RIGHTS, DUTIES & OBLIGATIONS OF COMPANY DIRECTORS

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

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Although there is a popular impression that the rights, duties and obligations of company directors have changed of late, in reality no changes have been effected in regard to the duties and obligations of directors of Companies; the rights of directors have, however, been cut down in the right of management.

The Vivian Bose Commission made recommendations with regard to:

(a) The possible misuse of the objects clause of the Memoranda of Association. It drew attention that it was possible for the Board of Directors of a Company to enter into trading, manufacturing, or business transactions of any kind covered by its Memorandum of Association however far they might be from the main activity of the Company and that that was not necessarily in the interest of the shareholders though technically within the powers of the management by reason of the wide nature of the clauses normally adopted in the Memoranda of Association of Companies.

(b) The practices in regard to payment of underwriting commission on the issue of shares or debentures.

(c) The practices in regard to the possible issue and allotment of shares in the names of fictitious or non-existing persons.

(d) The practices in regard to the holding of shares on blank transfers and that of nominee holdings.

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(e) The practices in regard to the appointment of directors, termed "dummy directors" by the Commission, whereby is meant persons occupying subservient and minor positions either in the company concerned or companies within the same group. The Commission also considered in the same connection the cases of absentee Directors and their liability.

(f) The practices in connection with loans to companies under the same management in particular and to other bodies corporate in general.

(g) The practices in connection with the appointment and termination of sole selling agents. The direction in which the Commission's mind was working was in regard to restricting payments on account of compensation on termination of selling agencies similar to those in respect of managing agents and managing directors.

(h) The practices in connection with the power which could be exercised in certain events to acquire shares of objecting shareholders under a scheme or contract which was got approved by the majority.

(i) The practices in connection with liquidation proceedings. The Commission's mind was working in the direction of ensuring that the Court should be in full possession of all the facts and circumstances relating to the liquidation, and the recovering of taxes from companies in liquidation.

(j) The practices in connection with destruction of books of account and records of both functioning companies as well as those in liquidation or already wound up.

(k) The practices relating to the allotment of shares prior to the Company obtaining sufficient funds.

The Commission also made recommendations regarding the administrative machinery of the Company Law Department being brought under the aegis of one Ministry.

None of the matters reported on By the Commission has been specifically legislated upon so far. Bill No. 23 of 1963 was introduced In the Rajya Sabha on 23rd August, 1963, but no decision has been taken on it. The Government introduced another Bill No. 46A of 1963 not referring to the above Bill or the Bose Commission's Report but containing regulatory measures including a substantive and very controversial provision regarding conversion of certain loans into equity capital. The Legislature has also amended the Banking Companies Act, 1949, whereby changes of great consequences have been made affecting directors of Banking Companies. There was a discussion in Parliament and a Select Committee was appointed which made a report which was presented to the Lok Sabha on 9th December 1963. Except in one major respect the Select Committee's amendments were accepted and the amending legislation which was passed has already come into effect in part. (See page 27)

My purpose in drawing attention to this legislation is that it is in consonance with the current trend of thought, particularly amongst the members of the several Legislatures in India that it is necessary to place curbs on the rights and powers of directors of Companies and that there should be more control over Companies. What is more important and at times disconcerting, especially to company managements, is that the power of regulation is not restricted to the shareholders of the Company concerned, but is handed over to Government agencies on the basis of a concept not particularly new, but, one which is very vigorously pressed, namely, that of the "public interest" which is definitely something much wider than the interest of the shareholders.

I have noted with care, and at times with concern, the progress made by this concept. As a director of a number of Companies for a number of years and as a Solicitor for the last over 35 years, I can claim to have examined the law on the subject a little more than as an amateur. I have come into contact with the Boards of Directors of various companies, have seen the managements thereof in action both in prosperity and adversity and have taken part in the conduct of proceedings under the Company Law in the Courts and before the Company Law Department. Further, it has been my good fortune to have been and to be working with Directors who have been

upright, conscientious, and anxious to carry out their obligations and duties in the interest of the shareholders and generally in the public interest. So far as Chairmen of the Boards are concerned, I can only say that I have been working under some marvellous persons. I owe a great deal to them.

The Companies Act, 1956, does not define the expression "Director". Section 2(13) merely describes a director, as including any person occupying the position of a director by whatever name called. Sub-Section (30) of the same Section defines the word "officer". It is also an inclusive definition and not a precise one. The word "Officer" is said to include, among othrs, any director, including a director of the managing agents or of the secretaries and treasurers if a corporate, or the director of a secretary if the secretary is a body corporate. The Act, therefore, equates in a measure a director with an officer. A director is clothed with three characters. He is an agent, and trustee, and employee in the sense that in his office are contained some of the characteristics of agents, trustees and employees.

Since the Companies Act itself does not define a "director", we must look to the text-books, comment ies, cases, and also to what we see everyday around us in regard to the characteristics of directors. We must also see what are the powers given to directors under the Act which regulates Company Administration in India or otherwise. Guidance is had from Section 291 of the Act, which provided that subject to the provisions of the Act, the board of directors of a company shall be entitled to exercise all such powers and to do all such acts and things as the Company is authorised to exercised and do. The consequent Sections 292 onwards restrict or regulate the powers which could be exercised by a board. In some cases, the procedure whereby they could exercise such powers is defined: for example, the power to make calls; the power to issue debentures; or to borrow monies otherwise than on debentures; the power to invest the funds of the company and the power to make loans. Such powers have to be exercised at board meetings unless delegated in particular manner

to particular persons. Then there are restrictions on the exercise of powers such as that the board of a public company or a subsidiary thereof cannot sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company, or remit or give time for the repayment of any debt due by a director; or invest (otherwise than in trust securities) compensation received in respect of compulsory acquisition; or barrow monies beyond the aggregate of the paid-up capital of the company and its free reserves; or contribute to charitable and other funds not directly relating to the business of the company, beyond the limits of Rs. 25,000/- or 5 per cent of the average net profits during the three financial gears immediately preceding the donation except with the consent of the company.

An Act of the English Parliament passed in 1844 described directors as "the persons having the direction, conduct, management or superintendence" of a company's affairs. This definition brings out the essence of what a director is and recognises two or rather three important matters. One is that a company is an artificial person made up of an aggregate of persons who in the total make up the artificial person recognised by law and capable of doing almost all of the things a natural person can do. The second matter is that a company, being an artificial and not a natural person, can act effectively only through agents and that agency is that the board of a company is expected to function as a whole and an individual director has in law apart from delegated powers no individual powers to act on behalf of the company.

Thus, directors are a special kind of agent, entrusted with the function of controlling the company's affairs and supplying the driving force behind it. How this control can be and is exercised must vary with different companies under different systems of administration and according to the composition of different boards. There must be variations from company to company, from country to country, and also from period to period. Control can be exercised for the good of the company and its shareholders or, as must be admitted with regret publicly, it can be and

is in a number of cases exercised adversely to the interest of the company and its shareholders and for the personal benefit of those in control of the company. Control can be exercised in matters of detail or in matters of general policy. By and large, in a well-run and properly organised large public company, control is exercised in the matter of the framing of general policy, in particular in matters of finance and trade, business or manufacturing policies, also in the choice of the company's main officers, also in ascertainment from those officers how they are carrying out their duties, and finally in regard to advising the members on the distribution of profits and matters of policy such as increase of the capital where shareholders' consent is necessary or desirable. If directors tend to do more, the result is, in the case of large companies particularly, disastrous.

It must follow, having regard to the fact that the determining factor in the case of a director is the factor of control, that those who are in effective control of the company's affairs would be deemed its directors whether they are described ,as directors and nominated or elected as such or they are not. It must also follow that the office of a director, endowed as it is with control, must carry with it responsibilities which could be enforced in accordance with the law. The existence of responsibilities postulates the existence of duties to be performed in accordance with the dictates of good conscience and in accordance with the public conscience. The higher the moral standards of a country or its people, the higher would be the standards of observance of duties and obligations by boards of directors.

Directors lay down the policy for observance by the management. It is quite clear that most matters of detail or of minor importance have to be and are left to the executive. Policy decisions would be those decisions of major importance which are intended to be laid down to determine and guide the activities of the company. But this is an easy definition. In Practice, much would depend upon the chairman and the directors of a particular company as to what they consider to be matters of policy. Here,

one has to differentiate between a director who is, what I may call, a pure director, that is a director not connected with the company in any other capacity, and a director having some interest in the company and connected with it such a managing director. This distinction is drawn by the well-known commentator, Mr. Read. There is also another possible distinction drawn by Mr. Read. He distinguishes between full-time directors on the one hand and other directors on the other hand. The full-time directors he divides between operational directors and functional directors. Operational directors are those responsible or some particular part of the business of a company which is sometimes carried out by a subsidiary company or a division of the company itself. Functional directors are those responsible for an activity which extends to all the operating units such as finance, accounts, personnel management etc. To sum up, the theory of the law (except as amended by status) is that the board of directors collectively are entitled to exercise all or any of the powers of the company which are not expressly vested in the shareholders either by the law governing companies or by the Articles of Association of the company or for the exercise of which no special sanction or permission of the Government is required, It follows, in strict theory, that the powers vested in the directors may, except as aforesaid, be exercised even without interference from the shareholders and that in a number of cases (apart from Section 397 & 398) the shareholders cannot overrule the board and thereby set aside the decision taken by the directors. In theory, the right of shareholders are confined to their taking action open to them under the law and the Articles of Association such as removing directors and replacing them with others who are more willing to fall in with their views. In the alternative, the shareholders can express their dissent from a particular course of action by a vote of want of confidence in the board or by not passing the Report of the Directors or the Balance-Sheet and Profit and Loss Account at an annual general meeting of the Company. In the last resort, the shareholders could go to the law courts for redress.

This was the law and to a considerable measure still is the law though now there are specific provisions in our Companies Act of major importance for interference from or regulation by Government authorities and/or by the courts and now by a Tribunal under the amended law. Whatever the prescribed procedure for the time being be, there always has been a right to take steps at law for the enforcement of the obligations and duties of directors.

The strong criticism that is at present focussed on directors and business, particularly big business, is based on tht assumption that they always tend to act in their own interests which is necessarily incompatible with the interests of the shareholders and of the public generally, and that, since the existing law does not provide remedies, it is necessary for the legislature to intervene.

It is also urged that the provisions of the law, specially those entitling directors to act on behalf of the company, and the right of the board to appoint additional directors and alternate directors, render the boards self-perpetuating and all-powerful bodies enabling them to act contrary to the interests of the shareholders and the public interest. The general answer has been given in England by the Cohen Committee, which stated that it was satisfied by the evidence that was placed before it that a great majority of limited companies there, both public and private, were honestly and conscientiously managed. Having regard to my own experience on boards and to the knowledge that I have gathered of the administration of the affairs of large-scale companies, I think that in India it will be found, if an inquiry is made, that the majority of public limited companies with large shareholdings (especially when there are no particularly large controlling interests) are reasonably honestly managed in the interest of their shareholders. The existence of undesirable elements in company managements and also the existence of certain practices of an undesirable nature are not ruled out. If it is possible, such elements should be weeded out. But the question is whether it is possible and fair to enact legislation on a basis applicable to all companies and if so to what extent such legislation should go. I am definitely of the view that in

the circumstances our country is in today, the most suitable method of rapidly industrialising the country is by not restricting private enterprise. Lack of capital, the vastness of our population and the desirability of speed do make out a case for the Public Sector in certain spheres. But so long as private enterprise holds its present legitimate and proper place in the economy of the country, it would be uanecesary and indeed dangerous to introduce new and mostly untried schemes for dealing with what should be the comparatively few cases of abuse of power by directors resulting in deliberate mismanagement of the affairs of companies under their control for personal or dishonest ends. Out of the several thousands of companies working in India, it would not be fair to their directors to be placed under restrictions some of which are irksome and result in delays because some directors have been found to be erring. By and large, all over the world, it is the institution of corporate existence that has been found to be providing the only systematised and appropriate method of mobilising the finance and resources of a country for the purposes of industry and trade and also to run such industry or trade on proper lines with a view to making profits and distributing them to the shareholders in their interest as well as in those of the country itself.

It must, at the same time, be recognised that in India the base of shareholding is extremely limited and there is rightful insistence on shareholding in new ventures being as broad based as possible. The larger the company, the more is the finance required and it must follow that the number of shareholders should be as large as possible, and that there should be means and methods whereby shareholders can know and enforce their rights.

I have briefly dealt with their rights which have always been and still are very substantial. Let me analyse the liabilities and duties of directors.

It is said, and quite justly, that a director incurs liabilities in the nature of those incurred by trustees although he is not a trustee. A director, therefore, can never justify the making of a secret profit out of his office, such

as receiving a commissian from a transaction in which the company is interested.

Personal profits can be of various kinds arising from either deliberate fraud, dishonesty or coruption or arising from the mere fact that a director holds a certain position. The law, both Indian and English, provides that a director is obliged to account to the company for any benefit he obtains from his position, additional to the remuneration prescribed for him. This theory has been taken to its logical conclusion in England. In 1942, the House of Lords, overruling both the High Court and the Court of Appeal, held [in the case of Regal (Hastings) Ltd. v. Guliver and others (1942) 1 A.E.R. 3781 that even in respect of a transaction the **bona fides** ef which were not in doubt, the directors were liable to reimburse the company certain benefits they had indirectly acquired. This company had owned a cinema theatre and had formed a subsidiary to acquire two other theatres. It subscribed only £2,000 of the capital which was all it had available for the purpose. The remaining capital was put up by the directors and certain friends of theirs. Subsequently, the subsidiary was amalgamated with the company and a profit of E2-16-14 per share was made by the holders thereof. The company sued to recover these profits made by the directors and both the High Court and the Court of **Appeal** held that the company had already subscribed as much as it could and the only way the transaction of having a subsidiary could be carried out was by the directors and others putting up the balance of the capital. The House of Lords accepted these facts, but said that as the directors had subscribed by virtue of their office and with the special knowledge acquired in such office, they must account to the company for the profits that had accrued to them. Lord Russell stated, "the Rule of Equity which insists on those who by use of a fiduciary position make a profit being liable to account for that profit, in no way depends on fraud or absence of bona **fides** or upon such consideration as whether the profit would or should otherwise have gone to the plaintiff or whether the profit was under a duty to obtain the source of the profit for the Plaintiff, or

whether he took a risk or acted as he did for the benefit of the Plaintiff, or whether the Plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well intended, cannot escape the risk of being called upon to account."

This is the ultimate in relation to the risks a director has to take when he makes a profit from a transaction in which his company is concerned. The House of Lords rejected the argument that in taking up the shares themselves the directors were merely acting as members of the public. The House of Lords stated that the directors could have protected themselves by asking the company in a general meeting to allow them to take up the shares.

This is undoubted law though it is not so stated in our Companies Act which has made elaborate provisions for directors, their remuneration and for their making good to the company any benefits that they may derive from the company in addition to their remuneration and for disclosure of interest by interested directors. All such provisions, which in reality are not as comprehensive as they are intended to be, merely confirm the law that for all that a director may obtain beyond his remuneration, he is accountable to the company and unless specifically sanctioned has to refund it to the company. These provisions of the law should be accepted by directors without reserve or exception. A director should not put himself in a position where his personal interests may come into conflict with his obligations to the company. The company has a "right to the voice of every director and the advice of every director; accordingly the directors must remain in a position whereby the advice they give is not vitiated or affected by personal motives."

There is, therefore, a misunderstanding or misconception in regard to the persistently growing demand for greater stringency in our laws relating to directors. In fact, the law is more stringent than the Act and no amount of particularisation by way of amendment of the Act can

achieve the object in view. The whole theory of the law is (a) that a director is liable for negligence or default and (b) that directors are jointly and severally liable to make good a loss suffered by the company owing to any breach of duty on their part. In a suit by a company against a director for negligence, the only answer can be either that there is no breach of duty or negligence or that there is a mere error of judgment. Otherwise, an enforceable liability attaches to the directors. Of course, there are limits to this liability. Nobody can be proceeded against for not having more skill and knowledge. There can be no responsibility for mere mistaken decisions. In cases such as those of banks or insurance companies, bad debts or claims are bound to arise but that does not mean that the directors who sanction the loans or agree to the issue of a policy or the acceptance of a risk are automatically liable for the losses.

Directors acting bona fide and accepting bona fide the statements of the officers of the company are acting properly, entitled as they are to rely upon the advice and experience of the officers, unless there is any reason to doubt the same. If there is any such reason, then the directors have to be upon guard and they must go to the bottom of the matter to the best of their ability. But even while exercising the care and caution ordinary prudent business men acting in their own affairs take, the director's liability is substantial and the extent to which the American courts, the English courts and now our own courts have gone can be gauged from the decision of the Allahabad Court in the Life Insurance Corporation of India v. Haridas Mundhra & Others. Subject to any revision from the Supreme Court, the Appellate Division Bench of the Allahabad High Court has gone to an extent to which, to my knowledge, no other Court in India has so far gone.

An application was made by the Life Insurance Corporation of India under Section 397 and 398 for relief on the grounds that the company's affairs were being conducted in a manner oppressive to the members and prejudicial to the interest of the company. Coupled with that prayer, the L.I.C. also applied for relief against individual directors

of the company for loss caused by their misconduct and breach of duty. Some of the claims were in respect of losses suffered by the subsidiaries of the British India Corporation. The Allahabad Appellate Court held that in law misfeasance or breach of trust in relation to the subsidiary company was misfeasance or breach of trust in relation to the holding company. Therefore, (a) the affairs of the subsidiary company were relevant under section 398 of the Act and also under Section 543 which entitles the Court to assess damages against delinquent directors in the case' of winding up as read with schedule XI of the Act; (b) the directors of the **holding** company could be responsible for wilful misconduct, misfeasance, or breach of trust in relation to the affairs of a subsidiary company.

According to this decision, even a single member of a company has the right under section 397 and 398 (provided, of course, that the single member holds not less than one-tenth of the issued share capital of the company) or otherwise 10% of the total number of the members of 100 members if that is the lesser number may make the application to seek reliefs for the benefit of the company, and this right includes the right to enforce jointly and severally the liability of directors for misfeasance.

The court recognised that the holding company was an entity distinct from the subsidiary company, but the court acted upon the theory of what is termed business reality. It is a theory which the American courts have to a large extent developed over the years. It is also recognised by English courts and now our courts have been using the same language and accepting the same principles. The court held that there was obviously a breach between dogma and reality in the realm of the corporate relations of a holding company and its subsidiary and that sections 397 and 398 had repaired the breach to an extent. The court, having held that the affairs of the subsidiary company were being conducted at the behest of the holding company, and that the affairs of the holding company were being controlled by certain directors of the holding company who were treating the subsidiary as a mere department, came to the conclusion that since, by and

large, the two bodies were fused together and the one was controlled by the other, the adversity of the one inevitably created a crisis in the other and that, therefore, the holding company's board of directors was liable for the losses of the subsidiaries incurred through misfeasance or breach of duty.

The court inquired into the history of the rise and growth of holding companies and concluded (though there are writers as well as enterpreneurs of eminence who would not agree with the conclusion) that the main cause for the rise of the holding company was the desire of a small group of finance and business entrepreneurs to acquire control over concentrated capital and industrial resources by the device of what could be relatively insignificant investments.

The court then construed Section 398 and said that the true import of the provision had to be comprehended by an examination of its purpose and context and that the full purpose itself could not be understood without a complete awareness of the dangers inherent in the system of holding companies, which were that the structure may become dangerously complicated and poisonous and that complicated and involved financial transactions may take place between the members of the two companies and that directors may by reason of intercorporate finance be attracted to improper or dishonest manipulation of accounts at the expense of a prosperous member of the group or to the prejudice of the minoriy shareholders of a company.

The Court came to the conclusion that the companies Act, 1956, treated the holding company and its subsidiary as a unified group rather than as separate personified institutions for purposes of ownership of capital and control of the subsidiary by the directors and managing agents as also their inter-corporate finance and accountancy.

The Court emphasised the validity of the theory of business realities and said that in the construction of a statute regulating the affairs of the companies the court would be justified in looking into business realities and it should not confine itself to a narrow legalistic view.

In arriving at such a decision, the Allahabad Court felt itself fortified by American and English decisions. The American courts have always said that they would not permit themselves to be deceived by mere forms of law but that they could deal with the substance of the transactions involved as if the corporate agency did not exist and the justice of the case may require. The doctrine of corporate entity would have to be disregarded when not to do so would work fraud or injustice. The English Courts have also adopted similar principles. The corporate veil be raised where not to do so would defeat public convenience, justify wrong, protect fraud or defend crime. Courts are prone, more prone than ever before, to cast aside the corporate mask and give recognition to the economic facts such as that in an entity composed of a group of companies, actual business enterprise is carried on by the component individuals active in the groups.

I have digressed into a discussion of the theory of the corporate veil and how easily the courts allow it to be raised. This is to point out that there is no radical change in the law about the liabilities and responsibilities of directors introduced either by the Companies Act, 1956, or the amendments thereto between 1956 and 1963. The radical change in the Companies Act, 1956, by the introduction of Section 397 and 398 was in regard to the procedure evolved which, according to the Allahabad High Court, can be utilised simultaneously for enabling applications to be made for relief in cases of oppression or in case of mismanagement (a right which the Courts previously had by the more elaborate method of a suit by shareholders for themselves and on behalf of the other shareholders or on behalf of the Company) and coupling this right with the right of obtaining relief.

When the judgment was delivered, I drew the attention of the Company Law Department to the implications of this judgment and that in my opinion very important questions arose which require determination by the Supreme Court and if the construction of the Supreme Court was the same as that of the Allahabad High Court then the legislature would have to consider those implica-

tions. I expressed my doubt whether it was wise or proper as a matter of procedure to allow a petition under section **397** and **398** or either of them to be used for the purpose of making a claim for damages against the directors or persons in control of a company. If sections **397** and **398**, read with section **539** and **544** and section **406** and Schedule II, entitle the Court to examine into the conduct of any person who has taken part in the promotion or formation of the company or any past or present director amongst other people and also compel him to repay or restore the money or property or any part thereof which the court might find he has taken away or benefited by as a result of any misapplication, retainer, misfeasance or breach of trust, then a great deal of burden is thrown on the court in determining claims which are different in nature and substance. Since now the powers and functions conferred on the court under section **397** and **398** may be delegated to the Tribunal, even the safety inherent in a hearing before the High Court and later on before Supreme Court might be jeopardised.

The persons most directly affected by action under these sections are directors. Normally they would be the persons against and in respect of whom action would be taken. If directions are given by the court and now the Tribunal, regarding the management it is the directors' powers which would be affected. If any payments are ordered, the directors would have to make the payments. The orders that could be passed would include orders to provide for the regulation of the conduct of the company's affairs in the future (which may be a short time or a long time), the purchase of the shares or interest of any members of the company by other members thereof or by the company itself (which otherwise would be impossible under the law), the termination, setting aside or modification of any agreement between the company and amongst other persons the managing directors and directors, upon such terms and conditions as may in the opinion of the Court or the Tribunal be just and equitable in all the circumstances of the case, and the termination setting aside or modification of any agreement between the company and

any other person, the setting aside of any transfer, delivery of goods, Payment, execution or other acts made or done by the company within three months before the date of the application on the same principles as applied to fraudulent preference in cases of insolvency of an individual and what is more the Court can make an order providing for any other matter for which in the opinion of the Court or the Tribunal it is just and equitable that provision should be made.

These powers are very wide and the legislature has intended that they be wide. Having regard to the well-known attributes of our higher judiciary, it may be expected that such powers would be used sparingly after the most complete consideration and only when the occasion necessitates them but the extent of those powers and the extent to which the exercise of these powers can affect the rights, duties and obligations of directors must not be under-estimated. An obvious danger or risk in such applications is that they are made in most cases by shareholders who are not necessarily fully aware of all facts. In fact, the risk may arise in varoius ways. I can envisage a number of different kinds of cases where the provisions of sections **397** and **398** may conceivably fail and indeed be a good weapon in the hands of evil-minded persons who desire to hide their own defaults. They may, for example, use the procedure of these sections for stifling a suit or other proceeding taken or proposed to be taken against them in due course of law. It must be remembered that a decision in such an application may amount to res judicata and if the company is subsequently taken into liquidation and the liquidator considers further investigation necessary into the same matters, he may be prevented. If a particular claim is adjudicated upon in these proceedings, would it be open to review in any other proceedings, or in liquidation when more facts are available? It must be remembered that with the recent amendment even the jurisdiction of the ordinary courts is removed which was not the case previously.

Further, if a general inquiry is made into the affairs of the company and the court comes to a finding that the

case must fail on the first part or that only claims in regard to certain items which may fail for want of sufficient proof or want of pressure? Under general principles of law, claims having been made, all those claims in respect of which relief is not granted may be deemed to have been refused. (See section 11 of the Code of Civil Procedure.)

I have again digresed in dealing with the provisions of Section 397 and 398 but I have done so purposely because I feel that these amendments must affect directors considerably and that they require reconsideration when viewing them from the point of view taken while legislating therefor.

Let me summarise the duties of directors and persons in the position of directors, such as controlling shareholders. There is, first and foremost, the duty of care; secondly, there is the duty of loyalty; thirdly, there are the duties of directors in the case of "transactions in shares of the Corporation or its assets" or "in transaction with or concerning the Company wherein they themselves are interested." Fourthly, there is the duty of directors towards creditors of the company; and lastly, there is a duty (which at present is advocated strongly) towards the public. These duties are owed to the company as such rather than to the shareholders or creditors individually. But in most cases, these duties are enforced on behalf of the corporation in suits or proceedings instituted by individual shareholders.

The standard of care that should be shown and taken is the same in theory in the case of any company, namely, that of the prudent business man acting in his own interest. But in actual practice, the standard varies from business to business and from transaction to transaction. Theoretically, the duty of care, according to the decisions, is to exercise the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs. American decisions perhaps modify this theory and the degree of care is there upgraded a bit, because it has been held by American courts that one who voluntarily accepts the position of a director and invites confidence in that relation undertakes with those whom he represents or

for whom he acts, that he possesses at least ordinary knowledge and skill and that he will bring them to bear in the discharge of his duties. There is noticeable difference between the two dicta. A man in the exercise of his own affairs may not be as careful in his duties or rigid as he undertakes to act with ordinary knowledge and skill appropriate to the business which he has to conduct or supervise for and on behalf of others.

Under the Head "Care", the primary and all-embracing duty is to supervise the acts of the executive. Direct supervision being impossible, especially in large corporations, this duty of supervision is, American text-books say, conditioned by the circumstances of the cases with the right to rely upon the judgment, advice and experience of the executive. In assessing the degree of care, the courts have always appreciated, that when directors have to come to a decision, judgment has to be exercised, risks have to be undertaken and that other errors of judgment or events and circumstances happening afterwards could upset predictions and projects. A mere error of judgment, therefore, cannot be upheld against a Director. There must be a case of improvidence, of recklessness or unreasonable action, of not taking that measure of reasonable prudence, care and skill which the law requires that renders vulnerable the position of a director.

It has been said quite often that directors are trustees. So far as it means that directors in the performance of their duties stand in a fiduciary relation to the company, that statement is essentially correct and it would be wise and prudent for directors to act as if they were trustees. Directors are, therefore, bound by all those rules of conscience, fairness and morality of purpose which the law imposes as guides for those who are under fiduciary obligations and responsibilities. Baker and Cury, in their treatise on the corporation, state that dirctors are held in official action to the extreme measure of candour, unselfishness and goodwill and that these principles are rigid, essential and salutary that a director who owes loyalty and allegiance to the company must owe that loyalty completely undivided and his allegiance must be influenced in action

by no consideration other than the welfare of the company of which he is a director. If in any cases any adverse interest arises, it has to be subjected by the director himself and by the other directors to an uncompromising scrutiny and it is only where such uncompromising scrutiny can stand that the transaction in question ought to be put through. It follows, therefore, that a director may not profit at the expense of the company concerned or in conflict with its rights and a director, therefore, must not act for personal gain or personal object. No opportunities which in fairness belong to the company could be utilised by a director for his personal gain.

Does this mean that a director must know the business which he is supervising, as if he was an executive officer having special knowledge thereon? I think not. What is expected of a director is that he should know of and give direction in regard to the general affairs of the institution and its business policy and have a general knowledge of the manner in which the business of the company is conducted, the character of the investments and the employment of the resources of the company.

In law it is quite clear that no custom or practice can make a directorship a mere position of honour void of responsibilities. There is no substitute for proper and ample care and attention. A board of directors exists not for the personal ends of the directors even if they own a majority of the shares nor merely for giving confidence or for attracting custom; the board must be able to afford Protection to the shareholders and, as the theory now holds, in some extent to the public. The directors are, however, not insurers. They are liable for breach of duty or negligence in the performance of their duties, but not for errors of judgment or mistakes so long as they act with reasonable skill and prudence and on the materials which they have before them or ought to have before them. The law recognises that the most conservative and careful director would not be infallible and that he can err in his judgment even to the extent of being in error or making mistakes, and that he ought to be excused, provided that he has used that degree of care, ordinarily exercised by

men. If he exercises that degree of care he is not liable, even though his opinion may have turned out to have been mistaken and his judgment faulty.

Another proviso, which shareholders and in a number of cases members of the Legislature as well as those in authority possibly forget, is that to assess that degree of care which a director must show one has to look at the facts as they exist at the time of their occurrence. Subsequent events may make one wiser but those events cannot properly be taken into consideration in assessing the liability of a director. While considering this degree of care, there may be a difference between director and director. I conceive that the position of the chairman or of the managing director is even more onerous, if such chairman or managing director, takes the duty of guiding his co-directors. In such cases, while on the one hand the others are entitled to depend on him, he is bound to be somewhat more careful, again on the basis that in a similar position as ordinary prudent person would show greater care.

It has been said, perhaps too generally, that directors are concerned only with what happens in their presence at board meetings. This is not a correct appreciation of the legal position. A director is bound, as he is entitled, to inform himself of what is going on with the company of which he is a director. By absenting himself, he cannot absolve himself from liability altogether. It is possible that in respect of one solitary transaction he may not be aware and he may not be liable. But having accepted a post of confidence, having been charged with the active duty to keep himself informed of the company's progress, he must keep himself generally informed about the same.

This brings me to the last question whether the responsibility is collective or individual. It is collective. Though a director of a company is liable for his own misconduct and not for the wrongful conduct of others, if he does not observe the duty of care, he may find himself liable for the active defaults of others even though he may be absent from a particular meeting which decides upon a particular transaction.

As regards loyalty of a director, there are numerous ramifications. The duty of disclosure of personal interest falls under this head. It is essential to ascertain and inquire towards whom is this duty, on whose part is this duty and under what circumstances is this duty to be exercised. In most of the cases, where loyalty and personal interest can come into conflict, as would be in the cases of contracts of interested directors, or interlocking directors, the law has made provisions rendering void or voidable contracts or transactions between a company and an interested director. Intricate questions arise whether interest of the directors are fully disclosed and even where that is so whether the terms of the transactions are fair, and lastly whether the particular director has taken part in the discussion and decision It is open to a company, after careful consideration of all known facts, to accept or even ratify and confirm a particular action or transaction. Much would depend in deciding such questions whether the facts were fully disclosed, and whether the transaction is fraudulent or unfair or lacking in faith.

In the light of the above, the effect of two important pieces of legislation, namely, the Banking Laws (Miscellaneous Provisions) Act, 1963 and the Companies (Amendment) Act, 1963, are to be considered. So far as these affect the rights, duties and obligations of directors, it appears to me that they affirm in regard to 'their duties and obligations the existing law but restrict, particularly in the case of banks, their rights especially of management of the affairs of the companies under their care. In matters of procedure, however, and in the matter of restricting the jurisdiction of courts of law to entertain certain matters there has been considerable amendment to the law. Perhaps my being a lawyer results in my deprecating all legislative measures depriving the courts of jurisdiction. I have made no secret of my views that it is incorrect and dangerous to deprive courts of law of jurisdiction and transfer jurisdiction to what at best can be administrative tribunals. Vital questions affecting the citizens are involved and a completely judicial approach which is at the same time

subject to appeal, revision or review by the Supreme Court should be most useful.

Directors of banks have come in for a number of restrictions. The Reserve Bank of India has been given considerable powers over banks and financial institutions. The Reserve Bank has been given authority to give directions relating to the conduct of business by banks which can in cases amount to overriding the wishes and powers of the directors of those banks. Further restrictions have been introduced in regard to unsecured loans or advances by banks to either their directors or to firms or private companies in which direcors are interested and in the case of public companies in which the chairman of the board of directors of a banking company is interested as chairman or managing director of that public company or as managing agent or director or partner of the managing agent of such public company.

The right at law of directors to remit debts is restricted in the case of debts due to a bank by way of its directors or any firm or company in which any of its directors may be interested in a variety of ways, and the law provides that if the directors make any such remission without the permission of the Reserve Bank it will be void. Important additional powers are granted to the Reserve Bank enabling it to give directions to a bank as to the purpose for which advances may or may not be made; margins to be maintained; the maximum amount of advance or other financial accommodation which may be made to any one company, firm, association of persons or individuals; the maximum amount of guarantees that may be given on behalf of any one customer and also the rate of interest and other terms and conditions on which advance or other financial accommodation may be made or guarantees may be given. All these, naturally, restrict the rights of directors.

A power of a sweeping nature, to remove from office any director, chief executive officer or any other officer or employee of the Banking Company is also vested in the Reserve Bank and, what is more, any such order made by

the Reserve Bank would effectively prevent such director or officer from being directly or indirectly concerned with or taking part in the management of any banking company for a maximum period of five years. A still greater power given to the Reserve Bank is to appoint any person it considers proper in place of the director or any other officer or employee who has been removed. The Reserve Bank has also the power to appoint for any banking company not more than five persons to hold office as additional directors. It is important to note that the nominees of the Reserve Bank are statutorily exempted from incurring any obligation or liability by reason of any acts of theirs done or omitted to be done in good faith.

These changes have been effected, according to the Statement of Objects and Reasons, for ensuring more effective supervision and management of the monetary and credit system of the country by the Reserve Bank, and to enable the Reserve Bank to give the banks directions in respect of matters in which the Reserve Bank, as the central banking institution of the country, may be interested from the point of view of the control of credit policy. The Reserve Bank's powers in relation to commercial banks are enhanced so as to provide for stricter supervision by it in the operations and workings of such banks. Quite clearly the amendments have been made following the new concept of public interest being the overriding factor in regard to company management.

In regard to companies, the legislature has, pursuing the same concept of public interest and following its expressed intention to ensure as far as possible the efficient and proper administration of companies, by the Companies (Amendment) Act 1963, provided for a Tribunal to exercise a number of the functions which courts at present exercise and replaces the Company Law Department by a Board of Company Law Administration.

So far as all this concerns directors — their rights, duties and obligations — there are no important changes in the law except that the Central Government has now the right to remove from office directors or officers of the

company in certain cases. There are other very important provisions compelling conversion of loans by the Government to companies into equity capital.

The Board of Company Law Administration will exercise and discharge such powers and functions as are conferred on the Central Government by or under the Companies Act or any other law and as may be delegated to it by the Government. The board will consist of a chairman and four members. It will act according to the prescribed procedure and it will be subject to the control of the Central Government.

A Tribunal will also be constituted and appointed consisting of as many members as the Central Government thinks fit to exercise and discharge the powers and functions conferred on such Tribunal by the Companies Act 1956 and such of the powers and functions conferred at present on the Court under Section 155 (rectification of register of members) Section 203 (granting of leave to a fraudulent person against an order restraining him from managing companies), Section 240 (compelling production of documents and evidence before an Inspector appointed by the Government and taking action in case of default) and Sections 397 to 407 (regarding prevention of oppression and mismanagement), which the Central Government may from time to time specify.

While the Tribunal will have as its chairman a Judge of a High Court or a person qualified to be a Judge of the High Court, I feel that the deprivation of the jurisdiction of the High Courts is not a desirable feature of this legislation.

The other provisions of the Amending Act affecting directors directly are those authorising the Central Government to remove managerial personnel (which would include directors) from office on the recommendation of the Tribunal. Section 388B, which is newly introduced, directly affects directors who, under normal Company practice as understood up to now, could only be removed by the shareholders or in certain stated cases by the court.

There are several grounds set out for which a director or an officer of the company may be removed by the Central Government, and one of them is the carrying on of the business of a Company in a manner prejudicial to the public interest. This is in accordance with the new concept of public interest which is gaining ground.

Ever since the system of corporate existence has taken rwt and developed, the duties and obligations of directors have been understood by the court and enforced. Their rights have crystallised in the process of development of the system and for a considerable time the all-powerful position of directors in the matter of control continued supreme on account mainly of the shareholders being unorganised and scattered and public opinion being not so critical, as it has become later on, in some cases deservedly and in others not so. But the courts have always taken care to protect the rights of shareholders and creditors and also the public interest by enforcing the duties and obligations of directors in their mixed-up capacities of agents, trustees and officers and, therefore, Me makers and supervisors of the policy governing the administration of the company concerned. The legislatures in England and in our country have legislated in favour of the shareholders by placing a few restrictions on the rights of the directors in the governance of their companies and further by prescribing for the formalities to be observed in certain matters and by particularising the procedure whereby shareholders, creditors and others connected with companies, (including in India the Central Government authorities), could strictly enforce the duties and obligations of directors.

As regards the pruning of the rights and powers of the directors, the pruning has not been considerable or restrictive. As regards the procedures now prescribed, there can be no particular objection, because procedural legislation does not affect the law. But procedures can be cumbersome and irksome and in my view the present legislative changes fails to achieve the objects contemplated. The dangers of such legislation are that the wide ambit of the unwritten law could be and is abridged and the policy

of depriving the jurisdiction of the regular courts of the country could and is likely to result in administrative judgments which are not always satisfactory. Believing as I do in the efficacy and integrity of our courts and of the system adopted in the courts whereby any possible mistake or error of judgment is capable of being corrected, I think it is a mistake to substitute for them what are at their best administrative Tribunals. As against the virtues of despatch and economy which such Tribunals are expected to possess (and which I doubt), the possibilities of mistakes and errors being committed and there being abuses resulting in possible denial of justice and laying down of incorrect principles are greater in the system of administrative Tribunals than in the time-honoured system of judicial redress.

(Note: The para on Page 3 stands modified to the extent that the Government is reported to be bringing in a comprehensive amending bill which would include the matters reported on by the Bose Commission.)

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.

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—A. D. Shroff

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