the Board meeting where the proposal of entering into the contract is considered. The Act does not prescribe a formal mode or manner in which such a disclosure can be made. Practically, during the course of a Board meeting when the directors discuss any contract the director so interested communicates to the other director of his interest in the said agreement and abstains himself from participating in the discussions or passing of any resolution with respect to such a contract.

(b) *General notice:* A general notice provided by a director to the Board, specifying that he is member or director of a body corporate or a firm, is sufficient disclosure of interest with respect to any contract entered into by the company. Such disclosure is given in Form 24AA⁸ and has to be renewed at the end of each financial year. Once a director discloses the name of the body corporate in which it is interested in and gets the same noted by the Board, the onus shifts to the company to track any transactions with interested parties. This is the most practical option available and followed by most companies, thus, exempting the director's from the duty of disclosure every time there is a conflict of interest.

(c) *In case of any other contract/arrangement in which the director subsequently becomes interested:* Under Section 299(2)(b) of the Act, in case of any transaction of the company in which the director subsequently becomes interested, the liability of disclosure arises when the director accepts the office as director. Therefore, disclosure has to be made at the first meeting held after the director becomes interested in the contract.

⁷ Article 48 of Table A of Schedule I of the Act.

⁸ As prescribed under Companies (Central Government's) General Rules & Forms, 1956

Disclosure at the Board level is the preliminary step and subsequent step under Section 302 requires that the company informs its members of entering or altering a contract, for appointment of manager or managing director, in which director(s) is interested. An abstract of the memorandum has to be circulated to every member, specifying the nature of the concern or interest of the director, within 21 days from the date of the contract.

The final requirement is to enter details of all contracts executed by a company in a register. Under Section 301, register of contracts of all nature in which directors, and the companies with which they are entered, are interested is to be maintained and kept open for inspection by members at the registered office. This helps in maintaining transparency in the management of the company.

4. Effects of non-disclosure

From the foregoing it is clear that the only duty that the director has is to make disclosure of interest. A director who has an interest in a company transaction is under a duty to ensure that the provisions of the Act are complied with, *viz.*, his declaration of interest. If a director makes a contract with the company and does not disclose his interest, that will constitute breach of trust. In case of non-compliance under Sections 297 to 302 of the Act, the contract or arrangement is not void or illegal but becomes voidable at the instance of the company. In cases where Central Government approval is necessary, but is not taken, the transaction would be considered void and in case Board's consent is necessary and not taken then the transaction would be voidable. The right to rescind the contract is generally given to the company so that it can analyze its loss, if any, due to the conflict of interest and, accordingly, come to a decision on the validity of such contract. The fairness or otherwise of the contract is not a relevant matter in deciding whether the company may rescind a contract. The defaulting director is punishable with a fine up to INR 50,000 (*US\$920.5 approx*) and ipso facto liable to automatic vacation from his office after a Board meeting is convened to specifically address the issue of considering his position. The director is also liable to account for the profits he might have made by misusing his position in the company.

Conclusion

It is crucial that the directors do not abuse their authority for their personal gain and also that the company is aware of an interest of any director before executing any contract where the director is so interested. This duty of disclosure ensures fairness in the dealings. Where the financial triggers require prior Central Government approval when there are common director(s), this must be taken so as to prevent the contract being declared void. The object is to prevent diversion of resources by promoter to another group entity to retain higher profits. Therefore, the statutory register maintained under Section 301 which captures all particulars of a contract or arrangement in which director is interested is available to any member for inspection.

Authored by:
Priyanka Das