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Corporate Governance Theory and Practice Regarding the Role of Board of Directors: A Legal Approach

Partha Sarothi Rakshit
HOD, Faculty of Law, North East Frontier Technical University (NEFTU)

Abstract

The concept, idea and importance of corporate governance is visualised by the active role, duties, liabilities and planning strategies by the Board of Directors (BODs), in India as well as world business. In the eye of law, corporate enterprise is always treated as legal fiction or artificial person compared to living person; the mind of the corpus (incorporated) is collective mind of intellectual individual(s) to monitor the business policy, governance and functions. The theories of corporate personality developed by the eminent jurists from time to time determine the position and role of director(s) in relation to corporate governance (CG). The role of director(s) in the present system of CG is metaphorical and role or function of BODs in modern corporate venture is appropriate. The will of the directors as per memorandum and articles is the will of the company or corporate entity; the nucleus of the corporate governance is based on the determinate role of the director(s) (BODs). This paper deals with legal theories of corporate personality, metaphor in CG and practice, and the position, role and accountability of board of directors (BODs).

Key words: corporate personality, corporate governance (CG), board of directors (BODs), metaphor in corporate governance, accountability.

Introduction: Corporate governance is a means to ensure and protect the interests of the shareholders or stakeholders of the society so that the leaders attend to the needs of all consumer citizens whereby they can use their power and responsibility for the welfare of the company as well as of the society. The role of board of directors in Indian corporate governance (CG) is as oldest as *Mahabharata* and Kautilya's *Arthashastra* and as modern as that of 1990s. The concept of good and effective governance is used several times in development literature (Gruberg and Khan ed. 2000; Orji 2001: 430-82). The concept of corporate governance (CG) is always connected with position, role, duties and metaphor of board of directors (BODs). Its structural value owes to governance, significance, responsibility of board members, concerns with corporate and other relevant laws, roles and activities of BODs (Sumaira and Sangmi 2016: 712). A board of directors (BODs) is assumed as a central point to the study of CG. In the present day, corporate management or governance is to rule with authority, to regulate, to manage intellectual activity, and

capacity to manage the board functions. Governance denotes to rule or govern with less authority, but with closer care and management, and exercise of judgment (*P Ramanatha Aiyar's Concise Law Dictionary*, July 2016: 553).

The ideas of CG define the system by which companies are directed and controlled (Cadbury Committee Report 1992: Para 2.5). The primary essentials of a corporate body are the shareholders, the management (led by the chief executive officer), and BODs; other participants include the employees, consumers, suppliers, creditors (fixed or floating), and the community itself (Monks and Minow 1996: xvii). The corporate management becomes impersonalised and no one claims that he is the real owner of the company or incorporated entity. The business now belongs to the group of persons assigned and their intellectual capacity rather than subscribers of the company.

Birth of a Corporate[1] or corporation[2] is by law. A corporate is a legal entity,[3] capable of enjoying all rights of its assets in its own name. A member does not have an insurable interest in the assets of the company. The corporate or corporation is the legal fiction in which all its assets are vested, controlled, managed and disposed of.[4] A company can be allowed to sue in *forma pauperies* under Or. 33, R. 3 of Civil Procedure Code.[5] Managing Director[6] is not a necessary party to corporate proceedings.[7]

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[1] It belongs to a corporation, as a corporate name; incorporated, as a corporate body (*P Ramanatha Aiyar's Concise Law Dictionary*, July 2016: 283).

[2] It is a body corporate, legally authorised to act as a single person, under Article 19 (6) (ii) of the Constitution of India.

[3] *Salomon v. Salomon & Co Ltd*. (1895-99) All ER Rep 33: 1897 AC 22, the House of Lords observed that Salomon & Co Ltd was a real company fulfilling all the legal requirements. It must be treated as a company, as an entity consisting of certain corporates, and as a distinct independent corporation.

[4] *Regl Provident Fund Commr v. Narayani Udyog* (1993) 1 Raj LR 224, property belongs to the company, and not to its members; nor directors are the company's employees.

[5] *Union Bank of India v. Khaders International Constructions Ltd*. (1993) 2 Comp LJ 89 (Ker).

[6] "Managing Director" means a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its 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, by whatever name called. Explanation- for the purposes of this clause, the power to do administrative acts of a routine nature when so authorized by the Board such as the power to affix the common seal of the company to any document or to draw and endorse any cheque on the account of the company in any bank or to draw and endorse any negotiable instrument or to sign any certificate of share or to direct registration of transfer of any share, shall not be deemed to be included within the

In the 13th century, Pope Innocent IV espoused the theory of legal fiction in relation to corporate personality because it existed only in abstract idea. The Supreme Court regarded this above cited enunciation as agreed to the foundation of separate entity principle in India.[8] The principle had been recognised in India in *Kondoli Tea Co Ltd, re*,[9] the asset of the company is clarified as not the asset of the shareholders; but it is the property of the company.[10] The court observed that the company was a separate person; a separate body altogether from the shareholders and the transfer was as much a conveyance, a transfer of the property, as if the shareholders had been totally different persons (*ibid*).

Today, corporate sector has a growing cadre of experts in the field of corporate management as the professional officers. With the financial backing that companies are able to provide, they are able to develop the business to a considerable extent. Men of the calibre are not to be found every day, but, when fund and support are provided, they are capable of achieving very high success in commercial dealings (Palmer 1961: 25-26). The professional managers or directors are performing the brain function of the corporation as per the memorandum, articles and nature of the corporate business, aims, corporate social responsibility (CSR), financial stability and achievements.

Importance and Scope of the Study: The good governance of any state is not only dependent on government initiatives, but involves also public and private initiatives for the growth of the national interest. In this context, the study of corporate governance and role of directors (BODs) in the corporate sector is very much relevant. Considering the impact of globalisation, the concept of business strategies, planning, consumer satisfaction, right of shareholders, and right of creditors, CSR, and the revenue generation of the government, it is important to accelerate the overall development and secure legal rights for the consumer citizens as well as stakeholders. The researcher tries to develop the idea relating to corporate governance in theory and practice for the role of board of directors in the juridical analysis.

Methodology: The study is basically one of doctrinal research; the analysis is based on the primary sources such as statutes, regulations, committee reports and landmark judgements and also on the secondary sources, i.e. law journals, research papers, encyclopaedias and e-sources.

Theories on Nature of Corporate Personality – Jurisprudential View: About the corporate nature of personality, different views have emerged from the jurists in the field of corporate law jurisprudence. The well-known theories of corporate personality are fiction

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substantial powers of management [s. 2(54) of the Companies Act, 2013 (18 of 2013)].

[7] *Bank of Maharashtra v. Racmann Auto (P) Ltd*. (1992) 74 Comp Cas 752 (Del).

[8] *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 613.

[9] ILR (1886) 13 Cal 43.

[10] *Gramophone & Typewriter Co Ltd. v. Stanley* (1906) 2KB 856, 869.

theory, concession theory, realist theory, bracket theory, purpose theory, the form of ownership theory, and Kelsen's theory (Kelsen 1945: 93-109). Sinibald Fieschi, Pope Innocent IV, was however, the first to employ the idea of *persona facto* or fictitious personality of groups. This fiction theory starts on the basic assumption that human beings alone are persons properly called so. It then concedes that some groups or institutions are regarded 'as if', they are persons.[11] Savigny, Salmond and Holland are considered as the most ardent supporters of the fiction theory of corporate personality. The theory starts on the assumption that the corporation gets a personality only by virtue of law.[12] The theory attributes to the corporation the acts of its members. The important case illustrating this idea of fiction theory is *Soloman v. Soloman.*[13] This case invariably supports the fiction theory by saying that the company is, in law, a person.

The realist theory of corporation is not a figment of the imagination, it is a reality but its reality is not a reality in the sense that it can run about, or marry or fall sick, as an ordinary individual can, as per Gierke, Beseler, Larson, Bluntschli, and Zitelmann (Bloomfield 2013). A group has a will of its own; its decisions are not the decision of its members.[14] No one who has ever sat on a committee or a board of directors can have failed to notice, that every permanent organisation has a feeling, a tradition, an atmosphere, an opinion of its own, in fact a group mind which differs from that of any individual member, and is certainly not the same as the sum total of the minds of the individual members (Murray 1926: 338).

The exponent of bracket theory is Kelsen and Ihering. According to this theory members of the corporation are the bearers of rights and bound by duties which are, for convenience, referred to the corporation itself. However, to understand the real nature of the corporate governance, we should remove the bracket to know the actual position of the company (cited in Aggarwal 2016: 202).

Role and Position of Directors in a Company – A Legal Approach: The Director[15] means a director appointed to the Board of a Company.[16] Reference to a Director is to an

[11] This theory started from the following proposition: "Besides men or natural persons, the law known as 'subject' of property rights contain fictitious, artificial or juristic persons, as one species of this class is known as the corporation. We must carefully understand this ideal person from these natural persons who are called its members".

[12] In 1819, C.J. *Marshall in Dartmouth College v. Woodward* (4 Wheat 518 at p. 636) defined a corporation as an artificial being, invisible, intangible and existing only in contemplation of law.

[13] (1887) AC 22.

[14] The general will is something different from the sum total of individual wills.

[15] In relation to- (i) a firm means a partner in the firm; (ii) an association of persons or a body of individuals, means any member controlling the affairs thereof. [Insurance Act (41 of 1999), s.105 A *Expln.* (a)]; One who directs; a superintendent; a member of the

individual and not to a body corporate.[17] The role and position of directors is still under cloud; neither is described in any legislative framework or statutes in the modern corporate governance. Sometimes they are called brain of the company, trustees of the company and even they play a role of managers or agents of the incorporated entity. Since various theories of incorporation are metaphorical, there is neither any determinate boundary to perform the function of the concerned board of directors; nor is there any legal postulate to regulate the day to day conduct of the board. At the same time, inactive, inadequate, and improper audits and week enforcement of the company or corporate law had led to many corporate scandals in the recent past.

The role the directors occupy in a corporate is not easy to explain;[18] they are professional intellectuals and officers hired by the company to direct company affairs in relation to corporate governance or management, business strategies, employer and employees relation, contract to third parties, shareholder rights (including minority shareholders), policy making decisions, stock market regulation, merger and acquisitions, corporate social responsibilities, civil liabilities, etc. The King's Bench tried to determine position of directors in *Moriarty v. Regent's Garage Co*. (1921) 1 KB 423, where Lush J, explained that a director is not a servant of any master. He cannot be described as servant of the company or anyone.

The Companies Act makes no effort to determine their position; sub-section (13) of Section 2 [1956 Act] only provides that directors include any person occupying the position of a director, by whatever name called. The Companies and Allied Matters Act, 1990 (Nigeria) defines: 'Directors of a company registered under this act are persons duly appointed by the company to direct and manage the business of the company.' On the other side, Bowen LJ described the position of directors in *Imperial Hydropathic Hotel Co Blackpool v. Hampso*n,[19] that Directors are described sometimes as agents, sometimes as trustees and sometimes as managing partners (Singh 2017: 248).

But the position of directors was clearly recognised in *Ferguson v. Wilson* (1866): the directors are, in the eyes of law, agents of the company. In the above cited case, the court said that the company is no person; it can act only through directors and the case is, as regards those directors, merely the ordinary case of principal and agent. The position of director as decided in Indian case in *Ramaswamy Iyer v. Brahamayya & Co*.[20] is adjudged

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Board appointed to direct the affairs of an establishment u/Article 31 A (1) (d) of the Constitution of India.

[16] s. 2(34) of the Companies Act, 2013 (18 of 2013).

[17] *Sita Ram Singhania v. State of Orissa*, AIR 1972 Ori 217, 219 [State Finance Corporation Act (63 of 1951), s. 10(e)].

[18] *Ram Chand & Sons Sugar Mills (P) Ltd. v. Kanhayalal Bhargava*, AIR 1966 SC 1899: (1966) 2 Company Law Journal 224.

[19] (1882) LR 23 Ch. D 1: 49 LT 150 (CA).

[20] (1966) 1 Comp LJ 107.

as trustee. In this case, the Hon'ble High Court of Madras pointed out that: 'The directors of a company are merely trustees for the company, and with reference to their power of applying funds of the company and for misuse of the power they could be rendered liable as trustees and on their death, the cause of action survives against their legal representatives.'[21] The Nigerian Act, 1990 contains this trustee position u/section 283 of Companies and Allied Matters that the directors are trustees of the company's money, properties and their power and as such must account for all the moneys over which they exercise control and shall refund any money improperly paid away, and shall exercise their powers honestly in the interest of the company and all the shareholders, and not their own sectional interests.[22] A corporate has no mind, heart, liver, and limbs; it ably imagines life of corporate or corporation without active organs (Organic theory); its brain function is based on the role, power, duty and liability of the boards (BODs). At present corporate law has no accurate code of conduct or ethics to determine the role, power and functions of director(s) in relation to affairs of the company; in every emerging situation, the director has to play appropriate role in the corporate governance. In the UK, USA, South Africa, Australia, New Zealand, Nigeria, Brazil and India, relating to role of directors (i.e., executive director, non-executive director, independent director, managing director or women director) in a company or corporate body or a body corporate, no clear picture exists as per the corporate law(s). Most of the nation's define the statutory duties and liabilities of the Boards according to their corporate law(s). But, due to lack of determinate role or function of director in the organisation, the law had failed in several occasions (e.g., Satyam scam in India). In this connection, it is important to take note of a leading decision examined in *Whitehouse v. Carlton Hotel Pty Ltd*, applying the 'proper purpose' test. Mason CJ, Dawson and Deane JJ concluded that: It is simply no part of the function of directors as such to favour one shareholder or group of shareholders by exercising a fiduciary power to allot shares for the purpose of diluting the voting power attaching to issued shares held by some other shareholder or group of shareholders.[23]

In the context of corporate governance, Cadbury (2002) referred to the need for appropriate checks and balances in the governance structure, particularly at board level, not only as controls to prevent the abuse of power, but also in relation to building board effectiveness.

Metaphor in the Corporate Governance: The word metaphor[24] is used in the business leadership studies (Tourish and Hargie 2012: 1045-1069) of corporate governance, ideas of

[21] *Ibid*.

[22] http://www.nigeria-law.org/CompaniesAndAlliedMattersAct.htm visited on 28-12-18 at 15:51.

[23] *Ibid*.

[24] An expression, often found in literature, that describes a person or object by referring to something that is considered to have similar characteristics to that person or object.

organisation and organisational identity, and development of group leadership. A 'metaphor' in social sciences is to use as a method of analysis in the area of governance studies and board management. In the field of corporate law in connection to shareholders as stakeholders (Green 1993: 1416-1422), it is synonymous of metaphor in relation to the Sarbanes-Oxley Act, 2002[25] (Kuschnik 2008: 65-95), corporate policing (Baer 2008), and of comparison of European Boardroom and American Law Proposals (Norburn 1985: 20). The use of metaphor within corporate law literature makes reference to aspects of corporate governance or management; such reference is made in relation to issues of legal compliance and legislative framework. The concept of metaphor is used in CG to address issues of legitimacy and accountability affecting corporate governance codes (Dragomir 2008: 32-43), and is claimed to relate transactional, transformational and transcendent forms of leadership metaphorically to the evolution of the theory and practice of corporate governance (Grandiner 2006: 62-76).

However, in a positive way, the role of a board of director (BODs) has also been referred to as that of a 'pilot' in relation to its directing function (Demb and Neubauer 1992; Johnson 2005: 710-717) and the performance dimension of governance. With regard to codified structural requirements for board composition, other scholars have termed boards as a governance mechanism that mainly ratifies or 'rubber stamps' management's decisions, and as a 'legal fiction' (Herman 1981; Vance 1983; Wolfson 1984). Thus, metaphors are used to convey particular meanings for corporate governance as a system, an institution i.e., legitimate authority, a framework (means rules, regulations, codes, relationships, processes and practices), a function (agency and compliance), or as agents or principals.

Disparity between Practice and Theory of Corporate Governance – A Metaphor: The disparity between theory and practice is particularly striking when comparisons are made between the mechanisms and effects of corporate governance in listed public limited companies and unlisted private companies. The practice and theory of corporate governance explain as to know how the real world of corporate governance works through the board members in listed and unlisted companies. The new dimensions of corporate law and new thought models for investigating corporate governance and corporate behaviour are based on both practical and theoretical analytical research. An analysis of the corporate governance integrates issues of company law, SEBI guidelines, regulatory practices, and company administration with contemporary corporate governance policies and structures (*ibid*). The corporate governance practice which forms the touchstone of regulatory policy is based on relationships, description of forces, and actors that hold on little similarity to the real world operations. The theory will turn out to be supported by the reality of practice; at other times the two will be in disagreement. But the current explanations of corporate

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https://dictionary.cambridge.org/dictionary/english/metaphor visited on 11-01-2019 at 16:56.

[25] The *Sarbanes– Oxley Act* of 2002 (Pub.L. 107-204 [1], 116 Stat. 745, enacted July 30, 2002).

governance used by policymakers do not correctly explain the real world; much of the practical superstructure of governance is directed towards the wrong purpose, or works only partially. Even in India, Cl. 49[26] of SEBI guidelines is applicable to the extent that it does not violate statutory provisions and guidelines or directives for all listed corporates, other listed bodies corporates like banks, insurance companies, financial institutions (FIs) and not applicable to mutual funds (MFs) (Cl. 49 applicable from 01.10.2014).

Accountability and Right to Know in the Corporate Governance: Accountability always ensures that the role and power of BODs in corporate governance is exercised according to the will of shareholders or stakeholders. Without accountability, democratic governance is always at risk even though majority shareholders impose decision making policy for the interests of the companies. Abuse of such power by the boards or management is treated as negative outcome, especially for the stockholders or shareholders and for the consumer people who are unable to seek injury or legal damages. In *Reliance Petrochemicals Ltd. v. Indian Express Newspaper Bombay (P) Ltd.*,[27] Mukherji, J. stated: "we must remember that the people at large have a right to know in order to be able to take part in participatory development in the industrial life and democracy. Right to know is a basic right which citizens of a free country aspire in the boarder horizon of the right to life in this age of our land under article 21 of the Constitution. That right reached new dimensions and urgency. That right puts greater responsibility upon those who take upon themselves responsibility to inform."

It is very much evident that a proper and accountable board function is the key to successful development in the corporate governance or management.

Conclusion: The role of board of directors in Indian corporate governance (CG) is as oldest as *Mahabharata* and Kautilya's *Arthashastra* and as modern as that of 1990s. The Companies Act, 1956 and 2013 (inclusive of all amendments), SEBI guidelines on CG, Cadbury Committee Report on CG in the UK (1992), Greenbury Committee (1995), JJ Irani Report on Company Law in India (MCA, 31st May 2005) have all dealt with the practice regarding governance matters. Metaphor in corporate literature is synonymous to corporate

[26] https://www.sebi.gov.in/legal/circulars/aug-2003/corporate-governance-in-listed-companies-clause-49-of-the-listing-agreement_15948.html visited on 04-1-2019 at 10:33 (SEBI, vide its circular dated February 21, 2000, specified principles of corporate governance and introduced a new clause 49 in the Listing agreement of the Stock Exchanges. These principles of corporate governance were made applicable in a phased manner and all the listed companies with the paid up capital of Rs 3 crores and above or net worth of Rs 25 crores or more at any time in the history of the company, were covered as of March 31, 2003. SEBI has issued six circulars on the subject of corporate governance inter-alia detailing provisions of corporate governance, its applicability, reporting requirements, etc.).

[27] AIR 1989 SC 190 (202-03).

culture on function of BODs, policies, strategies, secure rights of stakeholders or shareholders and consumers.

The corporate governance is supposed to work, irrespective of the fact that traditionalist or conventional or legal approach to theories of governance is used. The conventional view typically emphasises on shareholders; concentrates on the ownership rights of majority shareholders; and dwells on the consequences of the relationship between shareholders, BODs and managers through the legal and economic prism of the principal-and-agent relationship. Occasionally, the traditionalist view may admit additional players (stakeholders) to the governance game but usually only grudgingly or by allocating walk-on parts.

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