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Corporate Sector in India: Ethical Issues

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Abstract

The economic reforms since 1991 have brought many changes to the environment in which Indian companies previously operated. The principal aim of these reforms was to strengthen market discipline and promote greater competition by putting an end to the “license raj,” namely through the abolition of the Industries Development and Regulation Act (1951) and amendments to the Companies Act and several other major laws, which had imposed a heavy legal and regulatory burden on the corporate sector. We know that a company is an artificial person and therefore it cannot perform task or function on its own. Since a company is not a natural person, it cannot be punished like a natural person. Therefore the role of director gets much wider when it comes to the investor’s interest and their grievances. This is because the investor is not aware of the internal functioning or the management of the company. In the case of *HL Bolton Engineering Co Ltd v TJ Graham & Sons Ltd*, it was held that directors and managers represent the directing mind and will of the company and also control the company. It was further held that the state of mind of the managers and directors is the state of mind of the company per se. In strict legal sense, a company cannot be represented by employees of the company as they follow the directions given to them by the directors. The Board of directors are the brains and only brains of the company which is the body, and the company can and does act only through them. The paper will address to the legislative intention in addressing to the corporate governance regime in consonance with the judicial pronouncements.

Key words: Corporate Law, Company, Director, Punishment.

Introduction: According to Black’s law dictionary, director means persons appointed or elected according to law, authorized to manage and direct the affairs of a corporation or company. The Federal Court of Australia has held that directors are the most visible and important elements of a company. The Federal Court further observed that the actions by directors have a profound effect on the community and not just the employees, creditors and shareholders.¹ The English law defines director as, “In the Companies Acts “director” includes any person occupying the position of director, by whatever name called”². Under the Companies Act, 1956 (hereinafter referred to as the CA, 1956), the definition of Director reads as, ““director” includes any person occupying the position of director, by whatever name called”³. Both the above definitions are exactly the same when it comes to defining director. The High Court of Punjab and Haryana has held that whoever comes within the ambit of section 2(13) of CA, 1956 shall be answerable to give statement of affairs of company. The Court observed that “director” is an elastic term that does not classify the person’s liability by the tag that he has, but by the position that he occupies.⁴ If we see the definition of director under Companies Act, 2013 (hereinafter referred to as the CA, 2013), it says that ““director” means a director appointed to the Board of a company”⁵. Further the definition of Board reads as, ““Board of Directors” or “Board”, in relation to a company, means the collective body of the directors of the

¹ Australian Securities and Investments Commission v Healey (No 2) [2011] FCA 1003

² Companies Act, 2006, UK, section 250

³ Companies Act, 1956, section 2(13)

⁴ *Northland Sugar Complex Ltd. v. Sansar Chand Maini and Ors.*, (2009) 155 PLR 658

⁵ Companies Act, 2013, section 2(34)

company”⁶ This means a director constitutes the board of a company. The role of board of directors is quiet large ranging from corporate strategy planning to represent the interest of shareholders.⁷ With such intrinsic and essential duties, the director is ought to come within the scope of strict judicial and legislative sanctions.

Director’s accountability: A company is an artificial person and therefore it cannot perform task or function on its own. In the case of *Gas Lighting Improvement Co Ltd v Inland Revenue Commissioners*, Lord Sumner said that “Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person, real though artificial, the company itself, and the business carried on is the business of that company, and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham...the idea that it is mere machinery for affecting the purposes of the shareholders is a layman’s fallacy. It is a figure of speech, which cannot alter the legal aspect of the facts.”⁸ The law has interposed directors for the control of a company⁹. The role of director gets much wider when it comes to the investor’s interest and their grievances. This is because the investor is not aware of the internal functioning or the management of the company. Supreme Court has held that when a cheque issued by a company to an investor (payee in this case) is dishonoured then payee of a cheque that is dishonoured can be expected to allege is that the persons named in the complaint are in charge of its affairs. The Directors are prima facie in that position.¹⁰ The judgement is clear in the notion that directors are responsible to the investors as directors are the very face of the company. Directors thus become the vital drivers of a company. Since they are the strategic and financial drivers and act as bridge between the company and shareholders, they can safely be considered to be the first face of a company.

Question arises as to how the liability of a director will be adduced. Section 141 of Negotiable Instruments Act, 1881 (hereinafter referred to as the NIA) talks about the liability which has been imposed to the Directors, partners or other persons in charge of and control of the business of the company or otherwise responsible for its affairs. In the case of *Raghu Lakshminarayan v. Fine Tubes*¹¹, the Apex Court observed that a person who is in transaction with a company is entitled to presume the fact that directors of the company are in charge of the affairs of the company. Therefore section 141 of NIC would apply on directors as directors are the in charge of company and act for or on behalf of the company. The liability of every person in charge of the company at the time of offence has been dealt in many laws like Section 278B of the Income Tax Act, 1961, Section 22C of Minimum Wages Act, 1948,

Section 86A of the Employees State Insurance Act, 1948, Section 14A of Employees Provident Fund and Miscellaneous Provisions Act, 1952, Section 29 of Payment of Bonus Act, 1965, Section 40 of The Air (Prevention and Control of Pollution) Act, 1981 and Section 47 of Water (Prevention and Control of Pollution) Act, 1974.¹² This broadens the horizons of liability imposed on the person in charge of the company in case of any offence.

Deciphering the Mens Rea of a Company: In the case of *HL Bolton Engineering Co Ltd v TJ Graham & Sons Ltd*¹³, it was held that directors and managers represent the directing mind and will of the company and also control the company. It was further held that the state of mind of the managers and directors is the state of mind of the company per se. In strict legal sense, a company cannot be represented by employees of the company as they follow the directions given to them by the directors. The Board of directors are the brains and only brains of the company which is the body, and the

⁶ Companies Act, 2013, section 10

⁷ *Board of Directors: Duties & Liabilities*, Professor David F. Lareker, Stanford Graduate School of Business, www.gsb.stanford.edu/sites/default/files/.../03.Board%20Duties.pdf

⁸ [1923] AC 723, *Employee Participation in Governance: A Legal and Ethical Analysis*, By Michael Lower, page 74

⁹ Companies Act, 2013, section 2(27)

¹⁰ *N. Rangachari v. Bharat Sanchar Nigam Ltd.*, AIR 2007 SC 1682

¹¹ AIR 2007 SC 1634

¹² *K.K. Ahuja v. V.K. Vora and Anr.*, AIR 2011 SC 20

¹³ [1956] 3 All ER 624

company can and does act only through them.¹⁴ The case of *Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co Ltd.*¹⁵, concerned a cargo claim which Lennards sought to defend by contending that Section 502 of the Merchant Shipping Act exonerated the owner from losses arising without his actual fault. The House of Lords held that they could not rely on that defence since the fault of the appropriate organ such as the Board of Directors or managing Director could be attributed to the company. The Canadian Court has held that not only the Board of Directors would be seen as the directing mind of a company but also the Managing Director or any other person to whom authority has been delegated by the Board and it suffices that the act has been committed by a person on behalf of and within the capacity of the corporation.¹⁶ The Indian Courts have also stressed on the interpretation of corporate mens rea. For instance, the Bombay High Court did not see any reason for exempting a corporate body from criminal liabilities committed by the directors acting for or on behalf of the corporation. The Court further observed that a company acts through its managing directors or board of directors through their state of mind, intention, knowledge or belief ought to be treated as the act or omission including the state of mind, intention, knowledge or belief of the company.¹⁷ The Supreme Court has observed an important notion that Courts would be shirking their responsibility of imparting justice by holding that prosecution of a company is unsustainable merely on the ground that being juristic person it cannot be sent to jail to undergo the sentence. The fundamental question in front of the Apex court was whether company can be attributed with mens rea on the basis that those who work or are working for it have committed a crime. The Court held that since there is no law which talks about the imprisonment of a company, there is no other way other than to impose monetary fine on the company. The Supreme Court directed its view on legislative lacuna pertaining to offences made by or on behalf of the company.¹⁸

Meaning of Person: Person has been defined in different statutes. Under the General Clauses Act, 1897, (hereinafter referred to as the "GCA") person includes a company or association or body of individuals whether incorporated or not.¹⁹ Under the Indian Penal Code (hereinafter referred to as the "IPC"), a same definition of person has been given.²⁰ According to both the definitions, person includes a company. This means that all the criminal acts which are covered by IPC are applicable on an individual as well as a company also. For example, if the director of a company is aware of any information which if not disclosed to the shareholders, the shareholders can be harmed in monetary sense and the director conceals such fact then such an act of the director will be covered by section 415 of IPC which talks about cheating. Again, the act of cheating is committed by the director on behalf of the company as he is representing the company per se. It must be observed here that in the IPC, GCA and the Income Tax Act, 1961²¹, the definition of person includes a company in all the three statutes. This shows the legislative intention of giving a company the status equal to a living person. In this respect, doctrine of identification plays a pivotal role. The doctrine of identification (also known as the alter ego theory) says that a company is identified with such of its key personnel through whom it works. A corporate entity can play hide and seek under its complex management structure so that the criminal liability is not imposed on a single person. In many English cases it has been held that the corporate personalities could be subjected to criminal action and the companies were held liable for crimes requiring mens rea²². In light of the above, the doctrine of identification was disseminated so as to put liability of the crimes committed by the people in charge of running the company. However, in the case of *R v. P & O European Ferries (Dover) Ltd*²³, a large corporate evaded liability under the common law test because a single directing mind could not be identified

¹⁴ Neville J. in *Bath v. Standard Land Co.* (1910) 2 Ch. 408 at p. 416

¹⁵ [1915] AC 705 HL

¹⁶ *Canadian Dredge and Dock Co. v. R.*, (1985) 11 RCSC 662

¹⁷ *State of Maharashtra v. Syndicate Transport Co. (P) Ltd. and Ors.*, AIR 1964 Bom 195

¹⁸ *The Assistant Commissioner, Assessment-II, Bangalore and Ors. v. Velliappa Textiles Ltd. and Ors.*, AIR 2004 SC 86

¹⁹ General Clauses Act, 1897, section 3(42)

²⁰ Indian Penal Code, 1860, section 11

²¹ Income Tax Act, 1961, section 2(31)

²² *D.P.P. v Kent and Sussex Contractors Ltd*, [1944] K.B, 146; *Moore v Bresler Ltd*, [1944] 2 All ER 515

²³ [1991] 93 Cr. App. R 72

despite eight defendants being brought to trial. In such cases when the management structure is complex then determination of liability also becomes very difficult. A question arises as to whether the director of a company will always be held liable for any criminal act committed by the company or not. In the case of *Harshendra Kumar D. v. Rebatilata Koley Etc.*²⁴, the Supreme Court held that a director whose resignation has been accepted by the company and that has been duly notified to the Registrar of Companies cannot be made accountable and fastened with liability for anything done by the company after the acceptance of his resignation.

Under section 447 of CA, 2013, a stringent punishment has been obtruded on any person who commits fraud. An imprisonment up to 10 years and fine up to 3 times the amount involved in fraud has been imposed. Person has not been defined anywhere in the entire CA, 2013. In the language of section 447, it is confusing when it says “any person who is found to be guilty of fraud”, this means the person can be an employee, a key managerial person, etc. If we safely assume that the definition of person as referred in the above line is referring to the individuals of the company then sanction under section 447 implies to any individual involved in a particular transaction. Hence, even in a complex management structure, any individual can be easily identified in case of a fraud committed by such individual.

Approach of CA, 2013 : When the definition of ‘person’ includes a company then it is natural that same sanctions will apply to a company which apply to an individual.²⁵ In this regards, the Supreme Court has held that there is no immunity for corporate from prosecution merely because it is in respect of offences for which punishment of imprisonment is mandatory.²⁶ It is important to see the definition of penal statute in this regards. Section 417 of IPC penalises any person who is convicted of cheating. It reads as, “Whoever cheats shall be punished with imprisonment of either description for a term which may extend to one year, or with fine, or with both”. The legislative intention from the above definition is clear as it has not used the word “And” between imprisonment and fine. The word “OR” helps to know the intention of legislature as they are aware that juristic person like a company cannot be imprisoned. Only monetary sanction can be imposed on such juristic person. The Supreme Court made a similar observation in *Standard Chartered Bank case*²⁷. Under the CA, 2013, the word “And” has been used between imprisonment and fine. Section 447 reads as, “any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud”. This means both fine and imprisonment will be applicable on anyone involved in the act of fraud.

In terms of determining the corporate mens rea, it is very important to determine the liability of individual person who is assigned to a task which is criminal in nature. This task when converted into actus reus, imposes criminal liability on the company per se. If the person involved in such a task is identified in the first instance then it becomes easy to determine the corporate mens rea of the company. In this view, the CA, 2013 has addressed to a very important aspect of corporate crimes which is insider trading. Insider trading was not dealt in CA, 1956. Under the CA, 2013, a very strict sanction has been made for any person who commits insider trading. A fine up to 25 crore has been made for any person involved in insider trading. Apart from monetary fine, an imprisonment for up to 5 years has also been made for the same.²⁸ This provision can help in determining corporate mens rea as not the entire company but the person who was involved in the act of insider trading is made liable and ones that person is identified, he/she will face sanction and not the entire company (as only the concerned person will be liable to pay fine or face imprisonment and not anyone else on behalf of the company).

²⁴ AIR 2011 SC 1090

²⁵ *Supra*, footnote number 20, 21

²⁶ *Standard Chartered Bank and Ors. v Directorate of Enforcement and Ors.*, AIR 2005 SC 2622

²⁷ *Supra*, footnote number 28

²⁸ Companies Act, 2013, section 195(2)

Recently Sahara India Real Estate Corporation Ltd faced the decision given by Supreme Court on its illegal method of raising money²⁹. The Company is yet to refund the hefty amount of Rs. 17,400 crores with 15% interest. This has not only troubled the directors of the company but has also lost the trust of investors who earlier had invested in the company and also lost the future investors. In this way, the company had to suffer both monetary and goodwill loses. Juristic entity like a company cannot be jailed but a loss of goodwill is the most vital loss to any company.

Conclusion: In the case of *The Assistant Commissioner, Assessment-II, Bangalore and Ors. v. Velliappa Textiles Ltd. and Ors*³⁰, Hon'ble Justice S. Rajendra Babu observed that there are countries which have taken a different form for imposing a sanction on companies. He gave the example of Germany, where a sort of administrative sanction to deviant corporations is made and the country does not recognize criminal liability of corporations. In the CA, 2013 there is no such provision which talks about an administrative sanction on corporations. In lieu of this, individual persons are made liable for their acts depending upon their respective positions that they hold in the company. When it has been held and observed in legislative as well as judicial pronouncements that a company is not a natural person but is a juristic person then it becomes necessary to have a punishment which is different from a punishment as imposed on a natural person. An administrative sanction on a natural person would be infinitesimal as a natural person may escape from such sanction. However a punishment of imprisonment would be ideal for a natural person. However such a punishment may not serve the purpose of justice as in case of a company. Nevertheless, from a holistic view, the director of a company is the very mind and thought mechanism of a company. Prima facie it is his responsibility to drive the company. His liabilities are in addition and not in derogatory with the liability of individual persons of a company. This is because the company functions on the very directions and guidelines given to its management and employees by the director or the board of directors. Hence a director cannot dodge from his liability per se.

²⁹ *Sahara India Real Estate Corporation Ltd. and Ors. v. Securities and Exchange Board of India*, (2013) 1 SCC

³⁰ AIR 2004 SC 86