DIRECTORS WHO DO NOT DIRECT—SOME REFLECTIONS ON THE *CITY EQUITABLE*[1] STANDARDS

K. Ponnuswami*

Introduction

The Bhabha Committee rightly recognized the urgent need in thi country to revitalise the institution of Board of Directors, to redeem it from the stifling domination of the managing agents, and to restore to it a pivotal position of powers and responsibility in the intra-corporate power structure.[2] With the abolition of the offices of managing agents and secretaries and treasures with effect from April 3 1970,[3] the importance of the board has been fully re-established and a new era has begun in Indian corporate management.

The Companies Act 1956, does not, however, contemplate that the board should manage the day to day affairs of the company. Though the powers of the board are co-extensive with that of the company except in respect of matters reserved for the general meeting, the board may delegate all its powers but the power to make calls or issue debentures to a committee of the board, or to the managing director or manager, or to any other principal officer of the company or its branch offices.[4] Under section 197A of the Act a company may now employ only one of the two categories of managerial personnel, namely, (1) the managing director and (2) the manager. A managing director is a member of the board who is entrusted with substantial powers of management which would not otherwise be exercisable by him.[5] It must be remembered that the board's powers are exercisable only jointly and an individual director as such has no power to act for the company.[6] The managing director

* Reader, Faculty of Law, University of Delhi.

1. *Re City Equitable Fire Insurance Co.*, (1925) Ch. 407 (C.A.).
2. Report of the Company Law Committee, paras 80 and 81 (1952), (hereinafter referred to as the Bhabha Committee Report).
3. The Companies (Amendment) Act 1969, sections 4 and 6.
4. The Companies Act 1956, (hereinafter referred to as the Act) section 292.
5. The Act, section 2(26).
6. See Gower, *The Principles of Modern Company Law* 517 (3rd ed. 1969). The references to this book are hereinafter made as Gower.

should be entrusted with substantial powers of management by the company's memorandum or articles or by an agreement between him and the company or by a resolution of the company at general meeting. A manager is an individual who has the management of the whole or substantially the whole of the affairs of the company, whether under a contract of service or not.[7] A manager may or may not be a member of the board. Both the manager and the managing director are subject to the superintendence, control and direction of the board. Anyone occupying the position of a director, managing director or manager falls within the respective designation, even if he is called by any other name.

What is the position of a person, not being a director, who is entrusted with substantial powers of management, but not the management of the whole or substantially the whole of the affairs of the company? He is strictly speaking neither the manager nor the managing director. Is he an officer within the meaning of the definition in section 2(30) of the Act? That inclusive definition leaves you guessing. Many sections of the Act hold the "officer who is in default" (defined by section 5) liable. Perhaps we need to define "officer" to include anyone entrusted with decision-making powers in respect of the management of the company.

The Act also speaks of whole-time directors.[8] If a whole-time director has substantial powers of management, he will of course be a managing director; if he has the management of the whole or substantially the whole of the affairs of the company, he will be a manager. A whole-time director is presumably a director who undertakes to work whole-time for the company, whether in a managerial or non-managerial capacity or position.

The Act imposes a ceiling, though very large—like the land ceiling in many states—on the number of directorships in companies that a person may hold at one time.[9] In the case of managers and managing directors, the ceiling is much stricter. No one can be a manager or managing director of a public company or private subsidiary, if he is also the managing director or manager of more than one other company, whether public or private.[10] Evidently this strict limit of two is designed to ensure that the managing director or manager will devote a substantial part of his time and energy to the company or companies which he is serving. But there seems to be no objection to his accepting ordinary directorships up to

7. The Act, section 2(24).
8. Under section 269 of the Act appointment of a whole-time director, as well as a managing director, needs to be approved by the Central Government in the case of public companies and their private subsidiaries.
9. The Act, sections 275 to 279.
10. The Act, sections 316 and 386.

the extent of the liberal ceiling imposed by section 275. This is unfair to the companies of which he is a managing director or manager as well as the companies of which he is an ordinary director and calls for re-thinking.

I. The Duties of the Board

The duties of the board are not spelled out by the Act and this is rightly so generally speaking. But the Act must spell out one fundamental duty of the board which mainly justifies its existence and that is to direct, control and superintend the management of the affairs of the company. This function of the board is implicit in the very word "directors." The English Act of 1844 defined "directors" to mean "the Persons having the Direction, Conduct, Management, or Superintendence of the Affairs of a Company," but ever since the English Act of 1856 that definition has been omitted. The present inclusive definition[11] (non-definition ?) made its appearance first in the English Act of 1908 and for some purposes "director" also includes any other person "in accordance with whose directions or instructions the directors of a company are accustomed to act."[12]

Companies Act 1956 spells out the ambit of the powers of the board.[13] Table A of the English Act provides that "The business of the company shall be managed by the directors." Table A of the Indian Companies Act 1913 contained identical provision and enjoined that the directors "shall duly comply with the provisions of the Indian Companies Act ..."and "shall cause minutes to be made in books...."[13a] In fact this bunch of Regulations of Table A was entitled "Powers and *duties* of Directors" (emphasis mine). The Companies Act 1956 on the other hand has, in shifting the old Regulations to the body of the Act, abandoned reference to the duty of the directors to manage the business of the company and concentrated in spelling out the powers of the board. The only duty of directors specifically mentioned is that they should sign the attendance register whenever they attend a meeting of the board or its committees.

Of course, it is implicit that the board is under a duty to control, direct and superintend the management of the affairs of the company. Why then not explicily provide so ? There may be a reason for the Constitution of India spelling out only Fundamental Rights and not the Fundamental Duties of the citizens of India. There can be none for the Companies Act not explicitly stating the Fundamental Duty of the board to direct, control and superintend the management of the affairs of the company. The new Ontario Business Corporation Act (which incidentally has no Table A)

11. The Act, section 2(13); English Act of 1948, section 455(1).
12. English Act of 1948, section 124(4), Sch. VI, sections 195(10), 200(9)(a), 201(4)(a), and Part X of the Act.
13. The Act, section 291 *et seq.*; Sch. I, Table A, Regulations 64-72.
13a. Regulations 71, 74 and 75.

expressly enjoins that "The Board of directors shall manage or supervise the management of the affairs and business of the corporation...."[14] Similar provision can be found in the American Model Business Corporation Act and several American State Corporation Acts.

An express provision is desirable because the law permits even the whole of the affairs of a company to be left to managers and substantial powers of management to be delegated to managing directors or committees. It must be made clear beyond all doubt that the board has not merely the *power* to control, direct and superintend the exercise of authority by the delegate, but the *duty* actually to do so.

Once the duty of the board to control, direct and superintend is so articulated, we are faced with the question of the degree of care, diligence and skill that an individual director should display in the direction, control and superintendence of the company, for though the powers of the board are collective, the duties and liabilities of the directors are several.

II. Directors' Duties of Care, Diligence and Skill

The leading authority on directors' duties of care, diligence and skill is the well-known *City Equitable* case decided in 1925 It may be recalled that until 1928 there was no statutory compulsion that a company should have any directors at all or that the affairs of a company be managed by a board of directors Thus early in this century in a decided case a company whose original articles provided for the appointment of directors altered the articles by special resolution to provide that there should be no directors, that the management "shall be vested in a manager or managers", and that the first manager should be a certain limited company to hold office "so long as they shall be willing to act." An aggrieved shareholder petitioned for the winding-up of the company, but was told by the court that "There is not a word [in the English Act of 1862] which in any way indicates that the Legislature at any time thought it was essential that there should even be directors of a company at all...."[15] It was in this era when directors were not considered quite a necessary part of company management, that Romer, J., was called upon to articulate the standard of skill, care and diligence required of directors and understandably the standard set is not too high. In fact Romer, J., appears to have set a higher standard than was expected for a half-century prior to his decision. In our days when the board has become obligatory, pivotal and powerful in the intra-corporate structure, the time has come to upgrade the low standard set for directors' skill and care by the *City Equitable* case.

14. Ontario Bill 125(1st Session, 28th Legislature, Ontario, 17 Eliz. II, 1968). My references are to the Bill as passed at its First Reading on May 17, 1968. I have assumed that there are no major changes made in it subsequently.
15. *In re Bulawayo Market and Offices Co., Ltd.*, (1970) 2 Ch. 458 (Warrington, J.).

Justice Romer's standard of directors' duties of skill, diligence and care has been expressed in the following proposition : "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,"[16]—a proposition which "probably applies equally to managing directors."[17] This standard, it is submitted, places a premium on ignorance, inexperience and inefficiency. As Gower observes, "It prescribes a test which is partly objective (the standard of the reasonable man), and partly subjective (the reasonable man is deemed to have the knowledge and experience of the particular individual)."[18] The position of a director, like that of a cabinet minister or member of a legislature, demands no particular qualifications for appointment or election. The less qualified or competent a director is, the better off will he be under this rule in respect of his liability for failure to exercise skill or diligence. The perpetuation of such a low standard will indeed render the board's control, direction and superintendence a mere mockery. The Bhabha Committee recognized that "The reform of the directorate is the key to the reform of company law,"[19] but no reform of the directorate can be complete unless responsibility to direct is firmly fastened to that organ of the company.

The Select Committee on the new Ontario Business Corporations Act observed :[20]

> "In researching and studying the role of the company director in contemporary commercial society, both with respect to the closely-held corporation and the publicly-held corporation, the Committee has determined that it is not the director's fiduciary relationship to the company which is unclear in law, nor do the precise scope or nature of his duties and responsibilities need codification....[T]he question ultimately faced by the Committee was simply this : what, in law, is the standard of conduct and care which should prevail in the board room ? The Committee is of the opinion that the Act can and should contain a clear statement of that standard of behaviour owed by directors in performing their complex and multifarious duties. The standard should be plain enough to be acceptable and practised in the board room and to be enforceable in the courts....[I]f the Committee's recommended legal standard is to develop into an

16. *Supra* note 6 at 550.
17. *Ibid.*
18. *Ibid.* at 551.
19. *Supra* note 2 para 84.
20. Interim Report of the Select Committee on Company Law 1967, para, 7.2.2, 5th Session, 27th Legislature, 15 and 16 Eliz. II (hereinafter referred to as the Ontario Report).

> accepted professional code of ethics, it must appeal to the fair minded director and be compatible with his role as a manager and risk-taker."

The Committee recommended the enactment of the following provision:

> "Every director of a company shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the company, and in connection therewith shall exercise that degree of care, diligence and skill which a reasonably prudent director would exercise in comparable circumstances."[21]

The section as it appears in the new Ontario Business Corporations Act, besides implementing the recommendation of the Committee, makes it applicable not only to directors but also to other officers of the company. The recent New York Business Corporation Law has a very much similar provision which reads:

> "Directors and officers shall discharge the duties of their respective positions in good faith, and with that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions."[22]

The New York and Ontario test is objective and at the same time flexible enough to permit the evolution of proper standards of skill and care with the growth in management education and training, without being unduly harsh so as to scare away honest and talented men from board rooms. If adopted in our country, it will pave the way to transforming the directorship from a cushy sinecure that it is today to one of real responsibility to direct, control and superintend the affairs of the company. The sections also admit of the imposition of a higher degree of care and skill on managers, managing directors and whole-time directors. American decisions have held directors liable for failure to exercise this objective standard of skill, diligence and care and directors in that country have not been heard to complain that it is onerous. Such a provision, it is submitted, must be enacted in our company statute if our boards are to occupy not only a position of power but also of true responsibility. It may also discourage directors from taking their job easy.

III. The Absentee Director

Justice Romer's proposition in the *City Equitable* case that the duties of directors are of "an intermittent nature to be performed at periodical

21. *Ibid.* para 7.2.3.
22. New York Business Corporation Law, § 717. Also North Carolina, section 55.

board meetings, and at meetings of any committee of the board upon which he happens to be placed" remains true of ordinary directors to this day.[23] This is obvious from the law permitting an individual to hold directorships in a large number of companies at the same time.[24] Besides board meetings need be held only once in three months and four times a year.[25] Any director who without leave of absence from the board absents himself from three consecutive board meetings or from all meetings of the board for a continuous period of three months, whichever is longer, vacates his office as director,[26] but that does not disqualify him for reappointment even immediately.[27] Thus if the board meets only the minimum number of times in a year, it is enough if the director attends a single meeting in a year and even that he need not, provided he has obtained the leave of absence from his colleagues. What is the duty of the absentee director? Is he under a duty to keep himself informed or is he under no such duty? If he disagrees with a decision taken in his absence, should he later express his dissent? Decided cases suggest absence is a blessing in disguise.[28] As Gower remarks :

> "As in other walks of life, if anything is going wrong there are great advantages in 'not being there'. The director who stays away runs... little risk of liability for what is done in his absence. Here, as throughout this branch of the law, questions of causation are of paramount importance; if a director is party to a decision to take a particular course of action it may be possible to show that this led directly to loss by the company, but it will be next to impossible to show that his laziness was the cause of the damage or that the action would have been different had he attended."[29]

It would, therefore, appear that an absentee director is under no duty to acquaint himself with what happened at a meeting during his absence and to dissociate himself expressly from any decision taken to which he has objection. This is again a premium on absence and indifference. Coupled with the low quorum requirement for board meetings[30] this state of the law will render the board's control, direction and suprintendence utterly ineffective.

The Act provides for notice of board meetings to be given to every director.[31] It is submitted that the law should require that the notice must

23. *Supra* note 6 at 550-52.
24. The Act, sections 275-279.
25. The Act, section 285.
26. The Act, section 283(1)(g).
27. The Act, section 274.
28. *Supra* note 6 at 551, f.ns. 43 to 45.
29. *Supra* note 6 at 551.
30. The Act, sections 287 and 288.
31. The Act, section 286.

set out details of the matters to be transacted at the board meeting so the director will have the means to know of the importance of the particular meeting and if he is unable to attend it, may as soon as possible ascertain what was transpired at the meeting. The Act spells out the powers of the board which are exercisable only at board meetings and not by circularised resolutions.[32] Obviously, these are important matters requiring considered decisions arrived at after due deliberation and discussion. The absent director denies to the board the benefit of his wisdom and experience. The law must at least require him to communicate to the board as soon thereafter as possible his dissent in case he finds himself unable to agree with a decision taken in his absence. If he fails to do so, he should be deemed to have consented to that decision.

IV. Enforcement

Equally important it is to make available to the company and its shareholders effective remedies to enforce the higher standard of care, diligence and skill advocated here. Present law in India will be inadequate for the purpose. Under it only the company can sue for a wrong done *to it* and no derivative action by a shareholder to redress a wrong done to the company is permitted.[33] Again, by the rule in *Foss* v. *Harbottle*,[34] no individual member can maintain an action in respect of a transaction whereby a wrong is done to the company, if a simple majority of the members at general meeting can ratify the transaction and thus retroactively authorise it, unless the transaction is illegal, or *ultra vires*, or is a fraud on the minority and the wrongdoers are themselves in control of the company, or the transaction is one which can be carried out only by a resolution requiring a special majority. The rules in *Foss* v. *Harbottle*, represent the philosophy of judicial non-interference in the internal affairs of companies which together with governmental non-interference composed the spirit of *laissez-faire* which has formed the foundation of English company law since its total triumph in the English Act of 1856. That this judicial non-interference is no longer the mood of the times is evident from the provisions of the Companies Act giving the court *carte blanche* to intervene and act at the instance of a qualified minority of shareholders to put an end to mismanagement and oppression.[35] The Central Government has also been clothed with powers for the same end.[36]

The Ontario Select Committee on Company Law was not impressed with section 210 of the English Act, corresponding to section 397 of the

32. The Act, section 292.
33. *Foss* v. *Harbottle*, (1843) 2 Hare 461; *Edwards* v. *Halliwell*, (1950) 2 All E.R. 1064 (C.A.).
34. (1843) 2 Hare 461.
35. The Act, secttons 397-407.
36. The Act, sections 408 and 409.

Companies Act 1956, which it felt raised as many problems as it laid to rest, and preferred to recommend instead provisions for derivative action on American model. Accordingly the new Ontario Business Corporations Act provides for derivative suits with necessary safeguards against strike-suits and other abuses. The Ontario section reads :[37]

> "Section 87. (1) Subject to sub-section 2, a shareholder of a corporation may maintain an action in a representative capacity for himself and other shareholders of the corporation suing for and on behalf of the corporation to enforce any right, duty or obligation owed to the corporation under this Act or under any other statute or rule of law or equity that could be enforced by the corporation itself, or to obtain damages for any breach of any such right, duty or obligation.
>
> (2) An action under sub-section 1 shall not be commenced until the shareholder has obtained an order of the court permitting the shareholder to commence the action.
>
> (3) A shareholder may apply *ex parte* to the court for an order referred to in sub-section 2, and, if the court is satisfied that,
>
> (*a*) the shareholder was a shareholder of the corporation at the time of the transaction or other event giving rise to the cause of action;
> (*b*) the shareholder has made reasonable efforts to cause the corporation to commence or prosecute diligently the action on its own behalf; and
> (*c*) the shareholder is acting in good faith and it is *prima facie* in the interests of the corporation or its shareholders that the action be commenced,
>
> the court may make the order upon such terms as the court thinks fit, except that the order shall not require the shareholder to give security for costs.
>
> (4) At any time or from time to time while an action commenced under this section is pending, the plaintiff may apply to the court for an order for the payment to the plaintiff by the corporation of reasonable interim costs, including solicitor's and counsel's fees and disbursements, for which interim costs the plaintiff shall be accountable to the corporation if the action is dismissed with costs on final disposition at the trial on appeal.
>
> (5) An action commenced under this section shall be tried by the court and its judgment or order in the cause, unless the action is dismissed with costs, may include a provision that the reasonable

37. Ontario Bill, *op. cit supra* note 14 section 87.

costs of the action are payable to the plaintiff by the corporation or other defendents taxed as between a solicitor and his own client.

(6) An action commenced under this section shall not be discontinued, settled or dismissed for want of prosecution without the approval of the court and, if the court determines that the interests of the shareholders or any class thereof may be substantially affected by such discontinuance, settlement or dismissal, the court, in its discretion, may direct that notice in manner, form and content satisfactory to the court shall be given, at the expense of the corporation or any other party to the action as the court directs, to the shareholders or class thereof whose interests the court determines will be so affected.'

The Ontario experiment is the first of its kind in the Commonwealth and doubtless will be watched with great interest.

Conclusion

With the abolition of the managing agency system the time has come to have a second and serious look at the boards. A higher standard of care, diligence and skill, made effective by derivative action, will ensure that directors do direct and not merely sit at board meetings, whenever they have nothing more lucrative to do, "look grave and sage, on two occasions say 'I agree', say 'I don't think so' once" and collect their sitting fee.