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Company Directors and the Law: A focus on Self-dealing Transactions by Company Directors.

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Abstract

To prevent directors from prioritising their personal gain over the company's welfare, Indian law has established a robust three-tiered defence system. This framework is specifically designed to curb "selfdealing," which occurs when those in corporate power use company resources for personal benefit. The first line of defence is built on transparency and recusal. When a director has a personal stake in a potential company deal, they are legally required to declare that interest immediately. Furthermore, they must step away from the decision-making process, ensuring they do not influence the discussions or vote on that specific transaction. The second layer of protection focuses on specific types of sensitive business deals. These transactions are not left solely to the company's internal discretion; instead, they require formal authorisation from both the Board of Directors and the Central Government. This creates an external check to ensure the deal is fair to the company's stakeholders. The most rigorous level of control is reserved for loans granted to directors. Because these are viewed as high-risk activities with significant potential for abuse, they are governed by much harsher regulations than any other form of self-dealing. In many cases, these transactions are strictly prohibited or subject to narrow exceptions. This research analyses how these three safeguards have evolved by comparing the regulations within the 1956 Companies Act against the modernised 2013 Companies Act. By examining the shift in these legal provisions, the study aims to offer practical recommendations that could further refine and strengthen corporate governance in India.

Keywords:

Self-Dealing Transactions, No-Conflict Rule, Fiduciary Duty, Disclosure, Abstention, Prior Approval, Tunnelling, Promoter Control, Minority Investors, Corporate Governance, General Notice, Indirect Interest, Beneficial Ownership, Loans to Directors, Common Law Remedies, Audit Committee.

Introduction

The **No-Conflict rule** establishes a fundamental mandate that a director or any other fiduciary of a company must strictly avoid positions where their duties to the firm clash with personal interests or obligations to third parties. A primary method by which this duty is breached is through **"self-dealing,"** a process where fiduciaries engage in transactions with their own company. In these scenarios, their personal pecuniary interests often stand at odds with the commercial goals of the entity. This dynamic is inherently problematic because a fiduciary may prioritise personal gain, leveraging their influence to secure deals that are more advantageous than those an independent, rational, and loyal decision-maker would accept, as noted in the landmark observations of **Lord Cranworth LC** in *Aberdeen Railway Co. v Blaikie Bros.* and **Lord Herschell** in *Bray v Ford*.

While such risks might suggest that all self-dealing should be prohibited, such a conclusion is legally and practically flawed. Not every instance of self-dealing is detrimental; in fact, a director might be the most efficient provider of a

specific service or asset. As **Lord Herschell** highlighted in *Bray vs Ford*, it can sometimes be more beneficial for a company to utilize the professional expertise and internal knowledge of its own fiduciaries rather than hiring a stranger. Consequently, the law does not seek to ban these transactions entirely but rather to curtail them only when they result in unfair outcomes. The objective of a robust legal system is to establish procedures that prevent conflicting interests from tainting the process, ensuring the company achieves equitable results.

In the context of Asian markets, and India specifically, **abusive self-dealing** has emerged as a significant corporate governance challenge. This vulnerability is driven by two defining characteristics of the Indian corporate landscape: high ownership concentration and the prevalence of business groups. Statistics from 2007 indicate that the average **BSE 100** company featured a promoter holding of over **48%**, with a mere ten companies having promoter stakes below **25%**. Similar trends exist within the **BSE 500**, where average promoter stakes hover around **49%**. This concentration, combined with the fact that single families often control multiple firms, creates a fertile ground for **"tunnelling."** This involves diverting profits away from minority investors toward entities where promoters hold higher ownership, often through skewed loans or asset transfers at non-market prices.

The impact of such practices is not merely theoretical; high-profile scandals involving **Subhiksha Trading** and **Satyam Computer Services** have demonstrated the real-world consequences of these mechanisms. Such a climate of opacity and unfair dealing can stifle capital markets by alienating both domestic and foreign investors. To address this, Indian law utilizes a three-tiered safeguard. The first involves mandatory disclosure and abstention by interested directors; the second requires specific approvals from the Board and Central Government for certain transactions; and the third imposes stringent regulations on loans to directors. By comparing the provisions of the **1956 and Companies Acts 2013**, and drawing insights from other common law jurisdictions, one can identify pathways to further strengthen Indian law against the persistent threat of abusive self-dealing.

A. The Requirements of Disclosure & Abstention

In corporate jurisprudence, a director serves as a fiduciary who is legally bound to act in the best interests of the company with utmost good faith, specifically avoiding any friction between personal gain and corporate duty. Under traditional common law principles established in cases such as *Aberdeen Railway Co. v Blaikie Bros.*, *A.B. Cook v George S. Deeks*, and *Regal (Hastings) Ltd. v Gulliver*, any arrangement where a director transacts with themselves or an interested firm is voidable at the company's discretion. This remains true regardless of the deal's fairness or the presence of actual financial loss. However, as noted in subsequent legal developments, a robust defense against such avoidance exists if the director discloses the conflict to the shareholders and receives their informed consent.

The **Companies Act, 1956** integrated these common law tenets but introduced modifications that proved structurally problematic in the Indian context. Under **Section 299**, the mandate for disclosure was shifted from the shareholders to the Board of Directors. Furthermore, **Section 297** required Board assent—rather than shareholder approval—for only a limited subset of transactions. Given that many Indian firms are dominated by specific promoter groups, this framework often resulted in "interested" boards essentially approving their own deals while shareholders remained uninformed. This systemic flaw was highlighted in litigations like *Globe Motors Ltd. v Mehta Teja Singh and Co.*, *Ravi Raj Gupta v Hansraj Gupta & Co.*, and *Suryakant Gupta v Rajaram Corn Products (Punjab) Ltd.*, where courts were unable to intervene because the technical requirements of **Section 299** had been met by boards comprised of the directors' close associates or relatives.

Further complicating the 1956 regime was **Section 299(3)**, which allowed for a "general notice" of interest to suffice for an entire financial year. This effectively bypassed the need for specific, detailed disclosures for individual transactions. Such a "blanket" approach contradicts the wisdom of **Lord Cairns** in *Imperial Mercantile Credit Assn. v Coleman*, who argued that true disclosure requires stating the specific nature of an interest, not just its existence. Without transaction-specific details, as cautioned in *Gray v New Augarita Porcupine Mines Ltd*, a board cannot make a truly informed decision. Moreover, this shifted the burden of diligence onto the Board to track potential conflicts through past minutes, rather than keeping the onus on the interested director.

The judiciary's historically permissive stance has also been a point of contention. In *A Sivasailam Tractors and Farm Equipment Ltd. v ROC*, and similar rulings like *Guntur Cotton Mills v Venkatachalapathy*, it was suggested that formal disclosure is unnecessary if the Board is already "aware" of the conflict. This interpretation risks undermining the literal mandate of the Act and the necessity of maintaining a formal record for

future auditors or directors. The importance of this formal record-keeping was emphasisedTanya Badkur in *Neptune (Vehicle Washing Equipment) Ltd. v Fitzgerald*, where even a sole director was required to formally record disclosures to fulfil fiduciary obligations. Additionally,

Section 299(6) offered an exemption for directors holding less than **2%** shareholding in a transacting party. However, the narrow definition of the word "hold" established by the Supreme Court in *Howrah Trading Co. Ltd. v CIT* meant that only direct, registered ownership was considered, potentially exempting significant indirect or beneficial interests.

Failure to adhere to these 1956 provisions triggered the vacation of office under **Section 283(1)(i)** and financial penalties under **Section 299(4)**. Beyond statutes, equitable principles applied in cases like *Costa Rica Rail Co. Ltd. v Forwood* and *Pandalai (K.C.) v S.I.G. Assurance Co. Ltd* ensure that directors can be stripped of any personal profits derived from such contracts. While **Section 300** mandated that interested directors in public companies abstain from voting and not be counted toward a quorum, the law strangely exempted private companies and certain indemnity contracts.

The **Companies Act, 2013** seeks to rectify these historical weaknesses through **Section 184**. This updated provision marks a significant advancement by requiring both a general notice at the start of the year (or upon any change in status) and specific disclosures for every transaction. This ensures that the Board is actively informed and shifts the burden of transparency back to the interested fiduciary. However, a potential drafting defect exists within **Section 184(2)**. By specifying that disclosure is required when a

director "holds more than **2%** shareholding" or acts as a "promoter, manager, or CEO," the Act may have inadvertently narrowed the scope of "indirect interests" compared to the broader language of the 1956 Act. If interpreted strictly, as per the *Howrah Trading* precedent, transactions involving a director's relatives might escape the net.

To ensure the 2013 Act remains effective, courts may need to adopt a broader definition of "holding" that includes equitable ownership, similar to the approach in the Australian case *Re Bennet (decd)*. Currently, **Section 184** imposes stricter penalties, including potential imprisonment for up to one year and fines up to **₹1,00,000**, while extending the abstention requirement to all companies, regardless of whether they are public or private. By examining these legislative shifts and judicial interpretations, it becomes clear that while the 2013 Act offers a more responsive system, the precision of its language regarding indirect interests remains a critical area for future legal refinement.

B. The Requirement of Prior Approval

While **Section 299** of the **Companies Act, 1956** focuses on the broad mandate of disclosure for any direct or indirect interest in a "proposed contract," **Section 297** establishes a distinct

requirement for prior approval. Unlike the expansive reach of the former, the latter is confined to specific categories, such as the sale, purchase, or supply of goods and services, or the

underwriting of shares and debentures, as clarified in *Rabindra Nath Mitra v Emperor*. Furthermore, while disclosure is mandatory for transactions between public companies under Section 299, Section 297 historically excluded such dealings from the requirement of prior approval. The 1956 regime specifically targeted contracts with a director, their relatives, or private firms where they held membership, but it famously lacked the "direct or indirect" catchall phrasing found in the disclosure rules, leading to significant regulatory gaps.

The primary weakness of **Section 297** lay in its rigid and narrow drafting. By failing to account for indirect interests—such as a company controlled by a director's family—the provision allowed many abusive self-dealing scenarios to bypass scrutiny. A particularly glaring omission was the exclusion of transactions involving immovable property. Since the Act relied on the

definition of "goods" from the **Sale of Goods Act, 1930** (which covers only movable property), the most valuable assets of a company could be transacted without prior approval. This loophole was confirmed in *Clarification No.9/41/90—CL-X*, which noted that renting office premises from an interested firm fell outside the scope of Section 297. The practical consequences of this narrow wording were seen in *Renuka Datla v Biological E. Ltd*, where the court ruled that neither the transfer of shares to a daughter nor the appointment of relatives as employees required prior approval under this specific section.

Under the 1956 framework, a two-layer approval mechanism existed: first, a formal Board resolution, and for companies with a paid-up share capital of ₹1 crore or more, the additional consent of the Central Government. However, the Board-level check was often toothless in the Indian corporate environment, where family-dominated boards frequently approved gross

inequities. In *A. Jawahar Palaniappan v Kumudam Publications (P) Ltd.*, for example, a board of family members approved a ₹3 crore purchase of assets worth only ₹8 lakhs. Even the government-level safeguard proved ineffective in practice, as the burden of oversight led to broad delegations to regional directors and various exceptions. Circulars like **No.13/75** further diluted the law by exempting professional services, which allowed for the nepotistic hiring of unqualified relatives, a reality upheld in *Shailesh Harilal Shah v Matushree Textiles Ltd.*

In stark contrast, **Section 188** of the **Companies Act, 2013** represents a major evolution in safeguarding company interests. It replaces the cumbersome government approval process with a more effective three-step oversight system: shareholder consent via special resolution for
highvalue transactions, the mandatory exclusion of interested parties from voting, and a requirement for the Board to justify such transactions in their annual reports. This shifts the power to the stakeholders who are most impacted by "tunnelling." Furthermore, Section 188 explicitly includes immovable property and offices of profit, effectively ending the exemptions that fueled nepotism. Recent rulings in *Jagran Prakash Ltd. v Union of India* and *Madhu Ashok Kapur v Rana Kapoor* confirm that the appointment of relatives now strictly requires approval, overturning the legacy of *Renuka Datla*.

A pivotal feature of the 2013 Act is the "arm's length" exception, which exempts transactions conducted in the ordinary course of business if they mimic terms between unrelated parties.
While this departs from the strict common law procedural focus seen in *Aberdeen Railway Co. v Blaikie Bros.*, it introduces a substantive test of fairness. As seen in *Madhu Ashok Kapur v Rana Kapoor*, and drawing from the Supreme Court's logic in *Atic Industries Ltd. v H.H. Dewa* and
A.K. Roy v Voltas Ltd., "arm's length" is interpreted as a substantive valuation check rather than a mere procedural formality. To enforce these new standards, the 2013 Act provides powerful remedies: the transaction is voidable, directors must indemnify the company for losses, and offenders face heavy fines, potential imprisonment, and a five-year disqualification from holding any directorship under **Section 164(1)(g)**.

C. The Regulation of Loans

In the complex landscape of self-dealing, loans occupy a uniquely precarious position. They frequently serve as a convenient mechanism for bypassing statutory restrictions on asset disposal, effectively masking what are essentially gifts. This occurs because such credit is often extended without a genuine expectation of repayment or on terms that lack any commercial justification. This inherent risk prompted the **Cohen Committee** in the UK to recommend a total prohibition on corporate loans to directors in 1945. Their logic was elegantly simple: a director with sufficient security could easily obtain credit from traditional financial institutions, while a director lacking such security represents a risk that no prudent company should undertake in the interest of its shareholders.

The **Companies Act, 1956** attempted to mirror these stringent recommendations through **Section 295**, which forbid direct or indirect loans to directors, their relatives, or entities in which they held an interest, unless prior approval was secured from the Central Government. However, this regulatory framework suffered from two major structural vulnerabilities. First, its application

was restricted to public companies and their private subsidiaries, leaving a massive segment of the private sector in a legal vacuum where directors could engage in unfair credit transactions with relative impunity. Second, the statute's reliance on the narrow term "loan" rather than a more inclusive phrase like "credit transactions" led to restrictive judicial interpretations.

The limitations of this technical phrasing were laid bare in **Fredie Ardeshir Mehta v Union of India**, where the Bombay High Court ruled that selling a company flat to a director on credit did not constitute a "loan" because it didn't involve the immediate grant of a sum of money. This precedent essentially allowed fiduciaries

to achieve prohibited ends through indirect means, such as purchasing property in the company's name and "buying" it back on credit. A similar
avoidance was upheld in **M.R. Electronic Components Ltd. v Registrar of Companies**, where substantial sums transferred to a director's spouse were categorized as "advance salaries" rather than loans, thereby escaping the reach of **Section 295**.

Violations under the 1956 Act carried significant weight, including fines and potential
imprisonment—though the latter was waived if the funds were fully recovered. Directors faced joint and several liability, and under **Section 283(1)(h)**, the discovery of such a contravention resulted in the immediate vacation of their office. Notably, as established in the case of **Ciro Citterio Menswear plc**, this remedy was personal rather than proprietary; it rendered the director liable for the debt but did not automatically transform them into a constructive trustee of the lent assets.

The **Companies Act, 2013** significantly fortified this regime through **Section 185**, which effectively aligns Indian law with the original vision of the Cohen Committee. In a major policy shift, the new Act extended the prohibition to all companies, regardless of their public or private status. While the term "loan" remains central, the legislature expanded its scope to include "any loan represented by a book debt." This broader definition targets credit sales and employee advances that were previously shielded, as supported by the reasoning in **Independent Automatic Sales Ltd. v Knowles & Foster** and **Raja of Venkatagiri v Krishnayya Rao Bahadur**.

Perhaps most importantly, the 2013 Act removed the possibility of obtaining Central Government consent, transforming a regulated activity into a near-total prohibition. The penal consequences have also been heightened to provide a more robust deterrent. Under the current law, both the company granting the loan and the recipient are liable for substantial fines ranging from five lakh to twenty-five lakh rupees. Directors may additionally face imprisonment for up to six months, ensuring that the "special danger" posed by self-serving credit transactions is met with equally severe legal accountability.

Conclusion

The Companies Act, 2013, has successfully addressed numerous issues under the 1956 Act's provisions on self-dealing. Nonetheless, the efficacy of the 2013 Act cannot be predicted – only its implementation will reveal any further shortcomings that may need to be addressed. At the same time, it would be beneficial to outline the areas in which the 2013 Act could improve, and the lessons it could learn from the law on self-dealing transactions in other jurisdictions.

A. Enhancing Supervisory Mechanisms over the Board of Directors

The unique ownership and management landscape in India makes the corporate sector especially susceptible to unfair self-dealing, often orchestrated by interested directors. Relying solely on the Board of Directors to regulate these transactions is a high-risk strategy. While the **Companies**
Act, 2013 successfully reintroduced the common-law requirement of shareholder approval, further refinements are necessary. For instance, **Clause 49(VII)(D) of SEBI's Equity Listing Agreement** offers a progressive model by requiring the Board's Audit Committee to verify and approve every self-dealing transaction. Expanding this requirement to all companies would be a significant step forward, though it would necessitate extending the mandate for independent directors beyond just public listed entities to all corporate forms.

Looking to international benchmarks, both Hong Kong and Singapore have pioneered transparency by requiring that all material self-dealing transactions be announced publicly.
Under **Stock Exchange of Hong Kong Listing Rule 14A** and the **Singapore Exchange Listing Manual Rule 9A06**, this public disclosure empowers investors and the general public to monitor corporate actions effectively.

Furthermore, while India requires shareholder approval for major related-party transactions where only independent shareholders may vote, these jurisdictions ensure that such votes are truly informed. They mandate that independent directors form a

specialized committee and appoint an external financial advisor to provide a formal fairness opinion on the transaction.

Adopting the UK's approach to shareholder approval could also enhance efficiency. Rather than focusing on a specific monetary value as the **Companies Act, 2013** does, UK law makes approval contingent on the nature of the transaction itself. By targeting high-risk categories— such as substantial property deals, service contracts, and political donations—the state can focus its regulatory energy on the most dangerous types of self-dealing while allowing routine transactions to proceed without the burden of shareholder intervention.

Finally, improving India's financial reporting is essential. **Accounting Standard 18**, which governs related party transactions, currently contains significant gaps. It does not apply to associate companies, nor does it require the disclosure of critical details like transaction pricing, the rationale for choosing a specific party, or an evaluation of fair market alternatives. Closing these loopholes is vital for creating an exhaustive and cohesive regulatory framework.

B. Addressing Issues of Drafting in the Statute

Despite its advancements, the **Companies Act, 2013** contains specific drafting flaws that require immediate attention. A primary concern is **Section 185**, which restricts the prohibition on director benefits to "loans." This terminology is excessively narrow and has led the judiciary to apply a highly technical and restrictive interpretation. To prevent directors from using indirect credit schemes to bypass the law, India should consider the English position under **Sections 197203 of the UK Companies Act 2006**. This framework expands the prohibition to include "quasiloans," "credit transactions," and other "related arrangements," effectively closing off indirect routes to personal enrichment.

Furthermore, the statute requires greater flexibility in defining what constitutes a "related party" or an "indirect interest." The current phrasing of **Section 184** is so specific that it frequently excludes various forms of indirect interests that a director might hold in a contracting party. In contrast, jurisdictions like the USA, Hong Kong, and Singapore utilize broad definitions of associated parties and avoid rigid classifications of transactions. Adopting a more expansive
definition would ensure that the requirements for disclosure and approval are triggered by the reality of the conflict of interest rather than the technical structure of the transaction.

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