

## **MANAGING CONFLICTS OF INTEREST: A FOUNDER'S GUIDE TO RELATED PARTY DEALINGS**

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In the nascent stages of a startup, the boundaries between the founder's persona and the corporate entity are often porous. To a founder, the company is an extension of their vision; it is common, and often operationally efficient, to leverage personal assets, family-owned real estate, or sister concerns to gain traction. In this "scrappy" phase, a lease agreement with a spouse or a service contract with a former colleague's firm is seen not as a legal hurdle, but as a strategic shortcut.

However, as a private limited company scales and seeks external institutional capital, this informality becomes a significant governance liability. The transition from a "founder-led" enterprise to a "board-managed" institution necessitates a fundamental shift in legal consciousness. At the heart of this transition lies the concept of fiduciary duty, a cornerstone of Indian corporate jurisprudence.

Under Section 166 of the Companies Act, 2013, a director is statutorily mandated to act in good faith to promote the objects of the company and in the best interests of its stakeholders. Specifically, Section 166(4) of the Companies Act, 2013 creates an absolute bar, stating that a director shall not involve themselves in a situation in which they may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.

The conflict in a Related Party Transaction (RPT) is rarely about the transaction being inherently "bad." Rather, it is about the risk of self-dealing. When a director sits on both sides of a negotiating table, the presumption of an "arm's length" negotiation vanishes. The law does not strictly prohibit these transactions; instead, it creates a rigorous framework of disclosure and approval to ensure that the company's interests are not sacrificed at the altar of personal gain.

The Indian judiciary has long upheld this principle of *uberrima fides* (utmost good faith). In the landmark case of *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd.*<sup>1</sup>, the Supreme Court of India observed that directors stand in a fiduciary capacity, and even if an act is within their legal power, it must be exercised for the benefit of the company and not for a "corrupt motive" or to maintain personal control.

For the modern founder, governance integrity regarding RPTs is no longer just a "compliance checkbox." In an era of heightened due diligence, murky related-party dealings are a primary cause for "valuation hair-cuts" or aborted investment rounds. Global investors view RPTs as a litmus test for a founder's maturity. Transparency, therefore, is not merely a legal requirement; it is a strategic asset that builds institutional trust and ensures the long-term sustainability of the enterprise.

### **De-coding the "Related Party": The Net is Wider Than You Think**

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<sup>1</sup> (1981) 3 SCC 333

To navigate the compliance landscape of Section 188 of the Companies Act, 2013, one must first master the expansive, and often counterintuitive, definition of a "Related Party." Under the Companies Act, 2013, the determination of a related party is not merely a matter of biological lineage or majority ownership; it is an exercise in mapping concentric circles of influence and economic interest.

### **1. The Primary Circle: Directors, KMPs, and the "Relative" Definition**

The statutory definition under Section 2(76) of the Companies Act, 2013 serves as the gatekeeper. For a founder, the first circle is the most obvious: directors, Key Managerial Personnel (KMPs), and their relatives. However, the definition of a "relative" under Section 2(77) of the Companies Act, 2013, read with Rule 4 of the Companies (Specification of Definitions Details) Rules, 2014, contains specific nuances. While it includes spouses, parents, siblings, and children (including step-relations), it notably excludes extended family like cousins or aunts and uncles. Founders must be cautioned, however, that while a cousin may not be a "relative" by law, a transaction with their firm may still be captured if the founder exercises significant influence over that entity.

### **2. The Entity Nexus: Partnerships and Private Companies**

The second circle encompasses entity-based relationships, which frequently trigger RPT norms in the private equity and venture capital ecosystem. A "Related Party" includes any firm in which a director or their relative is a partner, or any private company in which a director is a member or director. This means that if a founder holds even a single share in a vendor's private company, every purchase order issued to that vendor qualifies as an RPT. Furthermore, for public companies, the threshold is set at a mere two percent of paid-up share capital held by a director along with their relatives<sup>2</sup>.

### **3. The "Shadow" Relationship: De Facto Control**

Perhaps the most overlooked category is the "Shadow" relationship—persons on whose advice, directions, or instructions the Board of Directors is "accustomed to act." While this excludes professional advisors (such as legal counsel or chartered accountants), it is designed to capture *de facto* controllers or "silent partners" who pull the strings of corporate policy from behind the curtain. If a founder acts on the persistent instructions of an unregistered "advisor" who holds economic interest, that advisor may be deemed a related party.

### **4. The Group Structure Trap: Holding and Subsidiary Dynamics**

Finally, for startups operating under a "House of Brands" or a holding-subsubsidiary model, Section 2(76)(viii) of the Companies Act, 2013 is critical. It mandates that any company which is a holding, subsidiary, or an associate company of the subject company is a related party. In practice, this means that "inter-company" service agreements, such as a parent

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<sup>2</sup> Section 2(76)(vi), Companies Act, 2013

company providing centralized HR, IT support, or brand licensing to its subsidiaries—must be documented, benchmarked, and approved with the same rigor as a third-party contract.

### **The Procedural Guardrails: Disclosure, Approval, and Ratification**

Navigating the regulatory labyrinth of Related Party Transactions (RPTs) requires more than just identifying the "who"; it demands a rigorous adherence to the "how." The Companies Act, 2013, establishes a three-tiered procedural framework designed to ensure that transactions with related parties are transparent, authorized, and capable of withstanding judicial scrutiny. For a founder, mastering these guardrails is essential to preventing a transaction from becoming voidable or, worse, a source of personal liability.

#### **1. The Disclosure Mandate: Section 184**

Transparency begins with the 'General Notice of Interest'. Under Section 184(1) of the Companies Act, 2013, every director is mandated to disclose their concern or interest in any company, body corporate, or firm through Form MBP-1. This is not a one-time exercise; it must be performed at the first Board meeting of every financial year or whenever there is a significant change in the disclosed interests.

Beyond this general filing, Section 184(2) of the Companies Act, 2013 imposes a specific duty of disclosure. If a director is, directly or indirectly, "concerned or interested" in a contract or arrangement entered into (or proposed to be entered into) by the company, they must disclose the nature of that interest at the meeting where the transaction is discussed. While directors in public companies are strictly prohibited from participating in such discussions, a critical "founder-friendly" exemption exists for private companies: interested directors may participate and vote, provided they have made a full and formal disclosure of their interest<sup>3</sup>.

#### **2. The Approval Hierarchy: Section 188 and the 10% Rule**

Once an interest is disclosed, the transaction must pass through the appropriate approval gateway. Under Section 188 of the Companies Act, 2013, every RPT, unless falling under the "Ordinary Course" and "Arm's Length" exceptions, requires prior approval by the Board of Directors. It is important to note that such approval must be granted at a meeting of the Board; the use of circular resolutions for RPTs is legally untenable.

For high-value transactions that exceed the thresholds prescribed under Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014, the Board's mandate is insufficient. Transactions involving the sale, purchase, or supply of goods or services exceeding 10% (ten percent) of the company's turnover, or the leasing of property exceeding ten percent of the net worth, require prior approval by the shareholders via an Ordinary Resolution. Crucially, any member who is a related party to the transaction is barred from voting on such a resolution<sup>4</sup>.

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<sup>3</sup> MCA Notification No. G.S.R. 464(E) dated June 5, 2015

<sup>4</sup> Proviso to Section 188(1), Companies Act, 2013

### 3. The Register of Interest and the Safety Valve of Ratification

To ensure a permanent audit trail, Section 189 of the Companies Act, 2013 requires every company to maintain a Register of Contracts or Arrangements in Form MBP-4. This register must be updated chronologically and signed by all directors present at the subsequent Board meeting. For founders, this register is often the first document requested during a due diligence exercise or a regulatory inspection.

The law acknowledges that in the high-velocity environment of a startup, procedural oversights can occur. Section 188(3) of the Companies Act, 2013 provides a "safety valve" by allowing for the ratification of an RPT within 3 (three months) of the date of the contract. However, failure to ratify within this window renders the contract voidable at the option of the Board. As underscored in *Fateh Chand Kad v. Hindsons (Patiala) Ltd.*<sup>5</sup>, the failure to adhere to disclosure and approval norms can lead to a director being held liable to indemnify the company against any loss resulting from the transaction.

#### The Safe Harbors: "Ordinary Course" and "Arm's Length"

While the procedural rigor of Section 188 of the Companies Act, 2013 is the default rule for Related Party Transactions, the Companies Act, 2013, provides a critical "Safe Harbor" for the seamless conduct of business. Under the fourth proviso to Section 188(1) of the Companies Act, 2013, the requirements for Board or Shareholder approval do not apply if a transaction is entered into by the company in its "Ordinary Course of Business" and on an "Arm's Length Basis." For founders, these exceptions are powerful tools for operational agility; however, they are also among the most scrutinized areas during forensic audits and investor due diligence.

#### 1. The Cumulative Test: A Dual-Gate Requirement

It is a common misconception that satisfying one of these criteria is sufficient to bypass Section 188 of the Companies Act, 2013. The law is explicit: the tests are cumulative. A transaction may be priced perfectly at market rates, but if it falls outside the company's typical business flow, it remains a regulated RPT. Conversely, a routine transaction conducted at a "founder's discount" fails the arm's length test and triggers the full spectrum of compliance mandates.

#### 2. Defining the "Ordinary Course of Business"

The Companies Act, 2013 does not provide a statutory definition for "Ordinary Course of Business" (OCB), leaving its interpretation to judicial precedents and accounting standards. To determine if a transaction is in the OCB, the judiciary often applies a "functional and frequency" test.

While the Memorandum of Association (MoA) provides the legal capacity to enter a transaction, mere inclusion in the "Main Objects" is not definitive proof of OCB. As observed

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<sup>5</sup> AIR 1957 Punj 149

by the Supreme Court in *Anuj Jain v. Axis Bank Limited*<sup>6</sup>, a transaction must be part of the "undistinguished common flow of business" to qualify. For a private company, this involves assessing whether the transaction is a regular, predictable feature of its operations, considering the industry's standard practices and the company's own historical conduct. A one-off sale of a core business asset to a related party, for instance, would rarely qualify as "ordinary," regardless of the profit generated.

### **3. The Arm's Length Standard: The "Unrelated Stranger" Rule**

The "Arm's Length Basis" (ALB) is defined under Explanation (b) to Section 188(1) of the Companies Act, 2013 as a transaction conducted between two related parties as if they were unrelated, ensuring no conflict of interest arises. The litmus test is simple yet demanding: would the company have entered into the exact same contract, on the exact same terms, with a complete stranger?

In the absence of granular rules under corporate law, Indian practitioners and regulators frequently draw upon the Transfer Pricing principles established under Section 92 of the Income Tax Act, 1961. This involves benchmarking the RPT against comparable uncontrolled transactions (CUTs). For founders, this means that "cost-to-cost" reimbursements or "interest-free" loans between group entities rarely meet the ALB standard, as no commercial entity would provide such terms to an unrelated third party in a competitive market.

### **4. The Burden of Proof: Building the "Defense File"**

The burden of proving that a transaction qualifies for these safe harbors rests entirely on the company. In the event of an inquiry by the Registrar of Companies (RoC) or a challenge by a minority shareholder, "intent" is secondary to "documentation."

To insulate the Board, companies must maintain a robust "Defense File" for every exempt RPT. This should include:

- (a) Independent valuation reports from Registered Valuers for asset transfers.
- (b) Internal "Transfer Pricing" memos documenting at least three comparative quotes from unrelated vendors.
- (c) Board minutes specifically recording the "Ordinary Course" and "Arm's Length" justification before the transaction is executed.

By treating these safe harbors as rigorous standards rather than convenient loopholes, founders can protect the company's governance integrity while maintaining the velocity required for growth.

### **Beyond the Act: The Contractual Overlay of SHAs and Investor Vetoes**

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<sup>6</sup> (2020) 8 SCC 401

For the modern founder, the Companies Act, 2013, provides the baseline for governance, but the Shareholders' Agreement (SHA) often dictates the ceiling. In the ecosystem of venture capital and private equity, statutory compliance is merely the point of departure. Investors, seeking to protect their capital from "value leakage," typically negotiate a layer of contractual oversight that is significantly more stringent than the thresholds prescribed by Section 188 of the Companies Act, 2013.

### 1. The Supremacy of Contract: SHA vs. The Statute

While Section 188 of the Companies Act, 2013 allows for "Ordinary Course" and "Arm's Length" exceptions to bypass board or shareholder approval, most SHAs effectively nullify these safe harbors through Affirmative Voting Rights (AVRs). In these agreements, Related Party Transactions (RPTs) are almost universally classified as "Reserved Matters." This means that regardless of whether a transaction is legally exempt under the Act, it cannot be executed without the prior written consent of the Investor or their nominee director.

For a founder, this creates a dual-compliance track: one must satisfy the Registrar of Companies (RoC) and the Board under the statute, while simultaneously securing a "veto clearance" from the investor under the contract.

### 2. The Entrenchment Requirement: Section 5 and the AoA

A critical nuance in Indian corporate law is the enforceability of these contractual vetoes against the company. Under Section 5 of the Companies Act, 2013, provisions for "entrenchment" – which impose more restrictive conditions than those in the Act – must be specifically incorporated into the Articles of Association (AoA).

The judiciary has been firm on this distinction. In *World Phone India Pvt. Ltd. v. WPI US Inc*<sup>7</sup>, the Delhi High Court clarified that if a right (such as a veto over RPTs) exists in the SHA but has not been transposed into the AoA, it may not bind the company's board in its decision-making. For founders, this means that every "Reserved Matter" negotiated in a term sheet must be mirrored in the company's charter to ensure legal certainty and prevent inter-shareholder disputes.

### 3. Lower Thresholds and Enhanced Information Rights

Investors rarely rely on the high statutory thresholds (e.g., 10% of turnover) to trigger their oversight. It is standard practice to negotiate "de minimis" thresholds – often as low as ₹10 Lakhs or ₹25 Lakhs – above which any transaction with a related party requires explicit approval.

Furthermore, SHAs often grant investors "Information Rights" that far exceed the statutory maintenance of Form MBP-4. These may include:

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<sup>7</sup> (2013) 178 Comp Cas 173 (Del)

- (a) **Monthly Disclosure:** A granular reporting of all RPTs in the Monthly Management Information System (MIS).
- (b) **Special Audit Rights:** The power to appoint an independent firm to conduct a "deep dive" into RPTs if a conflict of interest is suspected.

#### 4. Strategic Negotiation: Avoiding Governance Deadlock

To maintain operational velocity, founders should negotiate "White-Listed" transactions within the SHA. These are pre-approved categories of RPTs—such as standard inter-company service agreements in a group structure or routine founder reimbursements—that do not trigger the investor's veto. By carving out these "Ordinary Course" necessities during the SHA drafting stage, founders can prevent governance deadlocks while upholding the spirit of transparency that institutional investors demand.

#### The Cost of Non-Compliance: Beyond Regulatory Penalties

In the high-velocity environment of an Indian startup, procedural lapses in managing Related Party Transactions (RPTs) are often dismissed as "technicalities." However, the Companies Act, 2013, and the evolving expectations of global investors have transformed these technicalities into significant existential risks. For a founder, the true cost of non-compliance is rarely the immediate fine; it is the secondary "governance discount" that manifests during due diligence, valuation, and leadership stability.

##### 1. Statutory Penalties and the "Strict Liability" Trap

The primary hammer of the law resides in Section 188(5) of the Companies Act, 2013. For a private company, any director or employee who enters into or authorizes an RPT in violation of the statutory framework is liable to a penalty of ₹5 Lakhs (Indian Rupees Five Lakhs)<sup>8</sup>. Following the 2020 decriminalization amendments, while the threat of imprisonment was removed for non-listed entities to promote the "ease of doing business," these financial penalties remain "strict liability" offenses. This means that a lack of "mala fide intent" or a simple "oversight" by the company secretary is not a valid legal defense once a violation is identified by the Registrar of Companies (RoC).

##### 2. The Leadership Risk: Automatic Vacation of Office

Perhaps the most disruptive consequence of non-compliance is found in the interplay between Section 184 and Section 167 of the Companies Act, 2013. Under Section 167(1)(c) and (d), a director *automatically* vacates their office if they fail to disclose their interest in a contract or act in contravention of the disclosure norms. This "automatic vacation" occurs by operation of law—it requires no formal removal process. For a founder-led board, such a sudden leadership vacuum can trigger defaults in bank loan covenants, breach "key-person" clauses in Shareholders' Agreements, and paralyze the board's ability to pass critical resolutions.

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<sup>8</sup> Section 188(5)(ii), Companies Act, 2013.

### 3. The "Office of Profit" and Personal Indemnity

The law also ensures that a company does not suffer for a director's unauthorized self-dealing. Under Section 188(3) of the Companies Act, 2013, if an RPT is not ratified by the Board or Shareholders within three months, the contract becomes voidable at the option of the Board. Furthermore, the director involved is statutorily mandated to indemnify the company against any loss sustained. As established in *Fateh Chand Kad v. Hindsons (Patiala) Ltd.*<sup>9</sup>, the judiciary empowers the company to proceed against the director to recover any personal profit derived from the unauthorized transaction, effectively stripping away the economic benefit of the conflict.

#### A Founder's Checklist for Governance Integrity

In the transition from a "scrappy" startup to an institutionalized enterprise, the difference between a successful exit and a failed due diligence often lies in the quality of the company's "paper trail." For the modern founder, governance integrity is not a stagnant compliance requirement but a dynamic valuation multiplier. The following checklist serves as a proactive roadmap for boards to ensure that Related Party Transactions (RPTs) are managed with clinical precision.

#### 1. The Benchmarking Mandate: Proving the "Arm's Length"

To insulate a transaction from future challenges by minority shareholders or auditors, the Board must look beyond the "fairness" of a deal and focus on its "comparability."

- (a) **The "Rule of Three":** Maintain at least three independent, contemporaneous quotes or bids for any RPT, even if it falls within the "Ordinary Course."
- (b) **Registered Valuations:** For the transfer of non-cash assets, shares, or intellectual property, obtain a report from an IBBI Registered Valuer. In the eyes of the regulator, a professional valuation is the primary shield against allegations of "undervaluation" or siphoning of funds.

#### 2. The Disclosure Discipline: Beyond the Annual Filing

While Section 184(1) of the Companies Act, 2013 requires an annual disclosure via Form MBP-1, true governance integrity requires an "event-based" disclosure culture.

- (a) **Real-time Updates:** Founders must foster an environment where directors disclose new interests immediately – not just at the next quarterly meeting.
- (b) **Recusal Protocols:** Even in private companies where the law permits an interested director to vote<sup>10</sup>, the "Gold Standard" is for the interested party to recuse themselves

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<sup>9</sup> AIR 1957 Punj 149

<sup>10</sup> MCA Notification No. G.S.R. 464(E) dated June 5, 2015

from the discussion. This ensures that the minutes reflect a truly independent decision-making process.

### 3. **The Digital Audit Trail: Form MBP-4 and Beyond**

The manual maintenance of statutory registers is rapidly becoming a liability.

- (a) **Digital Registers:** Utilize automated board management software to maintain the Register of Contracts (Form MBP-4) in real-time. This ensures that the 10% statutory thresholds are tracked systematically across all group entities.
- (b) : Periodically review the Shareholders' Agreement (SHA) to ensure that all "Reserved Matters" regarding RPTs have been correctly entrenched in the Articles of Association (AoA), as required under Section 5 of the Companies Act, 2013.

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