

Quadrant II – Notes

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Module Name: Powers of Directors, Duties of Directors

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The duty of good faith

The directors should act in the best interest of the company, interest herein implies the interest of present and future members of the company, given the going concern principle. They should not exploit corporate opportunities to their own personal benefit resulting in secret profits. The good faith would require that all the endeavours of the directors must be directed to the benefit of the company. Greatest good faith is expected in a discharge of their duties.

It has been held that men who are in complete control of a company's business must not take the company's interest at liberty as they are bound to protect the same. Recently the Delaware Supreme Court ruled out to postulate the character of the duty of good faith wherein it was made clear that negligent conduct is different from conduct in bad faith because statutory provisions differentiate between the two. If the conduct is in absolute disregard with duties and responsibilities, then it would constitute bad faith. Mere failure to act in good faith does not impose fiduciary liability, as it is a subsidiary element of duty of loyalty.

Duty of care

Director by virtue of his esteemed position should take utmost care and due diligence while working in the best interests of the company. However not more than what an ordinarily prudent man would have done can be expected out of him. The duty of care is uniform for all directors. Such care need not be extraordinary in nature. This degree of care and skills shall vary with the nature

of the business. However, courts have extended relief where liability has been incurred even after acting in good faith. They are not to be held liable for mere errors of judgement.

Duty not to delegate

As directors are agents of the company, they already have delegated a power which can't be delegated any further. They are bound by the maxim delegates non potest delegare. It is their skills and judgement on which shareholder rely and the same would get diluted when delegated but there are many exceptions where delegation is permitted subject to the company law and the articles of association. Subsequent to the delegation, if there is no suspicious activity, there is a presumption that affairs of the company are properly conducted.

Duty to act honestly

Directors hold the office of trust from where entails a duty to perform truly. Directors have an obligation to act with honesty since they hold a fiduciary position of trust. They should be held liable for straying from duties if that has culminated into frauds and losses.

Sec 166 of companies act 2013 wherein various elements have been stated like:

How Director Shall Act

The law in subsection {1} stipulates that a director shall act according to the article of association of the company. Although this does not mandate any specific laying down of the duties if that is so, it will be a desirable provision.

Acting In Good Faith and in Best Interest

The next subsection {2} provides that a director shall act in good faith. This encapsulates a great amount of subjectivity but at the same time should be seen from an ordinarily prudent man's perspective. It has also been held that all efforts of directors must be directed towards benefiting the

company. Pertinently, a wide coverage has been made by usage of both the terms “members” as well as “shareholders”. “Members are those persons who agree in writing to become members and whose names are entered in the register of members or whose names are entered as beneficial owners”. Necessarily it does not follow that all shareholders are members and vice versa.

Acting with Care, Skill & Independent Judgement

Subsection {3} goes on to lay down that the director shall exercise his duties with due and reasonable care. Although there is a great subjectivity involved here the touchstone for the same can be that of what a reasonable would do in given circumstances. Further, an exercise of the independent judgment indicates that there should be no external influence, he should have complete freedom to reach to his judgement.

No Conflict of Interest

The following subsection {4} stipulates that a director should avoid conflict of interest. This prescribes that a director should not get involved in such a situation where conflict may arise in his personal interest and the company’s interest. Whenever any such kind of situation arises, precedence should be given to the company’s interest over his personal interest.

No Undue Gain or Advantage

The provision of the subsection {5} stipulates that no personal benefit should be made out of the company’s business neither it should be accrued to director’s relatives, partners, associates.

This section also provides for disgorgement of gains as the intent behind this is that there should not be any loss to the company.

No Assignment

Subsection {6} prohibits the transfer of the office's rights to another person. He cannot assign his office, and if done it shall be void.

Contravention

The last subsection {7} lays down the penal provisions where a director contravenes the section. Such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees. Although this attracts a penalty it does not ask for the vacation of office u/s 167 of Companies Act 2013.

Liabilities of Directors

Along with duties, liabilities accompany, liabilities can also be statutory liabilities as provided in specific statutes, it can also be general duties which are applicable to all uniformly. They can be :

The liability of a director could arise in the following manner :

- **Breach of fiduciary duty:** As the directors hold the office of trust along with power they are expected to exercise this power in the best interest of the company. Whenever there comes dishonesty in fulfilling this duty, there is a breach of fiduciary duty. There is always a possibility of a conflict of interests but should such a conflict arise the concerned director should make complete disclosure and try to obtain the confidence of stakeholders in the general meeting. If such is not a case then it shall be held as a breach of fiduciary duty and he will be liable for indemnification to the company. It has been held that directors being the trustee have to deal with business and its property the way they treat their own personal property and interest.
- **Ultra vires act:** Directors have powers subject to Companies Act, Memorandum and Articles of association. Whenever they exceed these limits they are personally liable for the act being ultra vires. But if acts are intra-vires the company such acts can be subsequently ratified by the shareholders in the general meeting, otherwise, if a

company suffers a loss on ultra-vires acts of its directors, the company can claim such loss from the directors.

- **Negligence:** As long as the Directors exercise reasonable care and due diligence, they are fulfilling their duties to the company. But as soon as there is the failure to exercise such care and precaution they are deemed to be negligent in their conduct and are personally liable for the consequent damages. However, the error of judgement will not be deemed as negligence. "Business runs on a going concern, which will not be possible if people doubt every step of the trust holders or office holders."
- **Mala fide acts:** Directors are the trustees for the money and property of the company. They hold an office of trust and if they misuse their powers they will be liable for breach of trust and may be required indemnify the losses incurred due to. they need to make regular disclosures on their profits, if any, earned in course of the performance of duties. Director can also be held liable for misconduct, provided it is not willful.

Liability to third parties

The directors as agents of the company are not most of the times personally liable to third parties for any transaction entered on behalf of the company. Their acts bind the company to third parties. Generally, the rule is that wherever an agent, in a principal- agency concept liable, directors would be liable. They can be held personally liable only in exceptional circumstances when they contract in a personal capacity, or when the principal is not disclosed, or when it is a pre-incorporation contract or when the contract is ultra vires the company and is not ratified subsequently

Positioning Directors duty in International Paradigm

Different countries have adopted different approaches to addressing the conundrum of duties and liabilities of Directors. In the UK directors are given full discretion to run the companies. Essentially directors are here deemed to have contractual powers according to which they can enter into any profitable contract that they deem fit for the company. Thus they act in the capacity of

agents whereas, in the US, directors are neither “agents” of the corporation nor of the shareholders. They have a fiduciary relationship according to which they have to manage the corporation.

Directors owe duties of care and loyalty to their corporation. They also owe a duty of absolute loyalty and utmost good faith. Prime difference between US & UK law is that in the latter the duty is owed as a whole to the corporation instead of owing it directly to the shareholders. However, an in-depth analysis shows that the duty of directors in the UK is basically a duty to their shareholders, but the way of interpretation has brought this difference. The duty herein is owed to shareholders as a body and not to individual shareholders which is well evident now in sec 170 of their companies act 2006. On the other hand as far as the duty of loyalty is concerned, directors have acted in the best interest of their company accompanied with good faith. Although this case is considered to be a good law and followed throughout the same has been dissented within subsequent cases wherein it was held that in circumstances where a shareholder has solely relied on the director’s guidance, a director may owe a greater duty to an individual shareholder.

The American business judgement rule focuses more on procedure than on result whereas in U.K there is an objective test to determine bad faith or good faith transactions. It’s only incomplete irrationality that directors are made liable for business decisions in America.

Finally, U.K jurisprudence requires that directors should act in such a manner that there exists no conflict of interests and also no personal advantage could be taken by virtue of their position. Here the defence of business judgement rule is ineffective when there is a violation of the duty of loyalty. They are better known here by the name of ‘The no- conflict rule’ and ‘The no-profit rule’ respectively.

Critical analysis of sec 166

Codified duties of directors is not a new concept. It’s been since long that countries like the UK, Singapore have done codification. Section 170 of the

English Companies Act stipulates that the director's duties are directed towards the company. The Indian Act fails to provide such clarity, due to which there still remains confusion as to whom the directors owe such duties primarily, company or the shareholders.

Companies Act 2013 is a revolution in corporate law development in India. The legislature, through this, has tried to bring the Indian corporate law in International paradigm. Although the inclusion of diverse groups makes it a bit complex still the efforts to serve the interest of stakeholders and society at large is applaudable. The major cause of concern is the unaccountability of directors due to differences in interests. Moreover, there is an immediate need to demarcate the duties owed to the company against that of stakeholders. There must be harmonious construction between commercial considerations of the company and the interests of stakeholders. Thus the courts have been left to strike such a balance so as to reconcile the differences in two extremes.

Also, it becomes pertinent to define good faith and best interest in order to gauge the difference between the two. Good faith is "*bona fide state of mind which includes honesty, faithfulness, observance of reasonable commercial standards and absence of intent to defraud*". Best Interest, on the other hand, involves the duty of loyalty with an intention to equitably serve the best interests of all concerned.

Directors should ordinarily balance out commercial interest and shareholder's interest on the scale of an ordinarily prudent person. The duty of good faith somehow acquires higher precedence than the best interest due to the additional element of 'belief'. It sets a higher benchmark as a director acting in violation of good faith could not be saved by 'business judgement rule' even if the act has the approval of the board of the company.

There is a lot of objectivity involved in the best interest criterion. The 'good faith standard' places itself on a higher platform as it includes belief too. Since the verbatim of section 166 of Companies Act 2013 does not create a hierarchy between various groups, priority selection creates an enigma. Sometimes maximization of profit may not go hand in hand with environmental interest.

Reconciliation of such interest poses serious problems and at such times, the director must take into consideration of all stakeholders and discharge his duty of acting in good faith, to arrive at a decision.

The mentioning of the term 'company' twice in section 166(2) evidently suggests that the director owes a duty of good faith read with best interest criterion. A distinction between the two terms could have been presumed had the term not been used in the second part. This results in a conclusion that the legislature intends to put interests of the company, as a whole, over other stakeholders.