

Lesson 3 – Part 1

QUESTION

ABC (Pvt) Ltd is a construction company. The board consists of three directors: Perera, Silva, and Fernando. ABC (Pvt) Ltd entered into a contract to purchase construction materials worth LKR 20 million from BuildWell (Pvt) Ltd. Unknown to the other directors at the time the contract was approved, director Silva is also a director and shareholder of BuildWell (Pvt) Ltd and would receive financial benefit from the transaction. Silva did not record his interest in the Directors' Interests Register nor did he disclose the nature and extent of his interest to the board before the transaction was approved.

Three months after the contract was executed, a shareholder of ABC (Pvt) Ltd discovered Silva's connection to BuildWell (Pvt) Ltd and informed the other shareholders. The company had already paid for the materials, which were supplied at market price and used in the company's projects.

- I. With reference to Section 192, was Silva required to disclose his interest in the transaction? Explain the nature of his obligation.
- II. What are the legal consequences for Silva for failing to disclose his interest and record it in the interests register?
- III. Under Section 193, can ABC (Pvt) Ltd avoid the transaction with BuildWell (Pvt) Ltd? Discuss the relevant conditions.

DRAFT ANSWER

The issue in this scenario relates to the duty of directors to disclose their interests in company transactions under the Companies Act No. 7 of 2007.

- I. Whether Mr. Silva was required to disclose his interest Under Section 192:

Meaning of “interested” – Section 191

A director is considered interested in a transaction if he: is a party to the transaction; may derive a material financial benefit from the transaction; has a material financial

interest in another party to the transaction; or is a director or officer of another party to the transaction who will or may derive a benefit from the transaction, ect

In this scenario, Silva is both a director, and a shareholder of BuildWell (Pvt) Ltd.

Therefore, Silva has a material financial interest in another party to the transaction and may derive a financial benefit from the contract. Accordingly, Silva is clearly an interested director within the meaning of Section 192.

Once Silva became aware of his interest, he was required to: Enter the details of his interest in the Interests Register and Disclose the nature and extent of his interest to the board of directors, since the company has more than one director. Silva failed to comply with both requirements, and therefore he has breached Section 192.

II. Legal consequences of failing to disclose

Section 192 provides that a director who fails to disclose his interest: commits an offence, and upon conviction is liable to a fine not exceeding LKR 200,000. Therefore, Silva may be criminally liable for failing to disclose his interest and failing to record it in the Directors' Interests Register.

Apart from the statutory penalty, his conduct may also amount to a breach of fiduciary duties owed to the company, particularly the duty to act in good faith and avoid conflicts of interest.

III. Whether the company can avoid the transaction

Under Section 193(1), a transaction in which a director is interested may be avoided by the company if: the director's interest was not disclosed to all shareholders, and the avoidance occurs within six months after disclosure of the interest to the shareholders.

In this case: Silva's interest was not disclosed, and the shareholders only discovered the interest three months after the transaction. Therefore, the company may seek to avoid the transaction, provided it acts within the statutory time limit.

However, this right is subject to an important exception.

If the materials were purchased significantly above market price, the company would likely argue that the company did not receive fair value, and the transaction was therefore prejudicial to the company. In such circumstances, the company would have strong grounds to avoid the transaction under Section 193 because statutory protection would not apply.

Section 193 provides that where a transaction: is entered into in the ordinary course of the company's business, and is made on usual terms and conditions, the company is presumed to have received fair value.

In this scenario, the purchase of construction materials appears to be within the ordinary course of ABC (Pvt) Ltd's business, and the materials were supplied at market price. Therefore, the law will presume that the company has received fair value.

As a result, even though Silva failed to disclose his interest, the company may not be able to avoid the transaction, because Section 193(2) prevents avoidance where fair value has been received.

