# DIRECTORS DUTIES IN INDIA: A CRITICAL ANALYSIS

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*The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private [firm] watch over their own.*

-Adam Smith
*An Inquiry into the Nature and Causes of the Wealth of Nature, 1776.*

## I. INTRODUCTION

"A company is an artificial being, invisible, intangible and existing only in contemplation of law." [1] "It has neither a mind nor a body of its own." [2] "A living person has a mind which can have knowledge or intention and he has hands to carry out his intention. Whereas, on the other hand, a company has none of these, it must act through the help of living persons." [3] This makes it necessary that the company's business should be in hands of some human agents i.e., Directors and collectively known as Board of Directors. The Companies Act, 2013 under Section 2(34) states that 'A director means a director appointed to the Board of a company.' Whereas, the Act under Section 2(10) states that 'Board of Directors or Board, in relation to a company, means the collective body of the directors of the company.'

The Act under Section 149 states that 'every public company shall have at least three directors and every private company shall have at least two directors.' [4] Talking about one person company, there has to be at least one director. Maximum number of directors can be fifteen and a company can have more than fifteen directors by a passing a special resolution. The following class of companies has to appoint at least one women director: i) every listed company and ii) every other public company having paid-up share capital of 100 crore rupees or more or turnover of 300 crore rupees or more. Further, the directors are elected by the shareholders. [5]

The position of the directors that they occupy in a company is not easy to explain. [6] "A director is not a servant of the company or of anyone." [7] Directors are managers of a company, who act on the behalf of it and act as their agents. A director has the right to work as an employee in a different capacity. This was made clear in the case of ***Lee v. Lee's Air Farming Limited***, [8] where the court held that "the principal controller and a director of a company was also working as its pilot. Following his death while acting as a pilot, his widow recovered compensation under the Workmen's Compensation Act." The Act makes no effort to define their position.

Even though the directors are elected by shareholders, they do not owe any fiduciary relationship with them but they have exclusive right to run the company. This was made clear in the case of ***Sangramsingh P Gaekwad and Others v. Shantadevi P Gaekwad (Dead) through Legal Representatives and Others***, [9] where the court observed that "the directors are under no fiduciary duty to shareholders but the directors take it upon themselves to give advice to current shareholders (neither have a duty to act in good faith and not fraudulently nor can mislead the shareholders whether deliberately or carelessly, in which event, they may have a remedy)."

As the directors are not the owners of the company, it is difficult to even think that they will always work in the interest of the company and use the company's money wisely. The agency theory supports this view. Way back in 1932, Berle and Means in their study found out that the directors being agent and not owners of the company and yet holding the management in their hand leaves shareholders at their mercy for protection of their interest in a company. This separation of ownership and control leads to problem of governance of a company. [10]

Determining the duties of the directors is one of the most difficult areas of law because they are defined or come into existence as a part of corporate fraud or breach of duty by the directors. The objective of this article is to analyze the role of directors in corporate governance by looking at the old and new Act (1956 and 2013 Act respectively), how the Indian Courts have interpreted the director's duties through the help of landmark rulings that will give you an in-depth knowledge on the same.

## II. DIRECTORS' DUTIES IN INDIA: AN ANALYSIS

Directors are held by their fiduciary duties to an unerringly strict standard, famously described by Cardozo J as 'not honestly alone, but the punctilio of an honour the most sensitive'. [11] The role of enforcement in corporate law serves as prophylactic function 'liability imposed on directors' are not to proscribe unjust enrichment but to stifle the siren call of temptation.' [12] Without enforcement there is no foundation to support the edifice of duty. [13]

The Companies Act, 1956 did not mentioned the duties of directors. As a result, the duties of directors were obscure. Thus, in India, one of them is not effective either the legal provisions making the directors liable or that their enforcement. Thus, it felt that there is a need for codification of directors' duties in India.

### Statutory Duties Under the Companies Act, 1956

To begin with, you should have a clear knowledge of the statutory duties of directors under the Indian statute law read along with the evolution of directors' duties with the help of case-laws. The Companies Act, 1956 under Section 2(13) defines a director as "any person occupying the position of director, by whatever name called." This definition has been generalized by the Indian judiciary and they have held directors to be trustees or agents of the companies. [14]

Some of the important statutory duties prescribed under the Companies Act, 1956 are mentioned. A director must satisfy certain conditions so that he/she is not disqualified under Section 274 of the Act. [15] If a director of a company is guilty of any negligence, default, misfeasance, breach of duty or breach of trust in relation to the company then no agreement, articles of a company or provision of the Act can relieve him of the liability. [16] If a director is guilty of fraud, misfeasance, and breach of duty in relation to the company, then the court may order that person shall not be director. [17] The directors have to face liability for fraudulent conduct of business if the official liquidator declares them to be knowingly parties to conduct of business in such manner. [18] The board has to lay the Directors Responsibility Statement at the company's general meeting. [19] The Act also states that if the director is absent from three consecutive board meetings or from all board meetings for a continuous period of three months, whichever is longer, without obtaining leave of absence from board, it would result in vacation of the office of the director. [20] The directors also have to carry out other duties in connection with meetings. [21] The board's consent is required for certain contracts in which particular directors are interested. [22] The board's consent becomes mandatory, if the directors wish to hold an office or place o profit. [23]

Another important statutory duty that the directors have to carry out is disclosure of interest. A fine can be imposed on directors who fail to disclose their interest when they are directly or indirectly concerned with a contract or arrangement being entered into by or on behalf of the company. [24] The director needs to disclose the nature and extent of interest or right in relation to shares or debentures which are to be recorded. [25] It is the duty of directors and persons deemed to be directors to make disclosure of shareholdings. [26]

The Act provides that in case of a limited company, the liability of the director may be unlimited if it is provided by the MOA [27] or is confirmed by a special resolution. [28] The Act provides for the civil and criminal liability of the director. For instance, a director who files statement in lieu of prospectus containing a false statement would incur criminal liability. [29] Moreover, the Supreme Court while examining the criminal liability of a director under the Indian Penal Code, 1860 observed that vicarious liability of directors would arise provided and provision exists in the statute. [30]

The 41st Law Commission Report has suggested certain amendments in the penal provisions thereby providing for substitution of imprisonment with fine in case of offender being a body corporate. The Report came back in 1971; however, no changes have yet been made in the law. [31]

With respect to the issue of Corporate Criminal Liability in India, there are three ways or methods for imputing liability. First, to identify the individual who was responsible to the corporation for the wrongful act which is in dispute. If he/she has successfully shown that the act was done without his knowledge then he may escape liability. Second, if one can prove that the wrongful act in question was done with the consent on part of a director, manager, secretary or any other officer of the company, such an individual will be held liable. The last way is making the company liable. The company can be held liable instead of the liability of a particular individual.

### Codification of Director's Duties in India

Duties of the directors are not set out specifically in the Act of 1956 but the Companies Act, 2013 seeks to codify the directors' duties. The initial steps that were taken towards codification originated in the first Code of Corporate Governance that was unveiled by the Confederation of Indian Industries in 1998 in the backdrop of a cascade of scams. [32]

The Desirable Corporate Governance Code states that *"the key to good corporate governance is a well-functioning, informed board of directors. The board should have a core group of excellent, professionally acclaimed non-executive directors who understand their dual role: of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors."*[33]

This was followed by the Report of Kumar Mangalam Birla Committee, wherein it stated that *"the* *board controls the company and its management by laying down the code of conduct, overseeing the process of disclosure and communications, ensuring that appropriate systems for financial control and reporting and monitoring risk are in place, evaluating the performance of management and providing checks and balances to reduce potential conflict between the specific interests of management and the wider interests of the company and shareholders including misuse of corporate assets and abuse in RPTs. It is accountable to the shareholders for creating, protecting and enhancing wealth and resources for the company."* [[34]] This report defined "Independent Directors" for the first time as directors, who does not have any material or pecuniary relationship with the company or directors. The recommendations of this Committee Report were incorporated by the SEBI into the Listing Agreement. [35]

In the year 2000, the Report of the Task Force om Corporate Excellence through Governance stressed on the need for independent directors as well as strict punishment for executive directors. To directly quote from the report, it states that *"this field calls for a greater role and influence of non-executive independent directors, a tighter delineation of independence criteria and minimisation of interest-conflict potential, and some stringent punishment for executive directors of companies failing to comply with listing and other requirements."*[36]

The issue relating to independent directors was also dealt with in the Naresh Chandra Committee Report which stated that *"directors are fiduciaries of shareholders and not of the management. This does not imply that the board must have an adversarial relationship with the management, but where the objectives of management differ from those of the shareholders, the non-executive directors on the board must be able to speak in the interest of the ultimate owners, and discharge their fiduciary functions. That's the reason independence has become a critical issue in determining the composition of board."* [37]

The NR Narayan Murthy Committee Report was constituted to make further recommendations and the definition of an independent director given by this committee was similar to that given by the Naresh Chandra Committee Report. [38]

The JJ Irani Committee Reports recommendations were the most significant. Since, this was the first Committee Report that was vehement in its suggestion for recognition of directors' duties in law. [39] The recommendations given by this Committee were incorporated into the Companies Act, 2013. [40]

Thus, the previous Act epitomizes the shareholder model of corporate governance where the primary role of the directors is to protect the interest of the shareholders and creditors in the event of insolvency. [41] However, the new Act, 2013 summarizes the stakeholder model of corporate governance wherein the directors will consider the non-shareholder constituencies like the employees, the community and the environment.

### Interpretation of Directors Duties by Indian Courts

The main source which governs the actions of the directors is the judiciary. In the Indian scenario, the judiciary has interpreted and incorporated the directors' duties as found in other common law jurisdictions. The Indian judiciary heavily relies on English authorities for interpretation of directors' duties.

In ***Nanalal Zaver and Another v. Bombay Life Assurance Company Limited and Others,***[42] the Court upheld that Section 105(C) imposes obligations on the directors of companies and as long as they are complied with, the Court would not interfere. J. Mahajan noted that the director of the company must act in the interest of the company. J. Das concurred in his view with J. Mahajan and said that when a director acts against the interest of the company, the court would interfere on the basis that there is a relationship of a trustee and of *cestui que* trust i.e., beneficiary of a trust between the directors and the company. To conclude, the directors should not use their powers to maintain their control over the affairs of the company or minority shareholders. One of the important questions that arose in this case was "Whether the courts can replace the judgement of directors, who have knowledge of business with their own knowledge?".

In ***Bank of Poona Limited v. Narayandas Shriman Somani***, [43] the Court said that "the directors of a company have a peculiar position in the management of a company since it must act through others. They are treated as being in a fiduciary position and greatest good faith is expected in the discharge of their duties. This provision is enacted so that they would be prevented from acting in such a manner that duty and self-interest should conflict. This section would appear to be intended for the protection of the interests of the company and if that is so the contract could not be avoided by the defaulting director." In short, good faith is expected in the discharge of their duties and the directors shall not use it for their personal gain.

Corporate law aims at controlling the agency problems among corporate constituencies. There are 3 generic agency problems and that are manager-shareholder, minority-majority, and the shareholder-stakeholder agency problem. Amongst all these three-agency problem, the one which is largely prevalent is majority-minority agency problem.

In ***Om Prakash Khaitan v. Shree Keshariya Investment Limited and Others,*** [44] the Court relived Om Prakash Khaitan, the director of any liability because it held that it was unreasonable to fasten liability on directors for the defaults and breaches of a company where such directors are either the nominee directors or are appointed by virtue of their special skill or expertise. In such cases, the directors should be relieved of their liability unless they are directly involved in the act complained or otherwise not acted honestly or have financial involvement in the company.

In ***Dale and Carrington Investment Private Limited and Another v. PK Prathapan and Others,***[45] the Supreme Court held that the directors in a private limited company are expected to make a disclosure to the shareholders of such a company when further shares are being issued and this flows from their duty to act in good faith and make full disclosure to the shareholders regarding the affairs of a company.

The Court then referred to the ***Needle Industries*** Case. [46] The Court referred to various old English cases in the above judgement, which the Court in the present case, cited with approval. This Court upheld the principle as cited in the English case of ***Piercy v. S. Mills and Company Limited,*** [47] that directors are not entitled to use their powers of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders. The Court finally concluded taking into account the judgements in ***Needle Industries*** case and ***Tea Brokers*** case. [48] The Indian Court have also applied the same test while testing exercise of powers by directors of companies as in other Commonwealth countries. Thus, the Court stated that the motive for the allotment was *mala fide,* hence the allotment must be set aside.

Thus, it is clearly visible that the Indian Courts have been strict towards the interpretation of directors' duties. They have made it clear to the directors that they must exercise their power with due care, diligence, skill and independent judgement, and company's interest has to be considered always.

## III. CONCLUSION

In India, there is no such rule that old laws should be read in harmony with the newly codified duties and responsibilities. As this will result in contrasting jurisprudence and can create chaos in the minds of judiciary i.e., whether to adopt a progressive view in interpreting duties of directors or to maintain harmony with the continuing jurisprudence that has evolved through various case laws in past.

But what needs more attention is that the codification reflects or depicts serious effort to ensure balance between both the sides i.e., those who supported codification and those who opposed. After codification, the law is more predictable and the scope for judge's discretion has been reduced.

Intellectuals argue that codification of director's duties in India has been a decision guided and influenced by the United Kingdom. But India failed to bring out the details which were carved out in the United Kingdom laws. For example: United Kingdom states that the old laws would prevail. Whereas, no such instance is mentioned under the Companies Act, 2013.

To conclude, the changes that have been taken place in the Companies Act, 2013 is facilitated by the United Kingdom laws and the Act in India is aligned in the right direction at the moment.

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