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Director's liability: accountability essential for effectiveness

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☞ INTRODUCTION

In a dynamic business world, the role of a director of a company holds immense significance. A director is an agent of the Company for the conduct of its business. The word *director* has been defined in section 2(13) of the Indian Companies Act, 1956 **("the Act"**) as any person who occupies the position of director by whatever name he may be called. The Articles of Association of an Indian company may provide for the delegation of functions to the extent permitted under the law. In certain cases, a director might be in breach of duty if he delegates to others, those matters for which the Board of Directors as a whole has to take responsibility. In other words, directors are ultimately entrusted with the management of the company and they cannot entirely divest themselves of their responsibility by delegation. Section 5 of the Act provides that the phrase *"officer-in-default"* means the specified officers of the company and includes the managing director, whole-time director, manager secretary, any person under whose instructions the board of directors is accustomed to act and any person who acts on the instructions of the board of directors. Moreover, according to section 5(g), if a company does not have a managing director, whole-time director, or manager in case of any default, the directors of the company are treated as *"officers-in-default"* and are liable for monetary and penal sanctions. Therefore, a director is not immune to liability under the Act which arises upon the breach of any duty. The duty of a director can be classified as either statutory or fiduciary. While the former is prescribed under the Act, the latter is a common law phenomenon.

This newsletter titled "Director's liability: accountability essential for effectiveness" discusses some aspects of directors' liability in respect of breach of both the aforesaid categories with special emphasis on liabilities arising from the breach of fiduciary duties.

1. Liability cannot be exempted

At the outset it is important to be aware that Section 201 of the Act bars any clause in the articles of association or agreement between the director and the company for exempting any officer of the company from liability arising from negligence, default, misfeasance, breach of duty, or breach of trust. The bar is also applicable on the auditors of the company. The directors can face prosecution and proceedings can be initiated in a court as per the provisions of the Act.[1] If the director is absolved of the charges made against him in any such proceedings then he may be indemnified by the company in respect of the costs incurred by him in defending himself in the proceedings.[2]

2. Fiduciary duty

Fiduciary duty per se is not defined in the Act. It is a common law concept and is a part of the Indian jurisprudence. Under the Indian law, a director's fiduciary duties require him to exercise his powers and position diligently, with care, loyalty and in good faith for the benefit of the company as a whole and not for his own benefit or for the benefit of a section of the shareholders, even if the section represents the majority of shareholders.

Black's law dictionary defines fiduciary duty as the duty of utmost good faith, trust, confidence, highest degree of honesty[3] and loyalty, the duty to act

[1] The procedure for the prosecution of offences against the Act is dealt in section 621-631 of the Act.

[2] The proviso to section 201(1) of the Act lays down the conditions when the company can indemnify the director in respect of defending himself in any proceedings initiated against him.

[3] Dikshit & Co. Ltd. v. Mathura Prasad AIR 1925 All 71 has held that the directors in fiduciary position must act without raising the slightest suspicion of dishonesty.

in the best interest of the company. This duty arises from the fiduciary relations between the director and the company. Black's states that the term fiduciary is very vague and has been put to many uses. Indian jurisprudence has also defined fiduciary duty through various judicial pronouncements.[4] As stated above, under the Indian law, the concept of fiduciary duty imposes an obligation on the directors to act for the benefit of the company and not for their own benefit. The law of trusts in equity and in legislations is not completely applied to the director; therefore, director is a trustee of a company but in a limited sense. The conduct of the directors has to be measured in reference to the character of the organization which they are appointed to manage.

2.1 Liability for breach of fiduciary duty

The complaints for the breach of fiduciary duty can be made under the general provisions of sections 621[5] and 628 of the Act. Criminal offences have to be tried in the court of the magistrate of first class.[6] The Department of Company Affairs has the authority to appoint public prosecutors in regard to such proceedings.[7] The court has the authority to impose fines under the Act and the proceeds of the fine goes to the payment of the cost of proceedings or to the person at whose instance the fine is recovered.[8]

The complaint against the director can be brought by the Registrar of the Companies, the shareholder of the company, or any person authorized by the Department of Company Affairs. The burden of proof lies on the person leveling the charges against the directors.[9] If a director is proved guilty then theoretically he is liable to be punished with an imprisonment up to two years and with a fine, the limit of which has not been specified in the Act.[10] However, while these sections act as a deterrent but in practice imprisonment is not common.

3. Statutory duties under the Act

The Act, lays down the duties of the director and two important ones are discussed below.

Disclosures: Section 299 of the Act places an onus on the director to disclose his interests in the contracts entered into by the company. Disclosure shall be made at the first meeting of the Board held after the director becomes concerned or interested in any contract. Disclosure may be made by a general notice in Form No-24AA given to the Board of Directors stating his interest, which shall be deemed to be sufficient disclosure of his interest. Such notice shall expire at the end of the financial year in which it was given. Notice must be revised annually.

The interest could be in relation to any contract already executed or to be executed in the future. Interest does not mean pecuniary interest solely. It can arise out of either blood or a fiduciary relationship like that of a principle and agent. In a landmark judgment[11] by the Supreme Court of India where section 299 of the Act was considered it was held that the interest under sections 299(1) cannot be merely a sentimental interest or an ideological concern. If a director fails to disclose his interest in any contract entered into by the company then he is liable for a fine of INR 50,000 (US$ 1,250).[12]

Prior approval for certain contracts: Section 297 of the Act, which applies to a private company only, provides that prior consent of the board is required for execution of certain types of contracts. The object of section 297 is that the Board of Directors must have knowledge of the extent of interest of a director in contractual dealings with the company or of any person connected with the director in any of the ways

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4 In R.K.Dalmia v. Delhi Administration [1962] Comp. Case 699 (SC) the Court held that the directors are agents or trustees of the company. Similar view was taken in the judgments of Needle Industries (India) Ltd. v. Needle Industries Newey India Ltd. [1950] Comp. Cas. 179 SC and Fateh Chand Kad v. Hindsons (Patiala) Ltd. [1957] 27 Comp. Cas. (Pepsu).

5 Section 621 of the Act deals with the persons authorized to bring complaints against the director.

6 Section 622 deals with the jurisdiction of the courts to try offences.

7 Section 624A empowers the Department of Company Affairs to appoint company prosecutors.

8 Section 626 deals with the provision for the imposition of fines.

9 Thomas Vettom v. Kuttanad Rubber Co. Ltd [1984] 56 Comp. Cas 284 (Ker.).

10 Section 628 of the Act stipulates the procedure for penalty in case of false statements made by the director of a company.

11 Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd. AIR 1981 SC 1298.

12 Section 299(4) of the Act prescribes the liability in case of failure of a director to disclose his interest in the contract.

mentioned therein[13] and accord their consent to such dealings. The consent contemplated is not a general consent but for each particular contract.

The consent of the board must be accorded by means of a resolution passed in a board meeting and such consent must be secured prior to the contract execution or within 3 months of the date on which it was entered into. If the contract is executed without the approval of the board then the board has the option to ratify the contract. If the board chooses to ratify the contract then the contract is valid.

In addition to the approval of the board, prior approval of the Department of Company Affairs is also required if the company has a minimum paid-up capital of INR 10 million (US$ 250,000) before contract execution. The sequential process involves prior approval of the board, followed by a formal application in a prescribed format to the Department of Company Affairs. Upon receipt of the Department's written approval the company can execute a contract.

If prior approval of the Department of Company Affairs is not obtained and a contract is executed, it is void. In such circumstances, the director is liable to a fine of INR 5,000 (US$ 125) and a further fine of INR 500 (US$ 12.5) for every day during which the default continues.[14]

The in-built safeguards in this section check the potential abuse of power by the directors and it is important that the terms of the contract are at an arm's-length.

3.1 Liabilities for breach of duty

It is clear that a director must perform his duty as per the provisions of the Act and other statutes, for instance the Income Tax Act, 1961 and the labor laws. Some of the obligations include ensuring that the funds of the company are used for legitimate business purposes and the company complies with the regulatory and legal requirements etc. Indian statutes put an onus on the director to be accountable towards the shareholders of the company. The failure to perform statutory duties results in liability which can be in the form of fine or imprisonment. In addition, the Act imposes several supervisory obligations on the directors, listed below:

- Convene the Annual General Meeting **("AGM")** within the proper time. Under Section 168 of the Act, failure to hold the AGM invites a penalty of INR 50,000 (US$ 1,250) and a further fine of INR 2,500 (US$ 62.5) for every day during which the default continues.
- Ensure that proper books of account are maintained; audited Balance Sheet and Profit & Loss Account are to be placed before the AGM. Failure to do so can lead to imprisonment of 6 months or a penalty of INR 10,000 (US$ 250) under Section 210(5) of the Act.
- Disclose his right or interest in any other company.[15] Under Section 308(3) failure to disclose such right or interest attracts a penalty of INR 50,000 (US$ 1,250) or imprisonment of 2 years.
- The director has a duty to distribute dividends on time. Failure to distribute the dividends invites a penalty of INR 1,000 (US$ 25) for each day of default and an imprisonment of 3 years.[16]

Under the Income Tax Act, 1961 in case of liquidation of a private company when the tax assessed cannot be recovered from the company then every person who was the director of the company during the previous year for which the tax is not recoverable is jointly and severely liable for the payment of tax.[17] However, the directors will not be liable if it is proved that the non-recovery of tax in the previous year cannot be attributed to any gross neglect, misfeasance or breach of duty on their part in relation to the affairs of the company.

[13] These contracts are between a company and a director or his relative or any firm in which the director or his relative is a partner, or a private company in which the director is a partner or a member.

[14] Section 629A of the Act prescribes the punishment for the company to enter into contract without prior approval of the Board of Directors and the Department of Company Affairs.

[15] Section 307(10) is a deeming provision which states that the director has a right over or has an interest in any other company if the board of directors of that company work under his directions or he has the control over more than 1/3rd of the votes in any AGM of any other company.

[16] Section 207 prescribes the penalty for the failure to distribute the dividends within 30 days of declaration.

[17] Section 179 of the Income Tax Act stipulates the liability of a director of a private company when the assessed tax is not recovered.

☞ CONCLUSION

Director of a company is a position of responsibility and, like every such position it has its share of duties and liabilities. The duty of a director has been dealt under equity as fiduciary duty and duties under relevant statutes like the Act. The law in India stipulates that the interest of the company should be of prime importance and the effectiveness of the Board is linked with the way the directors conduct themselves in the affairs of the company. The liabilities for breach of any duty may vary depending on the gravity of the offence. Directors are bound to use reasonable diligence in discharging their duties. Express liability usually arises when a director has personally guaranteed the performance of a contract. As far as fiduciary duties are concerned, any breach by directors would make them liable. ***(Prashant Kumar)***

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