

**BEYOND THE BOARDROOM VOTE: INDEPENDENT DIRECTORS'
LIABILITY FOR FAILURE TO CHALLENGE MANAGEMENT IN
RELATED PARTY TRANSACTIONS UNDER INDIAN CORPORATE LAW**

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ABSTRACT

Related party transactions lie at the heart of many corporate failures in India. The law depends on independent directors to keep promoters and management in check whenever such transactions reach the board and the audit committee. The real question, however, is what follows when independent directors approve a transaction, or let it pass without objection, and it later turns out to be abusive. This article studies the liability of independent directors who fail to challenge management in related party transactions under the Companies Act 2013 and the SEBI Listing Regulations. It reads Section 149(12) together with Sections 166, 177 and 188, and measures the statutory standard against Indian rulings on director liability as well as leading English and Delaware authorities. The article contends that the expression “attributable through Board processes” turns the quality of the record, that is the questions raised, the documents requested and the dissent recorded, into the true test of diligence. It concludes that casting a vote without inquiry offers no safe harbour, and it recommends clearer regulatory guidance, structured review by audit committees and consistent enforcement, so that diligence is rewarded and passivity is not.

Keywords: *independent directors, related party transactions, Section 149(12), duty of care, corporate governance, SEBI Listing Regulations*

1. INTRODUCTION

Take a promoter-controlled company that buys raw material from a firm owned by the promoter's family, lends money to a group entity at a low rate of interest, or pays a heavy licence fee to a related brand owner. None of this is unlawful in itself. Related party transactions can be efficient, since the parties already know and trust each other. The problem is that this same closeness lets value drain out of the company and into the hands of those who control it. Economists describe this as tunnelling, and it continues to worry markets in which promoters hold large shareholdings, as they do in India.¹

Indian law answers this in two ways. First, it demands approvals at several levels, namely the audit committee, the board and, beyond certain limits, the shareholders. Second, it puts independent directors at the heart of the process, expecting them to offer an outside perspective and to protect minority shareholders.² The thinking is straightforward. If a person with no stake in the promoter's success reads the papers and asks difficult questions, abusive deals will be caught early.

That thinking is put to the test whenever a scandal occurs. Investors want to know where the independent directors were. Regulators ask whether the approvals were real or only ceremonial. Directors, on their side, say they relied on information from management and on the advice of auditors. The law must decide how much reliance is reasonable and when reliance turns into negligence or something worse.

This article poses a focused question. If an independent director votes for a related party transaction, or raises no objection to it, without meaningful inquiry, at what point does this failure to challenge management give rise to legal liability? Part II sets out the statutory framework for related party transactions. Part III describes the role of independent directors. Part IV examines Section 149(12) of the Companies Act 2013. Part V reviews case law from India and abroad. Part VI draws practical lessons from corporate failures. Part VII proposes reforms and Part VIII concludes.

2. THE STATUTORY FRAMEWORK FOR RELATED PARTY TRANSACTIONS

¹Simon Johnson and others, 'Tunneling' (2000) 90 American Economic Review 22.

²Umakanth Varottil, 'Evolution and Effectiveness of Independent Directors in Indian Corporate Governance' (2010) 6 Hastings Business Law Journal 281.

The starting point is Section 2(76) of the Companies Act 2013, which defines a related party to include, among others, directors, key managerial personnel, their relatives, firms and companies in which they hold interests, and holding, subsidiary and associate companies.³ Section 188 then governs particular categories of contracts with related parties, such as the sale, purchase or supply of goods, the disposal of property, leasing, availing or rendering of services, and appointment to an office or place of profit.⁴ Such contracts require prior board approval and, once the thresholds laid down in the Companies (Meetings of Board and its Powers) Rules 2014 are crossed, a special resolution of the shareholders in which related parties may not vote.⁵ The first proviso to Section 188(1) exempts transactions that are in the ordinary course of business and at arm's length, so the quality of that finding carries great weight in practice.⁶

Section 177 adds the audit committee layer. The committee must have at least three directors, with independent directors in the majority, and its functions cover the approval of related party transactions and of any later modification to them.⁷ A listed company must also maintain a vigil mechanism, which offers directors and employees a channel for reporting concerns.⁸ Disclosure is governed by Section 134(3)(h) and Form AOC 2, under which the board's report has to describe material contracts with related parties.⁹ Separately, a director must disclose any personal interest under Section 184.¹⁰

For listed companies, Regulation 23 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 is more demanding. Every related party transaction needs prior audit committee approval, and since 1 April 2022 only those audit committee members who are independent directors may grant it.¹¹ Material transactions require shareholder

³Companies Act 2013 (Act 18 of 2013), s 2(76).

⁴Companies Act 2013, s 188(1).

⁵Companies (Meetings of Board and its Powers) Rules 2014, r 15; Companies Act 2013, s 188(1), second proviso.

⁶Companies Act 2013, s 188(1), first proviso.

⁷Companies Act 2013, ss 177(2) and 177(4)(iv).

⁸Companies Act 2013, ss 177(9) and 177(10).

⁹Companies Act 2013, s 134(3)(h); Companies (Accounts) Rules 2014, r 8(2) and Form AOC 2.

¹⁰Companies Act 2013, s 184.

¹¹Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 23(2), as amended by the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations 2021 (effective 1 April 2022).

approval by resolution, with related parties abstaining.¹² Regulation 18 requires at least two thirds of the audit committee to be independent directors.¹³

Two conclusions follow. First, the framework assigns independent directors a formal gatekeeper function, and the law does not regard their approval as a mere signature. Second, the consequences of a breach reach directors personally. Under Section 188(3), a transaction entered into without the required approval, and not ratified within three months, can be avoided at the option of the board or, as the case may be, of the shareholders, and where the contract is with a related party to a director or has been authorised by another director, the directors concerned must indemnify the company for any loss.¹⁴ Section 188(5), as amended in 2020, now imposes a monetary penalty on the director or employee who contravened the section, fixed at twenty five lakh rupees for a listed company and five lakh rupees for other companies.¹⁵

3. THE ROLE OF INDEPENDENT DIRECTORS —

Section 149(6) lays down the criteria for independence. It calls for integrity and relevant expertise, and it excludes pecuniary relationships with the company, its promoters and its management, other than sitting fees and similar permitted payments.¹⁶ A listed public company must have independent directors making up at least one third of its board.¹⁷ Schedule IV, the Code for Independent Directors, describes their role in greater detail. They are expected to bring independent judgment to board deliberations, scrutinise management's performance, satisfy themselves about the integrity of financial information, safeguard the interests of all stakeholders and especially minority shareholders, and act as moderators where the interests of management and shareholders conflict.¹⁸ Their duties include informed participation in board

¹²Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 23(4).

¹³Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, reg 18(1)(b).

¹⁴Companies Act 2013, s 188(3), as amended by the Companies (Amendment) Act 2017, s 63.

¹⁵Companies Act 2013, s 188(5), as amended by the Companies (Amendment) Act 2020, s 39.

¹⁶Companies Act 2013, s 149(6).

¹⁷Companies Act 2013, s 149(4); Companies (Appointment and Qualification of Directors) Rules 2014, r 4.

¹⁸Companies Act 2013, s 149(8) and Schedule IV, Part II.

and committee meetings and reporting concerns about unethical behaviour or suspected fraud.¹⁹

These obligations come on top of the general duties that Section 166 places on every director. A director must act in good faith, perform duties with due and reasonable care, skill and diligence and independent judgment, and steer clear of situations that conflict with the interests of the company.²⁰ Courts have long treated directors as holding a fiduciary position.²¹

The policy reasons go back to several reform committees. The Naresh Chandra Committee, the Narayana Murthy Committee, the J J Irani Committee and, later, the Kotak Committee all regarded independent directors as a counterweight to promoter dominance.²² Scholars have observed, however, that independence on paper does not always lead to effective monitoring, since independent directors are usually selected through promoter influence and operate with limited time and information.²³ This gap between expectation and reality is why the question of liability is delicate. If the law asks too little, independence becomes merely ornamental. If it asks too much, capable people may decline the role.

4. SECTION 149(12): THE LIABILITY STANDARD

The central provision on liability is Section 149(12). It provides that an independent director, and a non executive director who is neither a promoter nor key managerial personnel, shall be held liable only for acts of omission or commission by the company that occurred with his knowledge, attributable through Board processes, and with his consent or connivance, or where he had not acted diligently.²⁴

¹⁹Companies Act 2013, Schedule IV, Part III.

²⁰Companies Act 2013, s 166(2), (3) and (5).

²¹*Dale and Carrington Investment Pvt Ltd v P K Prathapan* (2005) 1 SCC 212.

²²Department of Company Affairs, *Report of the Naresh Chandra Committee on Corporate Audit and Governance* (2002); SEBI, *Report of the SEBI Committee on Corporate Governance* (Narayana Murthy Committee, 2003); Ministry of Corporate Affairs, *Report of the Expert Committee on Company Law* (J J Irani Committee, 2005); SEBI, *Report of the Committee on Corporate Governance* (Kotak Committee, 5 October 2017).

²³Varotttil (n 2); Afra Afsharipour, 'Corporate Governance Convergence: Lessons from the Indian Experience' (2009) 29 *Northwestern Journal of International Law and Business* 335.

²⁴Companies Act 2013, s 149(12).

Three features call for attention. First, the word “only” marks a deliberate limit. Independent directors do not guarantee everything the company does, and Parliament recognised that they serve part time and rely on information provided by management. Second, the provision offers more than one route to liability, namely knowledge with consent, knowledge with connivance, and lack of diligence. Third, knowledge must be attributable through board processes. This phrase is significant for related party transactions because the process is formal. It involves a notice, an agenda, a set of papers, a committee note, a discussion and minutes. Knowledge gained at these stages is attributable to the director. A director cannot plead ignorance of what the papers placed before the committee clearly disclosed.

The diligence limb carries the most weight. It lays down an objective test that does not depend on bad intent. An independent director who approved a transaction without asking why a group entity was chosen, how the price was benchmarked, or whether the valuation was independent may be found not to have acted diligently, even if he gained nothing personally. Section 166(3) strengthens this by demanding due and reasonable care, skill and diligence.²⁵

At the same time, Section 149(12) shields the director who does what the process demands. A director who reads the papers, raises questions, secures an independent valuation or legal opinion, records dissent when dissatisfied, and escalates concerns can demonstrate diligence. The minutes serve as the evidence. An approval recorded without reasons and without questions is therefore a weak defence, whereas a detailed record of inquiry is a strong one.

The interface with fraud also needs mention. Where a related party transaction forms part of a fraud as explained in Section 447, the penal consequences are serious.²⁶ Independent directors are unlikely to face Section 447 merely for poor diligence, but those who knowingly assist, or deliberately turn a blind eye, may. The facts draw the line between negligence and connivance, and the record again determines on which side of that line a director stands.

5. THE JUDICIAL APPROACH

Indian courts have not yet delivered many decisions that deal directly with Section 149(12) and related party transactions. What is available is a set of principles drawn from older company

²⁵Companies Act 2013, s 166(3).

²⁶Companies Act 2013, s 447 and Explanation (i).

law cases and from rulings on director liability under other statutes, which are now applied by analogy.

On the standard of care, *Official Liquidator, Supreme Bank Ltd v P A Tendolkar* is the most helpful Indian authority. The Supreme Court held that directors of a bank could be held liable for misfeasance where their negligence allowed fraud to occur, and that proof of personal dishonesty was not always required where a director had closed his eyes to obvious mismanagement. The Court regarded it as a question of fact, to be decided on the evidence in each case, whether a director had acted reasonably, honestly and with due diligence.²⁷ The case matters for independent directors in two respects. It shows that the inquiry concerns what a reasonable director would have done on the facts, so hindsight alone is not the test. It also shows that a director cannot escape by pointing to someone else, usually the managing director, as the person in charge. On fiduciary duty, *Dale and Carrington Investment Pvt Ltd v P K Prathapan* confirmed that directors owe duties to the company and, in some circumstances, to shareholders, and *Needle Industries (India) Ltd v Needle Industries Newey (India) Holding Ltd* held that the board's powers must be exercised in good faith and in the interest of the company.²⁸ A related party transaction approved to benefit the promoter instead of the company sits uneasily with these principles.

The Supreme Court's rulings on directors under Section 141 of the Negotiable Instruments Act 1881 are instructive on a different point, namely that holding office alone does not create liability. In *SMS Pharmaceuticals Ltd v Neeta Bhalla*, the Court held that a person must be shown to be in charge of, and responsible for, the conduct of the business, and that directors cannot be dragged in merely because of their designation.²⁹ *Pooja Ravinder Devidasani v State of Maharashtra* applied the same reasoning to a non executive director and quashed the proceedings.³⁰ *K K Ahuja v V K Vora* explained how different categories of directors are treated under the same section.³¹ These cases support the idea found in Section 149(12) that liability follows function and knowledge. They do not, however, say that an independent director who

²⁷*Official Liquidator, Supreme Bank Ltd v P A Tendolkar* (1973) 1 SCC 602 : AIR 1973 SC 1104.

²⁸*Dale and Carrington* (n 21); *Needle Industries (India) Ltd v Needle Industries Newey (India) Holding Ltd* (1981) 3 SCC 333.

²⁹*SMS Pharmaceuticals Ltd v Neeta Bhalla* (2005) 8 SCC 89; Negotiable Instruments Act 1881, s 141.

³⁰*Pooja Ravinder Devidasani v State of Maharashtra* (2014) 16 SCC 1.

³¹*K K Ahuja v V K Vora* (2009) 10 SCC 48.

sits through a suspicious approval without asking a single question is safe. They rest on the wording of a different statute and on the need for specific averments in a criminal complaint.

Foreign decisions show how diligence is tested in practice. In *Re Barings plc (No 5)*, the court stated that directors have a continuing duty to acquire and maintain sufficient knowledge of the business to discharge their responsibilities, and that non executive directors are not excused from supervision.³² In *Re D'Jan of London Ltd*, Hoffmann LJ applied an objective standard to a director who signed a document without reading it.³³ In *Smith v Van Gorkom*, the Delaware Supreme Court held directors grossly negligent for approving a transaction without being properly informed.³⁴ In *Re Caremark International Inc Derivative Litigation*, the court recognised a duty of oversight, and in *Marchand v Barnhill* the Delaware Supreme Court stressed that boards must make a good faith effort to put a monitoring system in place.³⁵ *Weinberger v UOP Inc* added that where a controller stands on both sides of a deal, the transaction must satisfy a standard of entire fairness.³⁶

Indian tribunals and courts are likely to rely on these ideas when asked whether an independent director acted diligently. The lesson across jurisdictions is consistent. Directors are not punished for honest, informed decisions that turn out badly. They are exposed when they approve a conflicted transaction without informing themselves.

6. PRACTICAL LESSONS FROM CORPORATE FAILURES

Corporate failures show how these principles work in practice. In December 2008, the board of Satyam Computer Services cleared a proposal to acquire two companies linked to the founder's family, Maytas Properties and Maytas Infra. Investors reacted sharply and the proposal was withdrawn within hours. A few weeks later the founder confessed to a large accounting fraud.³⁷ The episode teaches two things. Related party proposals are a common route for diverting value, and a board that clears such a proposal without testing its rationale quickly loses credibility.

³²*Re Barings plc (No 5)* [1999] 1 BCLC 433.

³³*Re D'Jan of London Ltd* [1994] 1 BCLC 561.

³⁴*Smith v Van Gorkom* 488 A 2d 858 (Del 1985).

³⁵*Re Caremark International Inc Derivative Litigation* 698 A 2d 959 (Del Ch 1996); *Marchand v Barnhill* 212 A 3d 805 (Del 2019).

³⁶*Weinberger v UOP Inc* 457 A 2d 701 (Del 1983).

³⁷Satyam Computer Services Ltd, Letter of B Ramalinga Raju to the Board of Directors and SEBI (7 January 2009).

The IL&FS crisis of 2018 raised similar concerns about governance in a group with many connected entities. The Government approached the National Company Law Tribunal under Sections 241 and 242 of the Companies Act 2013, alleging mismanagement and weak governance and risk management, and the Tribunal superseded the board on 1 October 2018.³⁸ Whatever the final outcome of proceedings against individuals, the episode drew fresh attention to whether non executive and independent directors had asked enough questions about group exposures.

Several practical lessons follow. First, independent directors should seek a written note on every related party transaction setting out the relationship, the commercial reason, the pricing method and the alternatives considered. Second, benchmarks should be independent. A valuation or transfer pricing report from an outside professional is more convincing than management's own comparison. Third, the audit committee should test whether a transaction is genuinely in the ordinary course and at arm's length, instead of accepting the label. Fourth, dissent or reservations should be minuted, because Section 149(12) rewards a record of diligence. Fifth, a director who is not satisfied should consider requesting more time, seeking further information, voting against, abstaining or, as a last resort, resigning with a clear statement of reasons. Resignation alone does not undo earlier approvals, but together with proper escalation it can show that the director took the role seriously. Sixth, directors should use the vigil mechanism, follow up on complaints and obtain legal advice where necessary.

7. SUGGESTIONS FOR REFORM

Several improvements deserve consideration. First, the Ministry of Corporate Affairs or SEBI could issue guidance on what diligence means for related party approvals, including a minimum information package for the audit committee. Section 149(12) is broad, and clarity would help directors and adjudicators alike. Second, the audit committee's terms of reference could require a short written finding on arm's length pricing and ordinary course status for each material transaction, in place of a bare approval. Third, enforcement should distinguish between passive independent directors who ignored red flags and those who raised concerns and were overruled. Without this distinction, directors may shun the role or fall back on boilerplate minutes that conceal real discussion. Fourth, access to independent advice at the company's cost should be made explicit for audit committees handling large related party

³⁸*Union of India, Ministry of Corporate Affairs v Infrastructure Leasing and Financial Services Ltd* (NCLT Mumbai, order dated 1 October 2018), petition under Companies Act 2013, ss 241 and 242.

transactions. Fifth, regulators should publish reasoned orders when independent directors are penalised, so that a body of precedent develops and the diligence standard becomes predictable. The Kotak Committee has already pointed towards stronger roles and accountability for independent directors, and these steps build on that direction.³⁹

8. CONCLUSION

Indian law has assigned independent directors a demanding position in the approval of related party transactions. They form the majority on the audit committee, they alone approve such transactions in listed companies, and Schedule IV directs them to protect minority shareholders. Section 149(12) offsets this by confining liability to cases of knowledge with consent or connivance, or lack of diligence, with knowledge judged through board processes.

The analysis in this article suggests that failing to challenge management is not a legal wrong in itself, but it becomes one when it reveals a lack of diligence despite information that was available through the board's own processes. Indian case law offers principles on care, fiduciary duty and the limits of liability by office, while English and Delaware decisions give a clearer picture of what informed oversight looks like. The common thread is that courts look at process. A director who inquires, documents and escalates stands on firm ground. A director who merely votes does not.

The future of the independent director's role depends on striking this balance correctly. Clear guidance, reasoned enforcement and better audit committee practice can protect honest directors and still give minority shareholders a real safeguard. The boardroom vote matters, but what happens before and around the vote matters more.

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