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in the circumstances was an order in favour of the voluntary liquidator, but he did not ask for it.

The appeal will be allowed but we make no order for costs in the appeal. The appellant did not disclose before the learned trial Judge the reasons why he was not proceeding with the application and his attitude was one which was sufficient to raise suspicion as to his motives. The liquidator will have his costs of the appeal out of the assets of the company.

G.R.

APPELLATE CIVIL.

Before the Hon'ble Mr. A. H. L. Leach, Chief Justice, and Mr. Justice Varadachariar.

1937, August 12.

D. DOSS (SIXTH RESPONDENT), APPELLANT,

v.

C. P. CONNELL AND ANOTHER, JOINT OFFICIAL LIQUIDATORS, (APPLICANTS), RESPONDENTS.*

Indian Companies Act (VII *of* 1913), *sec.* 235—*Misfeasance summons—Articles of association—Liability of directors for wilful neglect or default under—What amounts to—Section* 103—*Non-compliance of—Directors commencing and carrying on business in spite of—Banking business—Deposits by constituents—Loss of moneys—Damages—Measure of—Insolvency of a director—Effect of—Section* 281—*Powers of Court under, if and when to be exercised.*

N, an Advocate, who was an undischarged insolvent, promoted a limited liability company, for the purpose, *inter alia*, of doing all kinds of banking business. He arranged that he should be appointed legal adviser to the company and the "advisory director". There were eight other directors, one of whom was the chairman. The articles of association provided : (i) the business of the company might be commenced as soon as fifty shares, that is, Rs. 2,500, had been subscribed ; (ii) the

* Original Side Appeals Nos. 26, 27 and 28 of 1937.

chairman should have the power of appointing, promoting, reducing and suspending and removing all officers of the bank (company) subject to the approval of the board of directors and should have the power to fix all remunerations, salaries and wages to be paid by the company. The articles also contained in effect a clause comprising the usual indemnity to directors for anything done by them, except where loss had been incurred as a result of wilful neglect or wilful default on their part. Before the company was incorporated a draft agreement had been prepared under which the company was to advance to N, a sum of Rs. 10,000, of which Rs. 5,000 was to redeem certain of his assets which had vested in the Official Assignee so that he might mortgage the same and a life policy to the company as security for the loan. After the incorporation of the company the agreement was executed and, in due course, N executed the requisite mortgage deed. Before the business was started, advertisements were inserted by N in the local press calling for applications for posts on the staff of the company. N made a number of appointments, the persons appointed furnishing security in the aggregate sum of Rs. 10,720. The company had no right to utilize this amount for its own purposes. N misappropriated Rs. 4,988-7-2 out of the same. The minimum subscription had been subscribed. The directors including N allowed the company to start the business, though the directors had not all paid the requisite proportion of their shares under section 103 of the Indian Companies Act. The certificate permitting the company to commence business was obtained as the result of a false declaration made by N that the conditions of section 103 had been satisfied. As a result of the directors having allowed the company to keep open its doors for business when they were not entitled to do so, the company suffered loss to the extent of Rs. 6,331-9-3. It was found : (i) None of the directors knew until at a late stage that N had utilized a large portion of the deposits towards the sum of Rs. 5,000 which was to be paid to him under the agreement but without utilizing the same for the purposes contemplated in the agreement. (ii) Although some of the directors knew from the inception of the company that N was an undischarged insolvent they had no reason to suspect the integrity of either the chairman or N. (iii) The directors were fully aware that all the directors had not paid the requisite proportion of their respective shares, that the company had

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no right to commence the business and that the company was utilizing its customers' moneys dishonestly. On a misfeasance summons taken out under section 235 of the Indian Companies Act by the Official Liquidators against the directors,

held: (i) The directors were not, in the circumstances of the case, guilty of wilful negligence and were not liable to make good the sum of Rs. 4,988-7-2. (ii) They were liable for the sum of Rs. 6,331-9-3 inasmuch as they allowed the company to carry on business on the strength of a certificate obtained by a false declaration in contravention of section 103 of the Indian Companies Act.

Held further: Even if it could be said that the directors acted honestly it could not be said that they acted reasonably and as such they were not entitled to relief under section 281 of the Indian Companies Act.

The dictum of ROMER J. in *In re City Equitable Fire Insurance Co.*(1) about the duties of directors and as to what amounts to wilful negligence followed.

The observations of LINDLEY M.R. in *In re National Bank of Wales, Limited*(2) and of Lord DAVEY in *Dovey* v. *Cory*(3) as to how far a director is justified in reposing trust in the officials of the company followed.

APPEALS against the order of GENTLE J. dated 5th February 1937 and made in the exercise of the Ordinary Original Civil Jurisdiction of the High Court in Application No. 2035 of 1935 in Original Petition No. 48 of 1934.

K. Krishnaswami Ayyangar and *E. Antony Lobo*, *S. R. Subramaniam*, *K. C. Subramaniam Chettiar*, *O. Rajavelu Chetty* and *A. Ramaswamy* for appellants.—The learned trial Judge has found that the first respondent was not aware of P.K. Nair's insolvency but was guilty of gross negligence. These findings are not enough to saddle the directors with liability in these proceedings. They could be proceeded against only on proof of wilful neglect. No doubt the first respondent was present at the first meeting of the directors. P. K. Nair was taking deposits from servants. P. K. Nair, though an insolvent,

(1) [1925] 1 Ch. 407. (2) [1899] 2 Ch. 629, 673.
(3) [1901] A.C. 477.

was practising at the Bar. Nothing happened which put the directors on enquiry that P. K. Nair was going to commit a criminal act. The moment the directors came to know of P. K. Nair's fraud they took steps for having the company wound up. The wilful default that is alleged against the directors in the notice of motion is that they failed to take criminal proceedings against P. K. Nair when the fraud was found out. That cannot amount to wilful default; see *Prefontaine* v. *Grenier*(1) which follows *Dovey* v. *Cory*(2). Under article 95 of the articles of association the directors could be proceeded against only on proof of wilful neglect or default. What amounts to wilful neglect or default has been considered in *In re City Equitable Fire Insurance Co.*(3). Business could be carried on only on trust and there was nothing wrong in the directors trusting their servants. They are not liable for mistakes; see *In re National Bank of Wales, Limited*(4), which was confirmed on appeal in *Dovey* v. *Cory*(2).

[The CHIEF JUSTICE.—On the facts it could be said against the first respondent that he allowed the company to function and carry on business. There is no doubt that the company was started under false pretences. So the directors are *prima facie* liable unless special circumstances are shown why a particular director should not be made liable.]

The damages should be the proximate cause of the starting of the business and the carrying on of the business. Even if the directors had paid the minimum subscription under section 103 (1) of the Indian Companies Act and had lawfully started the business, this loss would have resulted to the company.

[VARADACHARIAR J.—The directors held out to the world that they were entitled to contract on behalf of the company and obtained money on that representation.]

The company suffered loss as a result of the swindling and not on account of the improper starting of business. The loss would have occured even if the company was lawfully started.

[The CHIEF JUSTICE.—This company ought not to have been allowed to start business. Were not the directors guilty of misfeasance in allowing the company to do business?]

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(1) [1907] A.C. 101, 109. (2) [1901] A.C. 477.
(3) [1925] 1 Ch. 407, 426, 428, 429, 453, 467, 468.
(4) [1899] 2 Ch. 629, 673.

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[VARADACHARIAR J.—In the cases under appeal we have got to assume misconduct and damages. The question is, what is the measure of damages? Your answer that the damages might have resulted even if the company had been properly started will not help you because in your example there is no misconduct and the damages are the result of misfortune and not of misconduct. The fact that the incorporation was wrongly obtained is no answer with respect to contracts of the company with third parties. The company's liability has got to be met by the company. Cannot the shareholders, who have got to contribute, say to the directors that the damages to the company resulted on account of their misconduct in having started and carried on the business improperly ?]

In *Indian States Bank, Ltd.* v. *Sardar Singh*(1) the liability of directors under sections 101 and 103 of the Indian Companies Act is dealt with. No case has arisen before the Courts where the point is specifically dealt with. *Burton* v. *Bevan*(2) supports the above submission.

A. Westmorland Wood for respondents.—The directors should have acted as prudent men of business and as they would have done in conducting their own private affairs; *Leeds Estate, Building and Investment Company* v. *Shepherd*(3). A director must take reasonable care, which is to be measured by the care which an ordinary man might be expected to take in the same circumstances on his own behalf; see *In re Brazilian Rubber Plantations and Estates, Limited*(4) which is approved by ROMER J. in *In re City Equitable Fire Insurance Co.*(5). This company was a banking company whose stock in trade was cash and securities. Employees in banks are obviously required to furnish security deposits and must be engaged before the commencement of business. Here P. K. Nair, the promoter of the company, was allowed by the directors to have the unfettered handling of moneys which they must have known were coming into his hands. The directors knew that P. K. Nair was an undischarged insolvent. This should have put the directors on their guard. They did not act as reasonable men. They would not have left their own moneys in the hands of an insolvent whom they had no particular reason to

(1) A.I.R. 1934 All. 855.
(2) [1908] 2 Ch. 240.
(3) (1887) 36 Ch. D. 787.
(4) [1911] 1 Ch. 425, 437.
(5) [1925] 1 Ch. 407, 428.

trust. The attitude of the Legislature with regard to undischarged insolvents is shown by the Companies (Amendment) Act, 1936, which disqualifies an undischarged insolvent from acting as a director. The indifference of the directors to their duties in this case is shown by the circumstance that they signed a memorandum authorizing the promoter to collect money on behalf of the company even after they had discovered his misappropriations. The directors are liable for allowing the company to start and to continue business in contravention of section 103 of the Indian Companies Act and the measure of the loss is the aggregate loss incurred through commencing and continuing the business; see *Indian States Bank, Ltd.* v. *Sardar Singh*(1).

LEACH C.J.

The JUDGMENT of the Court was delivered by LEACH C.J.—This appeal and Appeals Nos. 27 of 1937 and 28 of 1937 arise out of a misfeasance summons taken out by the Official Liquidators of the General Banking Corporation, Limited, against the directors of that company. The appeals have been heard together and it will be convenient to deal with them in one judgment.

The company was registered on 11th May 1933 for the purpose, *inter alia*, of doing all kinds of banking business. The promoter was one P. K. Nair, a Barrister-at-law, who was at the time and has since remained an undischarged insolvent. Nair, who was the ninth respondent in the proceedings before the learned trial Judge, arranged that he should be appointed legal adviser to the company and the "advisory director". A prospectus was prepared, but fortunately there was no general application made to the public to subscribe shares. There were eight other directors, who were respondents 1 to 8. Two of them, respondents 3 and 5 (B. Gulabchand Sowcar and M. L. Ranganayakulu) were

(1) A.I.R. 1934 All. 855.

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not served and they took no part in the proceedings. The fourth respondent, A. Madhava Rao, who was the chairman of the company, and Nair absconded before the proceedings commenced. The Official Liquidators sought to make all the respondents, except respondents 3 and 5, liable under section 235 of the Indian Companies Act, 1913, for (i) a sum of Rs. 4,988-7-2 which had been misappropriated by Nair and (ii) a sum of Rs. 6,331-9-3, representing liabilities incurred by the company from the date it started business until the date it closed its doors. The certificate permitting business to be started was issued on 4th September 1933 and business was actually commenced on the 7th of that month. The bank's doors were closed on 16th February 1934 ; a petition for winding up was presented on 5th March of that year and on 6th April 1934 a compulsory winding-up order was passed.

GENTLE J., before whom the case came, held that respondents 1, 2 and 4 (Rao Bahadur M. C. Rajah, V. Venkateswara Sastrulu and A. Madhava Rao) were each liable to pay the sum of Rs. 4,988-7-2 claimed as the first item, and respondents 2, 4 and 6 (the sixth respondent being D. Doss) were each responsible for the payment of the sum of Rs. 6,331-9-3, the second item claimed. He also held that, in respect of the sum of Rs. 6,331-9-3, the first respondent was liable to pay Rs. 2,833-9-9, and the seventh respondent Rs. 5,408, these sums being calculated in accordance with the dates on which they resigned from the board of directors. Appeal No. 26 is the appeal of the sixth respondent in respect of the sum of Rs. 6,331-9-3 ; Appeal No. 27 is by the

seventh respondent in respect of the sum of Rs. 5,408; and Appeal No. 28 embraces the appeals of the first and second respondents in respect of the sum of Rs. 4,988-7-2, that of the first respondent in respect of the sum of Rs. 2,833-9-9 and that of the second respondent in respect of the sum of Rs. 6,331-9-3. The fourth respondent has not appealed and the order of the learned Judge has become final as against him.

The nominal capital of the company was Rs. 1,00,000 divided into 2000 shares of Rs. 50 each. Of the Rs. 50 payable on each share, Rs. 10 was payable on application, Rs. 15 on allotment and the balance in five equal instalments. The articles of association provided that the business of the company might be commenced as soon as fifty shares, that is, Rs. 2,500, had been subscribed. Before the company was incorporated a draft agreement had been prepared under which the company was to advance to Nair a sum of Rs. 10,000 on the security of his interest in the assets of the Indian Law Times, Limited, and a life policy of Rs. 10,000. The Indian Law Times, Limited, had been acquired by Nair and his insolvency arose in connection with this business. The arrangement was that out of the loan of Rs. 10,000, Rs. 5,000 should be paid to Nair for the purpose of enabling him to redeem the assets of the Indian Law Times, Limited, from the hands of the Official Assignee. After the incorporation of the company the agreement was executed and, in due course, Nair executed the requisite mortgage deed. Although business was not started until 7th September 1933, advertisements were inserted by Nair in the local press on 21st June and 15th July 1933, calling for applications for posts on the

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staff of the company. It was intimated that the successful candidates would be required to deposit security for the proper performance of their duties. Applications were received in the course of July and August and a number of appointments were made, the persons appointed furnishing security in the aggregate sum of Rs. 10,720. I should mention that article 63 of the articles of association provided that the chairman should have the power of appointing, promoting, reducing, suspending and removing all officers of the bank, subject to the approval of the board of directors, and should have the power to fix all remunerations, salaries, and wages to be paid by the company. Subscriptions were received for only sixty-five shares. The subscriptions by the respondents were as follows :—

Respondent No.	No. of shares.
1	5
2	5
3	20
4	10
5	5
6	5
7	5
8	5

Respondents 1, 2, 4 and 6 paid nothing in respect of their shares. The third respondent paid Rs. 250 on account of the Rs. 1,000 owed by him in respect of his 20 shares, and the seventh respondent paid Rs. 30 on account of the Rs. 250 owed by him in respect of his five shares. Respondents 5 and 8 appear to have paid for their shares in full. The actual capital which the company had when it started business was Rs. 780.

The first item of the claim, viz., the sum of Rs. 4,988-7-2, represents security deposits provided

by the employees which Nair put into his own pocket. The company had no right to utilise these monies for its own purposes and the fact that Nair misappropriated them is common ground. The learned Judge held that respondents 1, 2 and 4 were responsible for this sum, because they had not used reasonable care in carrying out their duties. He considered that it was incumbent on them to see that the company's monies were in a proper state of investment and that Nair being an undischarged insolvent should not have been allowed to take charge of the security deposits of the employees. The learned Judge held as a fact that the second and fourth respondents had knowledge of Nair's insolvency, but he was not satisfied that the first respondent had such knowledge. He, however, held that they were all liable as they took no steps to see that a responsible person was attending to the company's finances. They had all failed to carry out their duties, and were guilty of the grossest negligence. The position with regard to this sum of Rs. 4,988-7-2 is altogether different from the position with regard to the sum of Rs. 6,331-9-3 which I will deal with separately.

With regard to the first sum, the learned Advocate for respondents 1 and 2 (appellants here) contends that the learned trial Judge has misconceived the law with regard to the duties of directors. He says that on the authorities it must be shown that the directors had knowledge of the facts and that they acted wilfully despite their knowledge. Before passing to the authorities I should refer to article 95 of the articles of association. This article has been very badly

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drafted, but it is intended to comprise the usual indemnity to directors for anything done by them, except where loss has been incurred as the result of wilful neglect or wilful default on their part, and it is accepted by both sides that it has this effect. The duties of directors and what is meant by wilful negligence were dealt with at length by ROMER J. in the case of *In re City Equitable Fire Insurance Co.*(1). The learned Judge who discussed the authorities there pointed out that, in order to ascertain the duties that a person appointed to the board of an established company undertakes to perform, it is necessary to consider not only the nature of the company's business, but also the manner in which the work of the company is in fact distributed between the directors and the other officials of the company, provided always that this distribution is a reasonable one in the circumstances, and is not inconsistent with any express provisions of the articles of association. In discharging the duties of his position thus ascertained, a director must, of course, act honestly ; and he must also exercise some degree of both skill and diligence. The learned Judge, however, pointed out that (i) a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience ; (ii) he is not bound to give continuous attention to the affairs of the company, his duties being of an intermittent nature to be performed at periodical meetings ; and (iii) in respect of all duties that, having regard to the exigencies of business and the articles of

(1) [1925] 1 Ch. 407.

association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. Dealing with the question of wilful negligence, the learned Judge observed at page 434 of the report:

"An act or an omission to do an act is wilful where the person of whom we are speaking knows what he is doing and intends to do what he is doing. But if that act or omission amounts to a breach of his duty, and therefore to negligence, is the person guilty of wilful negligence? In my opinion that question must be answered in the negative unless he knows that he is committing, and intends to commit, a breach of his duty, or is recklessly careless in the sense of not caring whether his act or omission is or is not a breach of duty."

This view was affirmed by the Court of Appeal consisting of POLLOCK M.R., WARRINGTON L.J. and SARGANT L.J.

With regard to the question whether a director is justified in trusting the officials of the company, I would also refer to the observations of LINDLEY M.R. in the case of *In re National Bank of Wales, Limited*(1):

"Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust; but for a director acting honestly himself to be held legally liable for negligence, in trusting the officers under him not to conceal from him what they ought to report to him, appears to us to be laying too heavy a burden on honest business men."

This case was taken to the House of Lords, [*Dovey* v. *Cory*(2)]. Lord DAVEY there said at page 492:

"I think the respondent was bound to give his attention to and exercise his judgment as a man of business

(1) [1899] 2 Ch. 629, 673. (2) [1901] A.C. 477.

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on the matters which were brought before the board at the meetings which he attended, and it is not proved that he did not do so. But I think he was entitled to rely upon the judgment, information, and advice of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion. I agree with what was said by Sir GEORGE JESSEL in *Hallmark's* case(1), and by CHITTY J. in *In re Denham & Co.*(2) that directors are not bound to examine entries in the company's books. It was the duty of the general manager and (possibly) of the chairman to go carefully through the returns from the branches, and to bring before the board any matter requiring their consideration; but the respondent was not, in my opinion, guilty of negligence in not examining them for himself, notwithstanding that they were laid on the table of the board for reference."

Now what is the position here? As I have pointed out, the matter of the appointment of the staff was in the hands of the chairman. It is not suggested that respondents 1 and 2 had any reason whatsoever to suspect the integrity of the chairman. It is also not suggested, apart from his insolvency, that they had any reason to suspect the integrity of Nair. It is true that Nair was an undischarged insolvent, but insolvency does not necessarily mean that a man is a dishonest man. There is here an entire absence of anything which would point the finger of suspicion to either the chairman or to Nair in the matter of these appointments. There was certainly no reason for any of the directors to suspect that Nair would utilise the security deposits for his own purposes, and there is no reason to suspect that the chairman knew that he was so doing. It is abundantly clear from the minutes that, when it was discovered that Nair had utilised these security deposits for his own purposes, the matter was

(1) (1878) 9 Ch D. 329. (2) (1883) 25 Ch. D. 752.

immediately taken up by the directors and he was called upon to repay. Nair appears to have utilised Rs. 4,500 of the deposits towards the Rs. 5,000 which was to be paid to him under the mortgage for the purposes of redeeming the assets of the Indian Law Times, Limited, but instead of redeeming those assets he kept the money. But nobody knew about this until afterwards. The authorities show that, where there is an indemnity clause of the kind we have here, not only must a director be guilty of negligence, but he must know that he is committing a breach of duty or is recklessly careless in the matter. ROMER J. at page 468 of the report of the *City Equitable Fire Insurance Company's* case(1) emphasised this. It seems to us that respondents 1 and 2 were justified in trusting the chairman and Nair to deal properly with the employees and therefore it cannot be said that they were guilty of wilful negligence in so doing. In these circumstances we consider that the appeal so far as it relates to the sum of Rs. 4,988-7-2 must be allowed.

But entirely different considerations arise with regard to the sum of Rs. 6,331-9-3. In this connection it is necessary to refer to section 103 of the Indian Companies Act. This section provides that a company shall not commence any business or exercise any borrowing powers unless (*a*) the shares held subject to the payment of the whole amount thereof in cash have been allotted to an amount not less in the whole than the minimum subscription ; (*b*) every director of the company has paid to the company on each of the shares taken or contracted to be taken by him

(1) [1925] 1 Ch. 407.

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and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares offered for public subscription or, in the case of a company which does not issue a prospectus inviting public to subscribe for its shares, on the shares payable in cash : and (*c*) there has been filed with the Registrar a duly verified declaration by the secretary or one of the directors, in the prescribed form, that these conditions have been complied with. In this case the minimum subscription had been subscribed, but the amounts due on them by the directors had not all been paid and the certificate permitting the company to commence business had been obtained as the result of a false declaration made by Nair. The learned Judge found that all the respondents knew of the obtaining of this certificate and that they were fully aware that the company had started business on 7th September 1933. They therefore all wilfully permitted the company to carry on business on the strength of a certificate obtained by a false declaration. We have no doubt that respondents 2, 6 and 7 had knowledge of the obtaining of the certificate and of the fact that business commenced on 7th September 1933. With regard to the first respondent it is said that he was actually in Madras only on 26th, 27th and 28th of July and between 13th and 18th of August. But it is clear on his own evidence that he returned to Madras on 28th September. We have no doubt that he was fully aware by that date, if not before, that the certificate had been obtained and that business was being carried on. We are also satisfied that

these four respondents were fully aware that the directors had not paid what was due in respect of their respective shares and that they knew that the company had no right to commence business. In any event they must be deemed to know the law. In *Burton* v. *Bevan*(1), which was also a case of misfeasance, NEVILLE J. remarked :

> "I think it is immaterial whether the director had knowledge of the law or not. I think he is bound to know what the law is, and the only question is, did he know the facts which made the act complained of a contravention of the statute?"

In the present case the learned trial Judge has held that they did know, and we are in entire agreement with him. This means that the directors allowed this company to open its doors and keep them open for months knowing full well that section 103 had not been complied with, that the company had no capital with which to carry on business, and that deposits made by customers in current and other accounts were being utilised by the management for the payment of wages and current expenses without any likelihood of the company being able to pay back such monies. In other words, they knew that the bank was utilising its customers' monies dishonestly. As the result of the company having obtained by means of a false declaration a certificate allowing it to carry on business, and as the result of the respondents having allowed the company to keep open its doors, the company has suffered loss to the extent of Rs. 6,331-9-3. We are of opinion that respondents 1, 2, 6 and 7 have been guilty of

(1) [1908] 2 Ch. 240.

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wilful negligence and that they are liable to make repayment under section 235 of the Indian Companies Act. We therefore agree with the finding of the learned trial Judge on the second part of the case.

We have been asked to relieve these respondents from the consequences of their wilful negligence under the provisions of section 281 of the Indian Companies Act. That section provides that if, in a proceeding for negligence, default, breach of duty or breach of trust, it appears to the Court hearing the case that the person may be liable but has acted honestly and reasonably and ought fairly to be excused, the Court may relieve him wholly or in part from his liability. This power to relieve is placed in the hands of the Court when it is convinced that a person has acted honestly and reasonably. In this case, even if it be said that these respondents acted honestly, it cannot be said that they acted reasonably, and we are unable to grant them any relief under this section. The order of the learned Judge against respondents 1, 2, 6 and 7 in respect of the second item of the claim will therefore stand. As the appellants have succeeded in part and failed in part, we do not propose to make any order as to costs. The liquidators will have their costs out of the assets of the company.

G.R.