CHAPTER

1

Corporate Governance – An Introduction

1.1 Corporate Governance

Corporate management and administration of the companies consist of general provisions and of provisions relating to management of corporate governance by which businesses are directed and controlled. The former deals with registered office, registers of members and debenture-holders, annual returns, meetings and proceedings, accounts, audit, investigation, etc. The latter deals with directors, their qualification, disqualification and remuneration, meetings of the Board, board's powers, procedure where directors are interested, etc. Corporate governance is the system of rules, practices and processes by which a company is appropriately managed and controlled. It essentially balances the rules relating to the power relations between members, employees and the stakeholders as well as the public at large are formulated.

Corporate governance has been a subject of considerable interest in the corporate world. The Organisation for Economic cooperation and Development (OECD) defines corporate governance as follows :-

> "Corporate governance is a system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation and other stake holders and spells out rules and procedures for making decisions on corporate affairs. By doing this, it also provides a structure through which the company objectives are set and the means of attaining those objectives and monitoring performance." [*Vodafone International Holdings B.V. Ltd v Union of India* (2012) 341 ITR 1 (SC), Justice K. S. Radhakrishnan]

Corporate governance shapes the growth and the future of any capital market and economy. Its fundamental objective is the "enhancement of shareholder value, keeping in view the interests of other stakeholders". The three key aspects of corporate governance, are accountability, transparency and equality of treatment for all stakeholders. A system of good corporate governance allows sufficient freedom to the Boards and management to take decisions towards the progress of their companies, while remaining within a framework of effective accountability.

Structures and rules provide a framework to encourage and enforce good governance.

Narayana Murthy Committee says, **"**corporate governance is a concept, rather than an individual instrument. It includes debate on the appropriate management and control structures of a company. Further it includes the rules relating to the power relations between owners, the Board of Directors, management and, last but not least, the stakeholders such as employees, suppliers, customers and the public at large". It quoted OECD as saying "Corporate governance. .. involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

1.2 Corporate Governance akin to State Functioning

The Supreme Court in *LIC v Escorts Ltd* 1986 AIR 1370, 1985 SCR Supl. (3) 909 compared Corporate Governance with State Functioning based on Constitution. The two primary organs of a company viz., shareholders in meeting and Board of directors, are comparable with the legislative and the executive organs of a Parliamentary democracy. It observed, "A Company is, in some respects, an institution like as State functioning under its 'basis Constitution' consisting of the Companies Act and the memorandum of Association. Carrying the analogy of constitutional law a little further, Gower describes "the members in general meeting" and the directorate as the two primary organs of a company and compares them with the legislative and the executive organs of a Parliamentary democracy where legislative sovereignty rests with Parliament, while administration is left to the Executive Government, subject to a measure of control by Parliament through its power to force a change of Government. Like the Government, the Directors will be answerable to the 'Parliament' constituted by the general meeting. But in practice (again like the Government), they will exercise as much control over the Parliament as that exercises over them. Although it would be constitutionally possible for the company in general meeting to exercise all the powers of the company, it clearly would not be practicable (except in the case of one or two - man - companies) for day-to-day administration to be undertaken by such a cumbersome piece of machinery. So the modern practice is to confer on the Directors the right to exercise all the company's powers except such as general law expressly provides must be exercised in general meeting. Gower's Principles of Modern Company Law. Of course, powers which are strictly legislative are not affected by the conferment of powers on the Directors as section 31 of the Companies Act provides that an alteration of an article would require a special resolution of the company in general meeting. But a perusal of the provisions of the Companies Act itself makes it clear that in many ways the position of the directorate *vis-a-vis* the company is more powerful than that of the Government *vis-a-vis* the Parliament. The strict theory of Parliamentary sovereignty would not apply by analogy to a company since under the Companies Act, there are many powers exercisable by the Directors with which the members in general meeting cannot interfere. The most they can do is to dismiss the Directorate and appoint others in their place, or alter the articles so as to restrict the powers of the Directors for the future. Gower himself recognises that the analogy of the legislature and the executive in relation to the members in general meeting and the Directors of a Company is an over-simplification and states "to some extent a more exact analogy would be the division of powers between the Federal and the State Legislature under a Federal Constitution."

The only effective way the members in general meeting can exercise their control over the Directorate in a democratic manner is to alter the articles so as to restrict the powers of the Directors for the future or to dismiss the Directorate and appoint others in their place. The holders of the majority of the stock of a corporation have the power to appoint, by election, Directors of their choice and the power to regulate them by a resolution for their removal. And, an injunction cannot be granted to restrain the holding of a general meeting to remove a director and appoint another.

1.3 Corporate Governance - key constituents

The three key constituents of corporate governance are :

- the Board of directors,
- the shareholders, and
- the management.

The pivotal role is performed by the Board of directors. It is accountable to the stakeholders and directs and controls the management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in a transparent manner to the stakeholders. An effective corporate governance system is one, which allows the Board to perform the dual functions efficiently of directing and controlling the management of a company and bring accountable to the shareholders.. Composition, structure and responsibilities of the Board are critical to the independent functioning of the Board. [(see Kumar Manglam Birla Report)

The shareholders' role is to appoint the directors and the auditors and to hold the Board accountable for the proper governance of the company by requiring the Board to provide them periodically with the requisite information, in a transparent manner, of the activities and progress of the company.

The responsibility of the management is to undertake the management of the company in terms of the direction provided by the Board, to put in place adequate control systems and to ensure their operation and to provide information to the Board on a timely basis and in a transparent manner to enable the Board to monitor the accountability of management to it.

1.4 Company power - divided between directors and shareholders

A company is a juristic person registered under the Companies Act.. It acts through its directors who are collectively referred to as the Board of directors. The directors and the shareholders are the primary organs of the company between whom the company's powers are divided. The general meeting retains ultimate control. The Board of directors can exercise the power and do an act which the company is authorized to do in the memorandum and articles of association. There are certain powers or acts which only the shareholders in a general meeting can exercise or do.

There are certain powers which the company can alone exercise in a general meeting. General body appoints the managing director, the auditor, the company secretary. Similarly, the general body approves or rejects accounts. It has the power to amend the articles, or take away the powers of the directors or remove them and in their place appoint others. It has no power to interfere with the day-to-day management of the company (see *Suburban Bank(P) Ltd. v Thariah* (1968) 38 Comp Cas 13 (Ker). That power of the directors can be taken away only by amending articles.

Powers of the company in respect of all matters are to be exercised by the Board of directors, except where these are reserved by company in general meeting (see *Nibro Ltd. v National Insurance Co. Ltd.* (1991) 70 Comp Cas 388 (Delhi)

1.5 Board Power - No interference by shareholders and court

VENKATARAMIAH, J. in *National Textile Workers vs P.R. Ramkrishnan* AIR 1983 75, 1983 SCR (1) 9 observed: "It is difficult even though it may not be impossible to administer the company law as it is now in force in India without the aid of the principles laid down by some of the leading English cases like *Salomon v. Salomon & Co.* [(1897) AC 22] laying down the principle of corporate personality, *Ashbury Railway Carriage & Iron Co. v. Riche* [(1875) 7 AC 653] dealing with the rule of *ultra vires*, *Royal British Bank v. Turguand* [(1856) 25 LJ QB 317(QB)] (3) laying down the rule of 'indoor management', *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.* [(1964) AC 465] which establishes the liability for negligent mis-statements in prospectuses, *Foss v. Harbottle* [(1843) 2 Hare 461] and *Burland v. Earle* [(1902) AC 63(PC)] dealing with the principle of 'the fraud on a minority' and *Ebrahimi v. Westbourne Galleries* [(1973) AC 360] dealing with the application of the 'just and equitable' principle in ordering the winding-up of a company."

In *Foss v. Harbottle* [1843] 2 Hare 461, it was held that the courts could not normally interfere with the internal management of the company at the instance of a minority of members dissatisfied with the conduct of its affairs by the majority. This approach was sought to be justified on various grounds. The first was that the members who had contracted to abide by the decision of the majority could not complain against something to which they had agreed. The second was that the majority alone knew what was good for the association or company, and that the court's views could not be imposed on them. And the third was that as the company was a separate juristic person, it alone, or at least only a majority of its members, could complain of any injury to it, and not a minority [see *Kerala Kumaranunni v. Mathrubhumi Printing and Publishing Co. Ltd.* [1983] 54 COMP CAS 370 (KER.)] The Court further observed, "In *Salomon v. Salomon & Co.* [1897] AC 22, the House of Lords went to the extreme of refusing to discover dummies and nominees behind the veil of incorporation, by placing emphasis on the separate legal personality of the company. In spite of the fact that free transferability of shares is one of the important features of any company, it was held in re Gresham Life Assurance Society : Ex fiarte Penney [1872] 8 Ch App 446, that where the articles of association vested an absolute discretion in the directors of a company to refuse to recognise a transfer of shares, the court would presume that the directors had exercised the power *bona fide*. They could not be compelled to disclose reasons for their refusal, unless want of good faith was affirmatively established by a petitioner. Dishonesty, fraud, bad faith, breach of trust and the like were the minimum to be established by individual shareholders before they could get any equitable relief from the Chancery courts; in all other cases, the contract was supreme."

The two principles were laid down in *Burland v. Earle*, 1902 AC 83 as regards management of the companies

- first, that the court would not interfere with the internal management of the company acting within their powers and

  secondly, that in order to redress a wrong done to the company or to recover money or damage alleged to be due to the company, the action would *prima facie* be brought by the company itself. (also see *Satyvart Sidhantalankar v Ary Samaj* AIR 1946 Bom 516;(1947) 17 Comp Cas 21(Bom)

The doctrine of supremacy of shareholders would apply provided first it is within their powers and secondly, that the acts of the shareholders are to cure mere informality and irregularity as opposed to the infraction of Articles or Statutes.

The Bombay High Court in the said case observed, as far the second rule, "As a general rule the company must sue in respect of a claim of this nature, but general rules have their exceptions, and one exception, to the rule requiring the company to be the Plaintiff is, that where fraud is committed by persons who can command a majority of votes, the minority can sue. The reason is plain, as unless such an exception were allowed it would be in the power of a majority to defraud the minority with impunity. These are thus the well-recognised exceptions to the second principle, viz. that in order to redress a wrong done to the company or to recover moneys or damages alleged to be due to the company, the action should *prima facie* be brought by the company itself."

In the case of *Isle of Wight Railway Co. v. Tahourdin* [1884] 25 Ch D 320 (CA), the court held that it would not interfere with the internal working of the company and that when the shareholders had requisitioned a meeting, the Board of directors is bound to call such a meeting and it cannot refuse to call such a meeting on the ground that some of the resolutions, if passed at such a meeting, would be irregular. Lord Justice Lindley observed in that case as follows (at p. 333):" We must bear in mind the decisions in *Foss v. Harbottle* [1843] 2 Hare 461 and the line of cases following it, in which this court has constantly and consistently refused to interfere on behalf of shareholders, until they have done the best they can to set right the matters of which they complain, by calling general meetings. Bearing in mind that line of decisions, what would be the position of the shareholders if there were to be another line of decisions, prohibiting meetings of the shareholders to consider their own affairs ?"

Thus, the Board has all freedom to exercise its powers subject to articles and the provisions of the Companies Act. Shareholders cannot interfere (see *Jagdish Prasad v Pt. Paras Ram* (1942) 12 Comp Cas 21 (All), and *Pothen v Hindustan Trading Corpn. (P) Ltd.* (1967) 37 Comp Cas 266 (Ker). The court also cannot interfere. It is for the court to recognize the corporate democracy of a company in managing its affairs. When the matter comes to the court, the court is not concerned with the *inter- se* relationship of the parties. It has to keep in mind the corporate democratic principles. It is not for the court to restrict the powers of the Board of directors, to interfere with the day-to-day functions, management and administration of a company unless it is established that the decision taken by the Board are *ultra vires* the Act or articles of association of the company, or, to dictate to the Board as to how it should function (see *Vivek Goenka v Manoj Somthalia* (1995) 83 Comp Cas 897 (Mad)

1.6 Management control vests in Board

The Board of directors as the working organ of the company is entrusted with the management and control of the company by the general body Management and control vests in the Board of directors and never with the shareholders. "Management and control" is a composite expression, implying both management and control, not the management alone of day-to-day business by the executive nor the control alone by shareholders through their voting power. It means highest level of control of the business as a whole. It refers to policy making and policy execution.

The expression "control and management" means *de facto* control and management and not merely the right or power to control and management. [see Ms Meenu Sahi Mamik, In re (2006) 157 Taxman 189 (AAR)]. Thus "control and management" does not mean controlling the company by means of voting powers, but control in relation to the company's business. The shareholder can, no doubt, compel the directors to do their will. It does not, however, follow that the corporators are managing the corporation. The contrary is the truth. They are not. It is the directors who are managing the affairs of the company (*American Thread Co. v Joyce (Surveyor of Taxes)* 1913 6 TC 163 (CA)]. The real business is carried where directors exercise their control over the company's affairs (*Egyptian Delta Land 7 Investment Co. Ltd. v Todd (Inspector of Taxes)* (1929) AC 1]. A company is managed by the Board of directors. Controlling the affairs or management means not the bare possession of powers by the directors, but their taking part in or controlling affairs relating to trading. They must exercise their powers of control in relation to business or activity wherefrom profit is derived (see *Egyptian Hotels Ltd. v Mitchell* (1915) 6 TC 542 (HL)]

1.7 Fiduciary capacity, duties and obligations

The directors are the agents of the company to the extent they have been authorized to perform those acts on behalf of the company in a fiduciary capacity and their acts and duties are to be exercised for the benefit of the company. The fiduciary capacity enjoins upon them a duty to act on behalf of a company with utmost good faith, utmost care and skill and due diligence and in the interest of the company they represent and; to make full and honest disclosure to the shareholders regarding all important matters relating to the company (see *Dale and Carrington Invt. P. Ltd. v P. K. Prathapan* (2004) 7 Scale 586; (2004) 122 Comp Cas 161 (SC). In a limited sense they are also trustees for the shareholders, Directors owe no fiduciary or other duties to individual members of their company.

Even if the directors owe some duty to the existing shareholders on the footing of there being some fiduciary (see Gresham Life Assurance Society, In re (1873) ILR 8 Ch App 446), there is no fiduciary relationship between the directors and persons who are complete strangers to the company (see *Nanalal Zaver v Bombay Life Assurance Co. Ltd.* (1950) SCR 391; (1950) 20 Comp Cas 179 (SC)

1.8 Duty to act bona fide (proper purpose doctrine)

The duty of the directors does not stop at the "to act *bone fide*" requirement. The courts in England and Australia have evolved a doctrine called "the proper purpose doctrine". In *Howard Smith Ltd. v Ampol Petroleum Limited* (1974) AC

821, the Privy Council felt that the *bona fide* test was not sufficient to meet the challenge because it failed to encompass the obligation of the directors to be fair. The directors' acts should not only satisfy the test of *bona fide*s, they should also be done with proper motive.

In *Bishopgate Investment Management Ltd. (in liquidation) v Maxwell* (No.2) (1994) 1 All ER 261 (CA), it was held by the Court of Appeal that the *bona fide*s of the directors alone would not be determinative of the propriety of their actions. The doctrine was given recognition in *Hogg v Cramphorn Ltd.* (1967) 37 Comp Cas 157; (1967) 1Ch 254, over and above the traditional *bona fide* test. In that case the director had allotted shares with special voting rights to the trustees of a scheme set up for the benefit of the company employees with the primary purpose of avoiding a takeover bid. Buckley J., found as a fact that the directors had acted in subjective good faith. They had indeed honestly believed that their actions were in best interest of the company. Despite this, it was observed: "an essential element of the scheme, and indeed its primary purpose, was to ensure control of the company by the directors and those whom they could confidently regard as their supporters." As such, he concluded that the allotment was liable to be set aside as a consequence of the exercise of the power for an improper motive. He also held that power to issue shares was fiduciary in nature.

In *Tea Brokers (P) Ltd. v Hemendra Prasad Barooah* (1998) 5 Comp LJ 463 (Cal), the principle enunciated in the "proper purpose doctrine "was applied without mentioning, as is clear from the following observations of Justice A. N. Sen : "It is well settled that the directors may exercise their powers *bona fide* and in the interest of the company. If the directors exercise their powers of allotment of shares *bona fide* and in the interest of the company, the said exercise of powers must be held to be proper and valid and the said exercise of powers may not be questioned and will not be invalidated merely because they have any subsidiary additional motive, even though this be to promote their advantage. An exercise of power by the directors in the matter of allotment of shares, if made *mala fide* and in their own interest and not in the interest of the company, will be invalid even though the allotment may result incidentally in some benefit to the company."

The doctrine was also applied by the Supreme Court in *Dale and Carrington Investments P. Ltd. v P. K. Prathapan* (2004) 122 Comp Cas 161 (SC).

1.9 Board's functions - usurpation by outsider "director"

There is a difference between, on the one hand, exercising management and control and, on the other hand, being able to influence those who exercise management and control., *L.J. Chadwick in Wood v Holding* [(2006) ECWA Civ. 26 (CA), observed:

> "27……, it is essential to recognize the distinction between cases where management and control of the company is exercised through its own constitutional organs (the Board of directors or the general meeting) and

> cases where the functions of those constitutional organs are "usurped" - in the sense that management and control is exercised independently of, or without regard to, those constitutional organs. And, in cases which fall within the former class, it is essential to recognize the distinction (in concept, at least) between the role of an "outsider" in proposing, advising and influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken. In that context an "outsider" is a person who is not, himself, a participant in the formal process (a Board meeting or a general meeting) through which the relevant constitutional organ fulfils its function"

The importance of this case lies in the analysis by Chadwick LJ of what is capable of constituting management and control of a company by a person who is not its constitutional organ (viz., Board of directors) A decision by a director and for that matter some directors is not the decision of the Board of directors. The director for that matter is an "outsider" Patton LJ observed as follows in *HMRC v Smallwood* [(2010) EWCA Civ. 778]:" in that context an 'outsider' is a person who is not, himself, a participant in the formal process (a Board meeting or a general meeting) through which the relevant constitutional organs fulfils its functions."

Controlling the affairs or management means not the bare possession of powers by the directors, but their taking part in or controlling affairs relating to trading. They must exercise their powers of control in relation to business or activity wherefrom profit is derived (see *Egyptian Hotels Ltd. v Mitchell* (1915) 6 TC 542 (HL)]

1.10 Constitution of Board

Board is a collective body of directors of the company. Save as otherwise expressly provided in the Act, every director shall be appointed by the company in its general meeting. A director may be a managing director, whole-time director, nominee director, independent director, or simply a director. A managing director is a director who by virtue of the articles of company or an agreement with the company or a resolution passed in its general meeting, or by its Board of directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director. A whole-time director is a director in the whole-time employment of the company. A nominee director a director nominated by any financial institution in pursuance of the provisions of any law for the time being in force, or any agreement, or appointed by the Government or any other person to represent its interest. Independent director, a director who, in the opinion of the Board is a person of integrity and possesses relevant expertise and experience.

CHAPTER 2

Directors and Board of Directors

2.1 Introduction

The basic features of corporate governance are : the composition of the Board of directors with provision for independent directors; the responsibility of the Board to put in place and monitor organisation level policies; and disclosures to be made in the financial statements. In this chapter, the composition of Board of directors, is discussed. The concept of independent directors is discussed in the next chapter.

Chapter XI of the Companies Act, 2013 deals with appointment and qualification of directors. It provides that every company must have a Board of Directors consisting of a number of directors as specified in section 149, appointed by the special resolution of the company, and independent directors appointed by the Board. It deals with the constitution of the Board of Directors, appointment of directors and appointment of independent, additional, alternate, and nominee directors, their qualification and disqualification, removal, resignation, etc. It also deals with allotment of Director Identification Number.

2.2 Board of Directors and Directors

Section 149 of the Companies Act, 2013 provides that every company shall have a Board of Directors consisting of individuals as directors. It corresponds to sections 252 and 253 of the Companies Act, 1956. "Company "is defined in section 2(20) to mean a company formed and registered under the Act or under any previous company law. A Board of directors in relation to a company is defined in section 2 (10) to mean the collective body of directors of the company, "director" is defined in section 2(34) to mean a director appointed to the Board of a company.

A company is a juristic person registered under the Companies Act. It acts through its directors who are collectively referred to as the Board of directors. All the powers and the management of the affairs of the company are vested in the Board of directors. The Board, thus becomes the working organ of the company. The general management and general administration of the company