§166(3) OF THE COMPANIES ACT, 2013: FILLING THE GAPS OF AN INCOMPLETE PROVISION

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Companies are the predominant vehicle through which businesses operate. They have a tremendous impact on society, and in this context, it is important to understand the responsibility placed on the decision-makers –the directors – of companies. In India, the key provision that places responsibility on company directors is§166(3) of the Companies Act, 2013 ('the Indian Companies Act'), which codifies the duty of care owed by company directors. In this paper, we analyse§166(3) of the Indian Companies Act in detail. In our analysis, we note that §166(3), in its current form,leaves important gaps in the director's duty of care. First, §166(3) does not specify to whom the duty of care is owed to, which significantly impacts the nature of the obligation. Second, the provision does not provide for a standard for the duty of care. In this paper,we argue that the duty of care is, and should only be owed to the company. This is in contrast to the duty of good faith in §166(2) of the Indian Companies Act and the duty of care in the United Kingdom ('UK'), which isowed to all stakeholders. Further, we argue that absent any express standard for the duty of care, India would be best served in adopting the ordinary reasonable man standard developed under tort law, which is objective in nature. We argue that standards found elsewhere, such as the subjective standard, the subjective-objective standards of agency law, the UK Companies Act, 2006, and the business judgement rule in the United States of America are not suitable for India. We conclude by postulating the objective reasonable man standard as best-suited to the Indian corporate landscape, which will bring much-needed clarity to the duty of care of the directors.

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I. INTRODUCTION

As companies grow bigger, so does their potential to cause harm. In the recent past, companies have been pulled up for storing and misusing data obtained from customers,[1] misleading the public through advertisements,[2] displacing communities,[3] damaging the environment,[4] and selling drugs to teenagers,[5] to mention a few. One only needs to look at the financial crises that occurred in the recent past in order to comprehend the impact that companies can have, not just in the countries where the operate, but across the world.[6] The potential for such crises is only increasing, with a growing number of companies now being valued at sums that are greater than the annual gross domestic product of several developed countries.[7]

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1 Business Insider India (Sarah Jackson), *Meta Agrees to Pay $90 million to Settle a Lawsuit Alleging Facebook Kept Tracking Users After They Logged Off*, February 16, 2022, available at https://www.businessinsider.in/tech/news/meta-agrees-to-pay-90-million-to-settle-a-lawsuit-alleging-facebook-kept-tracking-users-after-they-logged-off/articleshow/89603510.cms (Last visited on March 18, 2022).

2 Reuters (Renju Jose), *Australian Watchdog Sues Facebook-owner Meta over Scam Advertisements*, March 18, 2022, available at https://www.reuters.com/technology/australia-watchdog-sues-facebook-owner-meta-over-false-cryptocurrency-ads-2022-03-17/ (Last visited on March 18, 2022).

3 Smitu Kothari, *Whose Nation? The Displaced as Victims of Development*, Vol.31, Economic and Political Weekly, 25 (1996).

4 The Guardian (Matthew Taylor& Jonathan Watts), *Revealed: The 20 firms Behind a Third of all Carbon Emissions*, October 9, 2019, available athttps://www.theguardian.com/environment/2019/oct/09/revealed-20-firms-third-carbon-emissions (Last visited on March 18, 2022).

5 The Economist, *What Are Companies For?*, August 22, 2019, available at https://www.economist.com/leaders/2019/08/22/what-companies-are-for (Last visited on March 18, 2022).

6 *See generally* Renae Merle, *A Guide to Financial Crisis – 10 Years Later*, Washington Post, September 10, 2018, available at https://www.washingtonpost.com/business/economy/a-guide-to-the-financial-crisis--10-years-later/2018/09/10/114b76ba-af10-11e8-a20b-5f4f84429666_story.html (Last visited on March 18, 2022).

7 Omri Wallach, *The World's Tech Giants, Compared to the Size of Economies*, Visual Capitalist, July 7, 2021, available at https://www.visualcapitalist.com/the-tech-giants-worth-compared-economies-countries/ (Last visited on March 18, 2022).

However, with the exception of imposing fines and penalties in specific cases,[8] there is little that the law does to provide for the potential harm that companies may cause.[9] Companies, bestowed with the features of a separate legal personality, limited liability, transferable shares, delegated management, and investor ownership, have been designed to maximise business and minimise responsibilities.[10] It has allowed individuals, who would otherwise be held legally and morally responsible for their actions, to pursue profit, at the cost of all else, with impunity.

Is it time to reconsider these principles of corporate law that legally separate companies from the individuals that operate it? Recently, the directors of multinational oil and gas conglomerate Shell were sued by the shareholders of the company for failing to prepare the company for the global shift to a low carbon economy.[11] A court in Australia held the directors of a company responsible for the defamatory actions they had engaged in through their company.[12] Closer to home, the Delhi High Court held the directors of a company liable for the dishonour of a cheque issued in the name of the company.[13]

To stay relevant and effective, corporate law must continuously evolve and adapt to accommodate new perspectives of the different stakeholders affected by companies.[14] Since directors are central to the operation of companies, it is important to understand the legal responsibilities that directors have when operating these companies. It is from this perspective that we analyse the responsibilities of directors for their companies under existing laws in India.

In India, the duties of directors have been codified in §166 of the Companies Act, 2013 ('the Indian Companies Act'). §166 provides for certain specific duties which require a director to act in accordance with the articles of association of the company,[15] and prohibits directors from *first* getting involved in a situation where she has a direct or indirect conflict of interest with the company,[16]

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[8] *See* The Companies Act, 2013, §§12(8),15,39,42(10),60,136,189,190; The Air (Prevention and Control of Pollution) Act, 1981, §40; The Personal Data Protection Bill, 2019, §84(3); The Competition Act, 2002, §48(1) (this is apart from the duties of directors under the Indian Companies Act which is discussed as a potential resource to hold individuals running a company responsible in this paper).

[9] Courts have applied the principle of 'piercing the corporate veil' to hold the directors of a company responsible in certain instances. However, this principle is not effective in imposing responsibilities on individuals who operate companies since it is applicable to a limited set of circumstances and requires engaging in litigation. For an assessment of the same, *see* David K. Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, Vol.56, Emory L. J., 1305(2007).

[10] Reiner Kraakmanet al., The Anatomy of Corporate Law: A Comparative and Functional Approach, 4-5 (Oxford University Press, 3rd ed., 2017).

[11] *Id*.

[12] De Kauwe v. Cohen, (No. 4)-2022 WASC 35.

[13] Hari Shamsher Kaushik v. Jasbir Singh, 2022 SCC OnLine Del 1379.

[14] *Id*., 98-99; Kraakman, *supra* note 10, at 24.

[15] The Companies Act, 2013, §166(1).

[16] *Id*., §166(4).

second making undue gains at the cost of the company,[17] and *third* assigning her office.[18] §166 also lays down certain general duties, which require directors to act in good faith for the benefit of the company, its members as a whole, its employees, shareholders, community and environment and places a duty of care, skill and diligence on a director.[19] §166 also lays down the liability of the director if she is in breach of any of the duties mentioned.[20]

In this paper, we analyse the general duty of care placed upon directors under §166(3) of the Indian Companies Act. The provision requires the directors to exercise her duties with due and reasonable care, skill and diligence, and exercise independent judgement. In this context, we particularly analyse two questions –*first*, to whom the duty of care under §166(3) is owed to, and *second*, the standard of duty of care that is expected from directors under the said provision.

In Part II, we set out our analysis of whom the duty of care under §166(3) is owed to. We compare the statutory embodiment of the duty of care with the duty of good faith under§166(2) of the Indian Companies Act, and distinguish it from the enlightened shareholder value approach ('ESV approach') that is followed under §174 of the United Kingdoms' ('UK') Companies Act, 2006 ('UK Companies Act'). We conclude by arguing that the duty of care under §166(3) is only owed to the company.

In Part III, we begin our analysis of the standard of duty of care under §166(3) by demonstrating, through rulings of Indian courts, the inconsistency in the application of the duty of care under the Indian Companies Act and the erstwhile Companies Act, 1956 ('the 1956 Act'). We attribute this inconsistency to the failure of the legislature to include the standard of duty of care in the Indian Companies Act and the erstwhile 1956 Act.

Subsequently, in Part IV, we look at various standards of duty of care applied in the context of company directors in other jurisdictions, as well as the application of the duty of care in agency law, with the objective of identifying a suitable standard for the duty of care under §166(3) of the Indian Companies Act. Specifically, we examine the subjective standard and the combined 'subjective-objective standard' applied in the context of company directors in the UK, the business judgment rule applied in the context of company directors in the United States of America ('USA') and the standard of duty of care applicable to agents in India.

In Part V, we continue our analysis of the standard of duty of care by imagining the application of the 'reasonable man standard', typically applied

[17] *Id.*, §166(5).
[18] *Id.*, §166(6).
[19] *Id.*, §§166(2), 166(3).
[20] *Id.*, §166(7).

in the law of torts, to company directors. We examine the feasibility of applying an objective reasonable man standard for the directors' duty of care. Further, we enquire whether directors should be equated with professionals and be subjected to a higher standard of care. We conclude that it is feasible to apply a reasonable man standard on directors without the judiciary replacing the commercial wisdom of directors. We also argue that directors should not be treated as professionals for the purpose of determining the standard of the duty of care.

In Part VI, we discuss the application of the reasonable man standard in different scenarios and juxtapose the outcome against the prevailing standards in the UK, the USA, and under agency law. We conclude this part by noting that the reasonable man test consistently leads to the most desirable outcomes and should be used to determine breaches of the duty of care under §166(3) of the Indian Companies Act.

In Part VII, we conclude the paper by observing that the duty of care, as set out in §166(3) of the Indian Companies Act, is owed only to the company and the reasonable man standard should be imported into §166(3) of the Indian Companies Act.

II. THE DUTY OF CARE: TO WHOM IS IT OWED?

§166(3) of the Indian Companies Act, which states the director's duty of care, does not specify whom this duty is owed to. A determination of the same is significant in assessing the standard of duty of care, and raises important questions, such as whether the duty of care is owed uniformly to all stakeholders.[21] In this part, we attempt to interpret §166(3) and determine the individuals or entities to whom this duty of care is owed. In doing so, we analyse the relevance of the stakeholder approach that is embodied under§166(2), which houses the duty of good faith, in interpreting §166(3).[22] We then analyse the different approaches that are traditionally followed in relation to the director's duty of care and explore whether their viability in the context of §166(3).

A. APPROACHES TO DIRECTORS' DUTIES

The natural corollary of a director's duty is a corresponding right holder. Under common law, this right holder was the company.[23] It did not include

21 Linda Spedding, India: The Business Opportunity, 308-310 (Hart Publishing, 2016).

22 The duty of care under §166(3) is distinct from the duty of good faith under §166(2), *see* Irani Committee Report, *Management and Board Governance, Duties and Responsibilities of Directors*, ¶¶18.1-18.3 (May 31, 2005); Mihir Naniwadekar & Umakanth Varottil, *The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis*, 11 (NUS Law Working Paper Series, Paper No. 16/03, 2016).

23 Percival v. Wright, (1902) 2 Ch 421; Simon Mortimore, Company Directors Duties, Liabilities and Remedies, ¶14.12 (Oxford University Press, 2013).

shareholders, employees, or the community.[24] However, this view has been consistently challenged by scholars who believe that the place that companies occupy is significant and influential, and therefore, companies must hold wider duties towards their employees, the shareholders, the community, and the environment ('the stakeholders').[25]

The tussle has led to the emergence of three broad approaches – the *first* approach states that the duty of directors is towards all stakeholders. Under this approach, each stakeholder has an individual cause of action against the directors if the duty is breached.[26] The *second* approach states that the duty of care is owed to the company alone, as under common law. This approach, commonly known as the shareholder approach, represents the traditional view in corporate law, where the directors are responsible solely to the company, to the exclusion of all others.[27] This does not mean that directors cannot account for the interest of stakeholders, but it would be entirely upon the discretion of the directors to do so.[28]

The *third* approach, which is the ESV approach,states that recognising the interests of the stakeholders can complement the interests of the company.[29] The ESV approach is an approach that seeks to strike a balance between the shareholder and the stakeholder approach. Introduced through the UK Companies Act in England, it states that directors owe a duty only to the company but must have regard to the interests of the stakeholders while making these decisions.[30] The underlying idea is that the interest of the company is also benefitted in the long term by considering the interest of the stakeholders.[31]

B. §166(2) AND THE RELEVANCE OF STAKEHOLDERS

While §166(3) does not mention the people to whom directors owe the duty of care, §166(2) states that the duty of good faith is owed to all stakeholders, i.e. the employees, the shareholders, the community, and the environment. In this sub-part, we analyse whether §166(2) truly follows the stakeholder or pluralist

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24 Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach*, Vol.29, Sydney L. Rev., 577-581 (2007).

25 *See* The Companies Act, 2013, §166(2); Naniwadekar & Varottil, *supra* note 22.

26 Umakanth Varottil, *The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony,* Vol.30, Am. U. Int'l L. Rev., 39(2016).

27 *See* Percival v. Wright, (1902) 2 Ch 421; Mortimore, *supra* note 23, at ¶14.12.

28 Naniwadekar & Varottil, *supra* note 22, at 4; Hutton v. West Cork Railway Co., (1883) 23 Ch D 645, 673.

29 Naniwadekar & Varottil, *supra* note 22, at 11.

30 *See* Deryn Fisher, *The Enlightened Shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties?*, Vol.20, I. C. C. L. R.,10-16(2009); Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach"*, Vol.29, Sydney L. Rev.,592 (2007); Virginia Harper Ho,*"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*,Vol.36, J.Corp. L., 79(2010).

31 *Id.*

approach, and if so, whether this impacts the interpretation to the duty of care under §166(3). §166(2) states,

> "A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment."[32]

A plain reading of the provision suggests that the stakeholder approach has been prescribed for the duty of good faith.[33] However, this is the only sub-section of §166 which specifically provides for the duty of a director to be owed to all stakeholders. As mentioned earlier, there is no such mention of a duty-holder under§166(3).

We must, therefore, consider whether the duty of care, under §166(3) can be read to be owed to all stakeholders. Here, we argue that this duty of care is owed only to the company. This is due to four reasons.

First, the mention of stakeholders for §166(2), but not the other subsections under§166 indicates that it was the intention of the Parliament to exclude stakeholders from the benefit of the other duties. The difference in the nature of the duties enlisted under §166 also indicates that it is not possible to readily impute an approach applicable for one duty to another. For example, if the duty of care were to be owed to all stakeholders, then a need to hierarchise the interest of the different stakeholders is likely to arise, as stakeholders may have conflicting interests.[34] However, for the duty of good faith under §166(2), the need to hierarchise does not arise, since the duty of good faith simply requires that the interests of all stakeholders be considered fairly;[35] that is, any injury or lack of benefit to a stakeholder does not give rise to an action under §166(2) if it can be proved that the action taken

[32] The Companies Act, 2013, §166(2).

[33] In their paper, Mihir Naniwadekar and Umakant Varottil have argued that the duty of good faith under §166(2) is ultimately owed to the company itself. This is contrary to the literal meaning of §166(2). They base their assertion on two arguments –*first*, stakeholders are mentioned only to be considered as factors in the decision-making process, and second, they do not have a justiciable right to sue the directors if they fail in this duty towards them. Their understanding of §166(2) is premised on the previous law. They cite certain cases that in effect allowed for derivative actions filed by employees and creditors through the company. This, coupled with the lack of clarity in the provision, according to them, means that the provision must be understood to restate the law that existed prior to the enactment of the 2013 Act. However, we disagree with the inference drawn by Naniwadekar and Varottil from these cases. *First*, in the cases cited, courts held the directors responsible to the employee and creditor, not because they envisaged an ESV approach, but because of larger considerations of 'public interest' and justice in the given factual matrices of the respective cases. *Second*, the plain text of §166(2) clearly indicates a pluralist approach, without any ambiguities. *See* Naniwadekar & Varottil, *supra* note 22, at 2.

[34] Kingsley O. Mrabure & Alfred Abhulimhen-Iyoha, *Corporate Governance and Protection of Stakeholders Rights and Interests*, Vol.11, Beijing L.Rev., 305 (2020).

[35] *Id*.

was in good faith, after considering all possible alternatives and in the best interests of the stakeholders.[36] Thus, rules of statutory interpretation would not permit extending the stakeholder approach to §166(3).

Second, the law prior to the enactment of the Indian Companies Act placed the duty of care solely towards the company.[37] The prior law holds significance in this instance since §166(3), unlike §166(2), does not explicitly answer the question of whom the duty of care is owed to. In the absence of any change prescribed by §166, it would be fair to impose the law that existed prior to the enactment.[38]

Third, and perhaps the most important objection, is that the duty of care is a fiduciary duty in India and consequently, cannot be extended to all stakeholders.[39] A fiduciary relation is created by placing trust upon the director and is an onerous duty. It is impossible to create or impute such a relationship between the director and all other stakeholders, even fictionally, unless the nature of this duty is changed fundamentally. In most fiduciary relations, such as that of a trustee-beneficiary relationship, for instance, it is the agreement that is signed by both parties that indicates the nature of the relationship.[40] In others, such as a guardian-ward relationship, it is the social position of the guardian that places fiduciary obligations upon her.[41] There exists no specific relation between directors of a company and the environment, employees, or the community, and thus, no fiduciary duty of care can be imputed on a director. In the UK, for instance, the ESV approach is followed in relation to the duty of care. However, the UK Government in their Parliamentary discussions explicitly state that the duty of care under §174 of the UK Companies Act is not a fiduciary duty.[42]

Fourth, it has been argued that the duty of care falls within the ambit of the duty of good faith, and therefore, the duty of care must also be owed to the stakeholders.[43] In the Indian context, however, the distinction between these two duties is well documented.[44] Further, the distinct exposition of the duty of good

36 Naniwadekar & Varottil, *supra* note 22, at 10.

37 Percival v. Wright, (1902) 2 Ch 421; MORTIMORE, *supra* note 23, at ¶14.12; Sangramsinh P. Gaekwad v. Shantadevi P. Gaekwad, (2005) 11 SCC 314, ¶51; Nanalal Zaver v. Bombay Life Assurance Co. Ltd., 1950 SCC 137, 416-17; Kamal Kumar Dutta v. Ruby General Hospital Ltd., (2006) 7 SCC 613, ¶42.

38 Bank of England v. Vagliano Brothers, (1891) AC 107, 83.

39 MORTIMORE, *supra* note 23; Dale and Carrington Invt. (P) Ltd. v. P.K. Prathapan, (2005) 1 SCC 212; Vijay P. Singh, *Directors' Fiduciary Duties to the Company: A Comparative Study of the UK and Indian Companies Act*, Vol.27(1),TRUST & TRUSTEES, 139 (2021).

40 Frank H. Easterbrook &Daniel R. Fischel, *Contract and Fiduciary Duty*,Vol.36,JOURNAL OF LAW & ECONOMICS, 427 (1993).

41 The Contract Act, 1872, §11.

42 Lord Goldsmith, Lords Grand Committee, February 9, 2006, Column GC 336, Hansard.

43 *See* Daniel Engster, *Care Ethics and Stakeholder Theory* in APPLYING CARE ETHICS TO BUSINESS, 93 (Springer, 1st ed., 2011);Christopher M. Bruner, *Is the Corporate Director's Duty of Care a Fiduciary Duty – Does It Matter?*, Vol.48, WAKE FOREST L. REV., 1032 (2013).

44 IRANI, *supra* note 22; Naniwadekar & Varottil, *supra* note 22.

faith and the duty of care under the Indian Companies Act makes such an argument difficult to sustain.

Thus, it can be concluded that §166(3) does not adopt the stakeholder approach.

C. §166(3) AND THE ESV APPROACH

In the previous sub-part, we noted that the existing law, prior to the enactment of the Indian Companies Act, stated that the duty of care is owed only to the company and not the stakeholders. In this sub-part, we explore whether it is desirable to read the Indian Companies Act in a manner that allows for the application of the ESV approach.

The ESV approach was introduced under the UK Companies Act as a compromise between the shareholder and stakeholder approach. It attempts to balance the conflicting interests by noting that the company's interests are better addressed when they consider the overall interests of the stakeholders. While there is no statutory basis to apply such an approach to §166(3) of the Indian Companies Act, we analyse whether it would be desirable to apply such an approach.

In our opinion, it is not desirable to apply the ESV approach to §166(3), primarily because it does not result in any real change to the shareholder approach. Despite the inclusion of stakeholders under the ESV approach in the UK, in practice, the duty of care is ultimately owed to the company, and is thus, similar to the shareholder approach. It does not allow stakeholders to make a claim against directors if their interests are not considered by directors, and even under this approach, the interest of the shareholders is still considered to be paramount.[45]

Scholars have argued that the ESV approach is simply a modern equivalent of the traditional shareholder value approach.[46] Much like the traditional shareholder value approach, the ESV approach recognises stakeholder interests as "instrumental" to further long-term shareholder interests.[47] From a legal perspective, companies and their directors would not be affected whether the approach under §166(3) is the shareholder approach or the ESV approach. In both approaches, the responsibility upon directors is to maximise value for shareholders. It is only that in the ESV approach, one important means of maximising value, i.e. recognising the interests of stakeholders, is explicitly mentioned. Equally, in both approaches, a conflict between the interests of the shareholder and stakeholders is likely to result in a decision made in favour of the shareholder.[48]

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[45] Naniwadekar & Varottil, *supra* note 22, at 12.

[46] Lucian Bebchuk et al., *Does Enlightened Shareholder Value Add Value?* Vol.77, The Business Lawyer, 2(2022).

[47] Harper Ho, *supra* note 30.

[48] Bebchuk, *supra* note 46.

It has been argued that the ESV approach will reduce myopic decision-making and lead to stakeholder welfare in the long run.[49] However, the relationship between long-termism and stakeholder welfare is itself tenuous. There are short-term decisions that are stakeholder-friendly such as giving bonuses to employees or lowering prices for customers. At the same time, there are long-term strategies that are detrimental to stakeholders. For instance, a company could relocate its manufacturing plants to reduce costs which would lead to unemployment at the original plants.

Thus, the ESV approach, even if read into §166(3) of the Indian Companies Act, is practically identical to the traditional shareholder approach and would not result in any real change. Thus, we conclude that the duty of care under §166(3) should not be read to incorporate the ESV approach.

III. THE STANDARD OF DUTY OF CARE IN INDIA

In this part, we will analyse the Indian jurisprudence on the standard of care of directors to highlight the inconsistency in its application in judicial rulings.

India attempted to import a standard of care from the English jurisprudence. However, even English jurisprudence was not uniform and consistent in its application.[50] While the debate has now settled in England because of the UK Companies Act,[51] the Indian Companies Act failed to codify the Indian jurisprudence on the point, leaving it open for courts to determine, as discussed below.

The Rajinder Sachar Committee, which was set up to suggest changes to the 1956 Act, and the Monopolies and Restrictive Trade Practices Act, 1969,[52] stated, without a detailed discussion, that the standard of duty of care is that of a 'reasonable man'.[53] However, unlike the UK, where the standard of duty of care flows from §174(2) of the UK Companies Act,[54] in India, the standard of duty of care has largely developed through judicial rulings on the subject.[55] This is because the 1956 Act did not explicitly have a provision dedicated to the duty of care by the directors. While the Supreme Court of India has attempted to bridge this gap under the 1956 Act, (which was modelled on UK Companies Act, 1948[56]) by

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[49] *Id*.

[50] Mortimore, *supra* note 23, at ¶14.05.

[51] *Id*.

[52] Rajinder Sacher Committee, *Report of the High-powered Expert Committee on Companies and MRTP Acts* (August 29, 1978).

[53] *Id*.,¶5.14.

[54] Mortimore, *supra* note 23, at ¶14.02.

[55] *See* David Bennet et al., Palmer's Company Law: Annotated Guide to The Companies Act, 2006, 175 (Sweet & Maxwell, 2nd ed., 2009); Mortimore, *supra* note 23, at ¶¶14.05-14.06.

[56] Sahara India Real Estate Corpn. Ltd. v. SEBI, (2013) 1 SCC 1, ¶54 (per Radhakrishnan J.).

mirroring the application of the standard of duty of care in the UK,[57] it has failed to do so consistently.[58]

For instance, in the cases of *Official Liquidator, Supreme Bank* v. *P. A. Tandolkar* ('P.A. Tandolkar')[59] and *N. Narayanan* v. *Adjudicating Officer, SEBI*,[60] the court attempted to apply an objective standard of the duty of care.[61] In both cases, however, the court took note of subjective factors such as the time spent by the director in the company and the experience of the director in managing the company to determine their liability.[62] Further, the ruling in *P.A. Tandolkar* has been interpreted to hold that a director's close association with a company for a long period of time is a relevant factor in determining their liability for fraud in the conduct of business.[63]

In a similar case, an independent director was found to have failed in their duty to exercise due care and diligence by allowing the company to fabricate figures.[64] The adjudicatory body of the Securities and Exchange Board of India ('SEBI') noted that the director, being a member of the audit committee, should have known the unreliability of the figures.[65] The court did not elaborate any further on the metrics used. However, it appears that the court applied a notion of reasonable knowledge and a consequent duty to disclose. The position and subjective circumstances of the director were crucial to the court's analysis. In a couple of other cases, the terms "utmost care and skill and due diligence" was used without any finding on the same.[66] Thus, in these rulings, courts have used circumstances subjective to the director while claiming to apply an objective standard of duty.

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57 *See* Supreme Bank Ltd. v. P.A. Tendolkar, (1973) 1 SCC 602, ¶¶37-52; N. Narayanan v. SEBI, (2013) 12 SCC 152, ¶¶32-40 ('N. Narayanan'); Ajay Surendra Patel v. CIT, 2017 SCC OnLineGuj 136, ¶¶12.1-12.2; Gururaja Rao v. State of Karnataka, 1979 SCC OnLine Kar 91, ¶¶14-18.

58 *Id*. (in these cases, the courts seem to adopt an objective standard by placing a minimum standard that all directors must be expected to adhere to. At the same time, the court accounts for the time spent by the director at the company to determine the standard of care owed by that director).

59 Supreme Bank Ltd. v. P.A. Tendolkar, (1973) 1 SCC 602, ¶¶37-52.

60 N. Narayanan, *supra* note 57.

61 *Id*., ¶33 (in this paragraph, the court cites the *P.A. Tendolkar case* to import a duty of care. The test stipulated that if a person was closely associated with the management of the company for a long time, they shall be deemed to be liable for fraud in the conduct of business,even though no specific act of dishonesty may be proved against them).

62 *Id*., ¶31;Supreme Bank Ltd. v. P.A. Tendolkar, (1973) 1 SCC 602, ¶45.

63 Ramsarup Industries Ltd., In re,2013 SCC OnLine SEBI 172, ¶22.

64 Securities and Exchange Board of India, Adjudication Order in respect of Shri. N. Narayanan and Shri. V. Natarajan in the Matter of Pyramid Saimira Theatre, 2011 SCC OnLine SEBI 66, Adjudicating Order No. BM/AO- 110-111/2011, ¶28.

65 *Id*., ¶33.

66 Sangramsinh P. Gaekwad v. Shantadevi P. Gaekwad, (2005) 11 SCC 314, ¶60; Dale & Carrington Invt. (P) Ltd. v. P.K. Prathapan, (2005) 1 SCC 212, ¶11; Franklin Templeton Mutual Fund, In re, 2021 SCC OnLine SEBI 837, ¶10; Securities and Exchange Board of India, Order dated January 21, 2020, in respect of Legal Representatives of Late Shri Y.N.Saxena in the matter of Sahara India Commercial Corpn. Ltd., 2019 SCC OnLine SEBI 233, ¶50.

The enactment of the Indian Companies Act has not clarified the position, as §166(3) does not explicitly provide for the standard of duty of care. Judicial rulings on §166(3) have also been sparse and inconclusive.[67] For instance, in a case which involved determining whether a director made personal gains at the cost of the company under §166(5), the Delhi High Court mentioned in passing that the director's actions demonstrated a lack of due and reasonable care and relied on §166 of the Indian Companies Act, and the Indian Trusts Act, 1882, to hold that the director had a fiduciary duty towards the company.[68] However, the court restricted its analysis to §166(5), and did not provide clear standard of care under §166(3).

Similarly, the Delhi High Court noted in passing that the directors owe a duty of care to the company to not act negligently in the management of affairs with the standard of a 'reasonable man' looking after their own affairs.[69] However, the case was concerned with the director's personal gains and entailed a subjective analysis of the director's position in the company.[70] Again, the case revolved around a conflict of interest and was not focused on the breach of duty of care.

Therefore, we see that Indian courts do not have a clear and consistent application of a standard of care for the duty of directors, which has led to a lack of a definitive position on this issue.

IV. THE DIFFERENT POSSIBLE STANDARDS OF THE DUTY OF CARE

In the previous part, we concluded that the standard of duty of care applicable in India is currently unclear, owing to the lack of legislative guidance and sparse and inconsistent judicial rulings on the issue. Since the question of the standard of duty of care applicable in India is open, in this part, we investigate the desirability of different standards of care that may be applied to company directors in India. These standards may broadly be compartmentalised into subjective standards and combined objective-subjective standards.

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67 Ernest Lim & Umakanth Varottil, *Climate Risk: Enforcement of Corporate and Securities Law in Common Law Asia*, NUS Working Paper No 2022/006, May, 2022, available at https://deliverypdf.ssrn.com/delivery.php?ID=712085084074108101024086027066066002122081004009095091026100085078100125069008012026018029054101050127023017087093103124003070058082046034028104103103108018096029121001093035068125006093122088125117106027115095079111095093004087127017104110027099122098&EXT=pdf&INDEX=TRUE (Last visited on March 30, 2022).

68 Rajeev Saumitra v. Neetu Singh, 2016 SCC OnLine Del 512, ¶52.

69 Su-Kam Power Systems v. Kunwar Sachdev, 2019 SCC OnLine Del 10764, ¶71.

70 Interestingly, the judgment cited a ruling of the Delhi High Court delivered in 1983, which in turn refers back to the Rajinder Sachar Committee report for the standard of duty of care, *see* Globe Motors Ltd. v. Mehta Teja Singh,1983 SCC OnLine Del 193, ¶8.

A. THE SUBJECTIVE STANDARD

The subjective standard of the duty of care was applied to company directors in the UK before it was replaced by the combined objective-subjective standard introduced by the UK Companies Act.[71] The subjective standard was developed through case law and was most clearly laid down in *Re Equitable Fire Insurance*[72] as a standard that applies the duty of care on the basis of the skill and experience of the director. In this case, which came after a string of cases that followed the subjective standard,[73] the company in question had suffered losses to the tune of 1.2 million pounds on account of fraud by the chairman, who was convicted of the fraud charges. However, the liquidator pursued further action against the directors for negligence.[74]

The court noted that a breach of the duty of care by each director was to be determined on a case-by-case basis, after ascertaining facts such as the division of duties between directors and the nature of the work and company.[75] Further, it was held that there is no minimum standard of care, and directors shall not be in breach of the duty of care as long as it is shown that their skill and experience justify their actions.[76] Thus, the court applied a subjective standard of the duty of care and held that only certain directors were liable for negligence.[77]

B. THE COMBINED SUBJECTIVE-OBJECTIVE STANDARD

In this sub-part, we will analyse standards of duty of care that incorporate both, objective and subjective elements for the determination of a breach. We will analyse the combined objective-subjective test prescribed under the UK Companies Act, the business judgment rule, which is applied in the USA to determine liability of directors, and the standard of care applied to agency law in India.

1. The Standard of Care under the UK Companies Act

The combined objective-subjective standard for the duty of care has been incorporated under§174(2) of the UK Companies Act.[78] The objective portion is embodied in §174(2)(a), which in effect states that the duty of care will be exercised with "the general knowledge, skill and experience" that may reasonably be expected of a person carrying out the functions carried out by the director of the

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71 D'Jan of London, Copp v.D'Jan, [1994] 1 BCLC 561.

72 Equitable Fire Insurance, In re,1925 Ch 407.

73 *See* Lagunas Nitrate Co. v. Lagunas Syndicate, (1899) 2 Ch 392; Dovey v. Corey, 1901 AC 477; In re Brazilian Rubber Plantation and Estates, (1911) 1 Ch 425.

74 Equitable Fire Insurance, In re, 1925 Ch 407, 416.

75 *Id*.

76 *See* Cardiff Savings Bank, In re, (1892) 2 Ch 100.

77 Equitable Fire Insurance, In re, 1925 Ch 407, 421.

78 Mortimore, *supra* note 23, at ¶14.03.

company. This means that a certain minimum standard of care may be expected of all directors, regardless of any other factors.[79] The subjection portion, embodied in §174(2)(b), states that the breach of duty of care must also account for the "general knowledge, skill and experience that the director has".[80]

This combined test operates with a basic objective standard and a subjective standard that is only triggered if the director possesses knowledge, skill or expertise that is greater than the level expected. Therefore, the subjective element in this combined test only operates to increase the standard of care in certain situations, but never to reduce the standard below a minimum standard expected of all directors.[81]

2. The Business Judgment Rule

The business judgment rule is a test used to determine a breach of the duty of care,[82] which is predominantly applied in the USA.[83] The business judgment rule essentially uses the finding of good faith at the behest of the director as a proxy for determining a breach of care.[84]

It is important to note that in the USA, different standards have been adopted for the assessment of breach of the duty of care when the substance of decisions are challenged versus when the decision-making process is challenged.[85] When the substance of a decision is challenged, the 'waste test' is used to determine breach, which places an extremely high burden on the person seeking to establish a breach of the duty of care.[86] To prove a 'waste claim', the plaintiff has to demonstrate that the consideration for a transaction "is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid".[87] On the other hand, when the decision making process is challenged, the business judgment rule is used.[88] Therefore, the question of good faith arises to determine breach with respect to the procedure and protocol followed in the making of a business decision.[89]

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79 *Id*.

80 *Id*., ¶14.04.

81 *Id*., ¶14.03.

82 M. J. Trebilcock, *The Liability of Company Directors for Negligence*, Vol.32, Mod. L. Rev., 500 (1969).

83 C.B. Rhoads, *Personal Liability of Directors for Corporate Mismanagement*, Vol.65, U. of Pa.L.R., 130 (1916); Theodore Farflagia, *The Business Judgement Rule: A Guide to Corporate Director's Liability*, Vol.7, St. Louis Univ. L.J., 154(1962); Mortimer Feuer, Personal Liabilities of Corporate Officers and Directors, 19 (Prentice Hall, 1974).

84 Trebilcock, *supra* note 82.

85 Julian Velasco, *A Defence of the Corporate Law Duty of Care*, Vol.40, J. Corp. L., 653-656 (2015).

86 *Id*.

87 *Id*.

88 *Id*.

89 *Id*.

A court in Delaware defined the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[90] An important element of this definition is good faith which is instructive in understanding the operation of this rule. Simply put, if a director has 'any' reasonable justification for acting negligently in the decision-making process, and the decision was made in good faith, then the director is not in breach of her duty of care.[91]

The business judgment rule is violated if it is evinced that there was a conflict of interest, bad faith or fraud.[92] More importantly, the standard of 'gross negligence' is imbued in the business judgment rule.[93] In this context, gross negligence is defined as a reckless indifference to or deliberate disregard of the shareholders.[94] However, the appropriate threshold for gross negligence lacks consensus.[95] For example, in *Smith* v. *Van Gorkhom*, the duty of care was breached when directors decided to sell a company only after a two hour-meeting without reading the merger agreement or the basis of the price.[96]

It appears that the requirement of conflict of interest and bad faith to prove a violation of the business judgment rule are subjective. Moreover, any justification for a business decision would also be tantamount to a subjective approach. However, the standard for gross negligence is partly objective. In any case, the business judgment rule stands as it is – predominantly a test of good faith on part of the directors.

In order to better understand the business judgment rule, it would also be useful to highlight the rationale behind it, which is well-documented.[97] In his article, Julian Velasco categorises these reasons into theoretical and practical. The theoretical reason is that directors' interests are generally aligned with the company, barring certain situations of conflict[98], and therefore a presumption of good faith in the decisions they take for the company can be properly made.[99] The business judgment rule accommodates this stance as a default rule, alleviating the court of the duty to monitor compliance with the duty of care strictly in

90 Aronson v. Lewis, 473 A2d 805, 812 (Del. 1984).

91 Velasco, *supra* note 85.

92 Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, Vol.67, S. Cal. L. Rev., 291 (1994).

93 Aronson v. Lewis, 473 A2d 805, 812 (Del. 1984); Smith v. Van Gorkom, 488 A2d 858, 873 (Del. 1985).

94 Gevurtz, *supra* note 92.

95 *Id*.

96 Smith v. Van Gorkom, 488 A2d 858 (Del. 1985).

97 *Id*.

98 Frank Easterbrook &Daniel Fischel, The Economic Structure of Corporate Law, 97-103 (Harvard University Press, 1996).

99 Velasco, *supra* note 85.

general cases.[100] The practical reason is associated with the nature of work that directors engage in.[101] Business, is by nature risky, and return is axiomatically associated with the magnitude of risk taken.[102] Risk-taking, therefore, is desirable from the perspective of all those associated with the company.[103] Therefore, a rule that strictly scrutinises the decisions of a manager to determine a breach of duty of care will not only make managers more risk-averse, but also repel able businessmen from the job.[104]

While we find the theoretical and practical reasons to be relevant, in our opinion, they are misplaced when used in the formulation of the business judgment rule. Evidently, the concerns of trust and risk are well placed in the waste test, which is used to review the substance of a decision made by a company director. Having greater scrutiny for the substance of a director's decision will take away the teeth of decision-making and director's powers. The idiosyncrasy of business decisions merits deference. However, the same cannot be true for the business judgment rule since it is concerned with the process of decision-making. Following procedure and protocol when making decisions is not only an inevitable part of conducting business, but the bare minimum that can be expected of a director. Allowing leeway to directors in this respect is not only disregards the rules that mandate the procedure, but also the rationale of collective wisdom and will, which animates most procedural safeguards.

The business judgment rule works on the presumption of good faith. If directors were to act in good faith, then following basic protocol would be the bare minimum they could do to evidence such good faith. The business judgment rule regime would, therefore, insulate directors from legal accountability. In fact, there have been a surge in post-crisis liability suits and the courts are tested on the discretion granted to directors.[105]

3. The Standard of Care in the Law of Agency in India

Directors are often, from a theoretical perspective, likened as agents of a company.[106] Therefore, it would be useful to examine the standard of care in a general principal-agent relationship. The Indian Contract Act, 1872 ('Indian Contract Act') prescribes a standard of care that is predominantly objective, but

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100 *Id.*

101 *Id.*

102 *Id.*

103 *Id.*

104 *Id.*

105 Klaus J. Hopt, *Responsibility of Banks and Their Directors, Including Liability and Enforcement* in Functional or Dysfunctional – The Law as a Cure?, 159 (Stockholm Centre for Commercial Law, 2014).

106 Easterbrook & Fischel, *supra* note 40, at 429; Noel O' Sillivan, *Insuring the Agents: The Role of Directors' and Officers' Insurance in Corporate Governance*, Vol.64, The Journal of Risk and Insurance, 545 (1997).

includes an element of subjectivity in cases where the principal had knowledge of agent's disposition.

§212 of the Indian Contract Act states that an agent is bound to conduct the business with "as much skill as is possessed by persons engaged in similar business" unless the principal knows about the agent's lack of such skill. Further, the agent is bound to act with "reasonable diligence" and use the skills she possesses. In case there is any loss or damage caused to the principal owing to the direct consequences of the agent's neglect, lack of skill, or misconduct, the agent is bound to compensate the principal for the same.[107]

Thus, §212 lays down an objective standard for the duty of care of agents.[108] Under this standard, an agent would be liable for an error of judgment only if this objective standard were breached, and not otherwise.[109] This objective standard is defined as "skill as is generally possessed by persons engaged in similar business".[110] However, §212 explicitly permits the application of a subjective standard when the principal is aware of the dearth of skills and experience in the agent.[111] This means that an agent's actions will be assessed under §212 as per her skill and experience if it can be proved that the principal was aware of her capabilities at the time.[112]

It is important to note that while the standard of duty under both, the Indian Contract Act and the UK Companies Act is a combined objective-subjective test, they are still different from each other. *First*, the trigger of the subjective element of the test in the UK Companies Act is the skill and experience of the director herself, while in Indian Contract Act, the trigger is the knowledge of the principal of the skill and experience of the agent. *Second*, in effect, the subjective element in the UK Companies Act only operates to increase the standard of care that is owed, while in the Indian Contract Act, the subjective element allows for the reduction in standard of care owed.[113]

V. THE REASONABLE MAN'S STANDARD AS THE STANDARD OF THE DUTY OF CARE

In the previous part, we analysed a number of standards that may be applied in the context of company directors' duty of care. In this part, we propose to analyse the objective reasonable man standard in the context of company

107 The Indian Contract Act, 1872, §212.

108 Nilima Bhadbhade, Pollock and Mulla The Indian Contract Act and Specific Reliefs Act, 1723-1724 (Lexis Nexis, 14th ed., 2012).

109 Rajaram Nandlal v. Abdul Rahim, 1915 SCC OnLine Sind JC 14.

110 The Indian Contract Act, 1872, §212.

111 *Id.*

112 *Id.*, Illustration (c); Bhadbhade, *supra* note 108, at 1724.

113 *Id.*

directors and evaluate its desirability in comparison with the standards discussed in the previous part.

A. THE 'REASONABLE MAN' IN TORT LAW

Indian courts have understood negligence as the breach of a duty caused by either an omission to do something which a reasonable person guided by considerations which ordinarily regulate the conduct of human affairs would do, or doing something which a prudent and reasonable person would not do.[114] This is an objective test which determines breach by contrasting the facts with rules that ordinarily regulate human behaviour.[115] A proxy that is often used to animate this standard is whether a reasonable person, in the circumstances, would have acted in the way the party did.[116]

However, since the reasonable man is simply an abstraction, it is often the intuition of the court that determines the reasonableness of a certain action.[117] This intuition is guided by an evaluation of each case's facts thoroughly, without creating general standards.[118] Since this test is objective, it does not evaluate whether a person behaved to the best of her abilities in a given situation, but rather, if she conformed to the behaviour that may be expected of an average reasonable person.[119]

The guiding principle when applying the reasonable man standard is that the precautions taken must be proportionate to the risk.[120] The objectivity of the reasonable man standard does not mean that a person is expected to treat a walking stick and a dynamite with the same level of care.[121] It means rather that the person is expected to treat the dynamite with greater care than the walking stick.[122]

The said standard, however, does accommodate for subjectivity in certain cases. Typically, this occurs when the party concerned is specially disposed. For instance, courts impute a lower standard of care where the party concerned is physically or mentally impaired.[123] Additionally, the law also imputes a

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114 G.P. Singh, Ratanlal and Dhirajlal,The Law of Torts (Lexis Nexis, 26th ed., 2010); Shriram Education Trust v. Mitaben Anilbhai Patel, 2010 SCC OnLineGuj 1384; New India Assurance v. Ranni, (2011) 87 ALR 301 (Indian courts have accepted that application of the reasonable man standard in the context of negligence claims under the law of torts,*see* Grewal v. Deep Chand Sood,(2001) 8 SCC 151, ¶14).

115 *Id.*; W.V.H. Rogers, Winfield and Jolowicz on Tort, 242 (Sweet & Maxwell, 17th ed., 2006).

116 *Id.*

117 Glasgow Corpn. v. Muir, 1943 AC 448, 457; Rogers, *supra* note 115.

118 *Id.*

119 *Id.*, at 243.

120 *Id.*

121 *Id.*

122 *Id.*

123 Goldman v. Hargrave, (1967) 1 AC 645. In the context of company directors' duty of care, the lower standard of care applied for physically or mentally impaired individuals is not relevant.

higher standard on specialists and professionals.[124] This higher standard, however, is applied uniformly to individuals that fall in that category. Therefore, in a case where a junior doctor argued that the standard of care imputed on him must be lower than that imputed on senior doctors, the court refused to accept the argument.[125] The court stated that a common standard of care would be imputed on all individuals that were members of a particular profession and specialisation.[126]

In the seminal judgment of *CBI* v. *K. Narayana Rao*,[127] the court held that a professional is liable for negligence if she did not possess the requisite skill which she professed to have possessed or she did not exercise, with reasonable competence in the given case, the skill which she did possess.[128] The latter, therefore, imposes a higher burden to exercise the specialised skill in a reasonable manner.

The standard of duty care under tort law, therefore, is objective, with a subjective standard that is triggered in instance where the party concerned is specially disposed.[129] Most typically, these include professionals and people with disabilities.[130]

B. THE FEASIBILITY OF THE OBJECTIVE STANDARD FOR COMPANY DIRECTORS

In this sub-part, we will now proceed to examine whether it would be feasible to impose an objective standard of duty on directors.

The preliminary question to consider is whether it is possible to impute the ordinary reasonable man standard on directors. It is felt that in an economy where companies are the dominant medium of conducting business, the people who wield power in these companies should be held to a higher standard of care.[131] This stance is generally acceptable, in a welfare state such as India, which would seek to, at the minimum, mitigate damage that could accrue due to the concentration of power.[132] Therefore, irrespective of the objects and interests of company directors, the standard that the law imposes upon them may account for the considerations and objectives of the government.

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[124] Rogers, *supra* note 115, at 247; Whitehouse v. Jordan, (1981) 1 WLR 246; Cardy & Son v. Taylor, 1994 NPC 30.

[125] Wilsher v. Essex Area Health Authority, 1987 QB 730(this case was reversed by the House of Lords, but not on this point of law); Wilsher v. Essex Area Health Authority, 1988 AC 1074.

[126] *Id*.

[127] CBI v. K. Narayana Rao, (2012) 9 SCC 512.

[128] *Id*.,¶27.

[129] Rogers, *supra* note 115, at 243-249.

[130] *Id*.

[131] *See generally* Tarun Khanna & Krishna Palepu, *Globalization and Convergence in Corporate Governance: Evidence from Infosys and the Indian Software Industry*, Vol.35, J. Int'l Bus. Studies, 484, 490(2004).

[132] *Id*.

At this point, it would be useful to discuss the mechanics of the reasonable man test, and the nature of its objectivity. As mentioned earlier, the objectivity of the reasonable man test does not mean that a person must be equally careful in all scenarios, but rather, behave as a reasonable man would, in a given set of circumstances.[133] Viewed in this manner, the objectivity of the reasonable man test comes not from the standard it prescribes but rather the approach it recommends.

In practice, the reasonable man standard applies as a function of the magnitude of risk and likelihood of injury in a particular situation.[134] Therefore, the outcome of the function is directly proportional to the precaution that is to be taken. For instance, if a factory uses and disposes hazardous material, then the precaution that must be taken by them in the careful usage and disposal of such material would be higher than the precaution required to be taken for a factory that processes food items.

In the context of corporations and directors, two preliminary questions need to be answered to determine the feasibility of the reasonable man standard.

First, with respect to whom must the magnitude of risk and likelihood of injury be measured – the directors themselves, the shareholders or the company. In our opinion, it is the company to whom the duty of care is owed,[135] and therefore any analysis of this function must be made from the perspective of the company. As we had argued previously, the text and the legislative intent of §166(3) point towards a company-oriented duty of care. The interests of the company may be ultimately pinned to profits and shareholder satisfaction as a whole, which leads to derivative factors such as the goodwill of the company, employee satisfaction or shareholders' satisfaction.[136]

Second, regarding whether the decisions made by directors can be reduced to fit the function with which the objective test is applied. In our opinion, it is possible for the purpose of applying the reasonable man test. The decisions that directors take, such as declaring dividends, raising debt and even day-to-day decisions are based on general principles of management, finance or business and the general practice in the industry.[137] For a director, therefore, the intelligibility of these decisions, would be based on an assessment of the decision, which is instead based on her understanding of these principles. This assessment of decisions, based on existing knowledge and practice, however, is not required for the pur-

[133] Rogers, *supra* note 115.
[134] *Id.*, 254.
[135] For details, *see* Part II on "The Duty of Care: To Whom is it Owed?".
[136] Naniwadekar & Varottil, *supra* note 22, at 5-7.
[137] Harvard Law School Forum on Corporate Governance, *Principles of Corporate Governance*, September 8, 2016, available at https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance/ (Last visited on March 21, 2022).

pose of applying the reasonable man test. This is because an inquiry into the prior knowledge and experience of the corporate director would be subjective. Further, the brand of reasonable man test we propose to apply only looks at the reasonability of the procedure and protocols adopted by the director in the circumstances.

The reasonable man test simply requires the culling out of two factors – *first*,how badly could this decision impact the company, and *second*,what are the chances of this occurring. Since the decision-making procedure is central to our argument, the reasonable person is placed in the shoes of the director 'at the time of decision making'. It is plausible that the events eventually pan out differently than anticipated at the time of decision-making. The utility of the existing knowledge and practice, therefore, is simply to help assess risk and likelihood of injury, and not the merit of the decision taken.

Once this is done, the test would merely require the directors to take proportionate precautions. This is because proportionality is fundamental to an analysis on reasonableness.[138] At the same time, it is essential to define the contours of the proportionality analysis in the reasonable man test we espouse. It is argued that the procedure to be adopted by directors should be proportional to the impact of the consequence. For instance, a reasonable director may choose not to hire external legal counsel for routine transactions such as purchase of goods, but may be well advised to seek external legal advice on a potential acquisition of their company.

This means that the requirement for taking precautions would translate into protocol and procedure followed prior to taking these decisions. These may emanate from common practice, experience, or existing knowledge. For instance, if a decision that affects the company as a whole is being taken, then the collective wisdom of the board should be sought.[139] A similar protocol could be followed to know the will of the shareholders.[140] If a decision is being made, in which a particular director on the board holds expertise, then her advice should be taken. If a decision is being taken in a niche area which requires special knowledge or skill, which no director holds, then a specialist should be consulted before making the decision. Further, if the common practice in the industry does not allow for the signing of blank cheques, then signing them would breach the reasonable man standard.[141]

The Indian Companies Act provides for some of these safeguards as mandatory requirements. Therefore, if a decision is to be made to buy-back securities under §68 of the Indian Companies Act, then the board's approval is

138 John Salmond & W. T. S.Stallybrass, The Law of Torts: A Treatise on the English Law of Liability for Civil Injuries, 29 (Stevens & Haynes, 7th ed., 1928).
139 The Companies Act, 2013, §179.
140 *Id*., §180.
141 Dorchester Finance v. Stebbing, 1989 BCLC 498.

required.[142] Further, if a substantial part of the company is to be sold, then a special resolution is required.[143] The registered office of a company cannot be changed without a special resolution.[144] Changing the nature of the company, public or private, also requires a special resolution.[145] This nature of precaution, which relies on the collective wisdom and will of the directors and shareholders, is acknowledged as a legitimate hurdle to a potentially harmful decision. In terms of signing the financial statement, the Indian Companies Act vests the responsibility with the director(s) authorised by the board of directors.[146] Therefore, these protocols may be used as an indicator of understanding the nature of decision and the appropriate the standard of care under the reasonable man test.

Therefore, the reasonable man test does not stand in judgment of the decision made by the directors, but rather, simply necessitates the observance of precautions that match the risk taken. The wisdom of the decision itself remains out of the ambit of the reasonable man test.

C. ARE DIRECTORS PROFESSIONALS?

Professional negligence is a branch of the law of negligence that deals with specialists and professionals.[147] In this sub-part, we explore whether directors form a distinct profession or class of 'specialists' that justifies imposing a higher objective standard of care upon them.

Under tort law, the standard of care imposed on professionals is higher than that imposed on an ordinary individual carrying out the same task.[148] Therefore, a doctor providing medical aid would be held to a higher standard of care than an immediate attendant providing first-aid to another person. The rationale behind this is that if care is to be received by a person who is a member of a profession that specialises in it, then it is reasonable to expect that higher standard of care.[149]

In our opinion, company directors cannot form a separate profession for the purpose of a heightened duty of care for four reasons.

First, there are no general barriers to entry to become a company director.[150] It does not require a certain level of skill or knowledge.[151] This is

142 The Companies Act, 2013, §179(3)(b).
143 *Id.*, §180(1)(a).
144 *Id.*, §12(6).
145 *Id.*, §14.
146 *Id.*, §134.
147 Rogers, *supra* note 115.
148 *Id.*
149 *Id.*
150 Barnes v. Andrews, 298 F 614, USA (Sydney 1924); Avtar Singh, Company Law, 308 (Eastern Book Company, 2016).
151 *Id.*

essential to constitute a profession or class of specialists.[152] Barring any requirement that may be incorporated in the articles of a company, no general barriers to entry exist for company directors. Therefore, a special standard of care cannot be imputed on a class of people that are not recognised for possessing any special skills or knowledge generally.

Second, the job of company directors cannot be unified by common principles or rules of conduct that govern the substantive decision-making of directors. Different scenarios would require the reasonable person to be placed in those facts and circumstances. The protocol mentioned earlier sets the standard to which courts can decide how important the situation was and whether the measure was proportional. However, there is no directive guiding each and every circumstance of how the director would fulfil her duty of care.

The work of company directors, apart from generic duties mandated by the Indian Companies Act, do not share any common threads. Directors are often appointed for starkly contrasting reasons. Some are appointed for their experience in raising finance, others for their technical know how. Even though both these directors come within the category of company directors, the work that they do is vastly different, requiring knowledge and skill that is not common to the post of a director generally. Common principles and rules of conduct are essential for the existence of a profession on the basis of their special knowledge or skills.[153] Therefore, it would then be improper to classify company directors into a profession and expect a higher standard of care from them for that reason. Ultimately, doing business is common to most, if not all directors, but doing business does not amount to a separate profession.[154]

Third, there is no distinct body of knowledge that is unique to company directors. Flowing from the fact that company directors are appointed for different reasons and to carry out different tasks, the expertise that is used draws from separate bodies of knowledge, such as finance, management, environmental studies, and many others. These are bodies of knowledge that all businessmen draw from, including those in partnerships and sole proprietorships. Just as a heightened duty is not imposed on partners and sole proprietorships, in the same manner, it must not be imposed upon company directors.[155] A common body of knowledge is another characteristic of a profession, and without it, company directors cannot be called a separate profession.[156] As opposed to professional negligence, which has profession guidelines and an established body of knowledge,[157]

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[152] *Id*.

[153] John W. Wade, *An Overview of Professional Negligence*, Vol.17, Mem. St. U. L. Rev., 478 (1987).

[154] *Id*.

[155] Even though companies are generally bigger, the increase in the precautions required can be accommodated within the matrix of the reasonable man test.

[156] Wade, *supra* note 153.

[157] Rogers, *supra* note 115, at 250.

which can be relied on to determine the best possible course of action, the same is not true of company directors.

A substantive review on the subjective merit of a director's actions will result in inconsistent expectations from the director. For instance, when a patient is diagnosed with a diseased, the doctor has to act in a manner guided by the body of knowledge of doctors. The same cannot be said for directors. There is no rule book on when a contract needs to be terminated or whether the company needs a rebranding. There is no one-size-fits-all approach to managing companies founded upon science. The director's actions have to be adjudged from the lens of a reasonable person. In the aforementioned examples, the procedure and deliberation of a decision to terminate contract or rebrand the company has to be looked at.

Fourth, company directors do not have a common body or union that represents them. For doctors, there is the Medical Council of India, for lawyers there is the Bar Council of India, but company directors remain distinct and isolated as such. This is further evidence that company directors do not form a uniform body of professionals or specialists.[158] Therefore, a special standard of duty of care for company directors, by virtue of their profession, seems wholly untenable.

VI. A CASE FOR THE REASONABLE MAN STANDARD

In this part, we present our case for the utilisation of the reasonable man standard for determining whether a director has breached their duty of care.

The reasonable man sets a basic minimum standard of care that can be expected of all directors. Irrespective of the expertise and experience of the director, a minimum standard of care towards the company may, therefore, be expected of directors in all activities that they undertake.[159] This is a desirable outcome, as it ensures that companies will not suffer due to the inadequacies that no reasonable man would expect. To illustrate, let us consider the case of an incompetent director whose decision is under challenge.

The reasonable man test is an objective one which applies pervasively, and therefore, would not allow incompetency to reduce the standard of care. Therefore, any decision that is taken by patently ignoring existing protocol would not be excused by a lack of competency. The same cannot be said for the subjective test, the agency rule and the business judgment rule. The subjective test manifestly permits an allowance for incompetence, while the agency rule would permit it if the principal (in the context of a corporation, the people who appoint the directors) is aware of their incompetence, and the business judgment rule would allow for

[158] *Id*.

[159] Mortimore, *supra* note 23, at ¶14.27; Grayan Building Services Ltd., In re,1995 Ch 241, 257-258.

incompetence if the substantive decision were under question. Only the standard under the UK Companies Act would achieve the same result as the reasonable man test. This is because the UK Companies Act sets up a minimum threshold that can only be raised if the director possessed special knowledge or skill. For instance, a director managing the marketing of a particular product in a specific geographical area. She is expected to know the rolling out of that product in that market due to her special knowledge she possesses.

In the context of incompetent directors, many scholars have argued for the application of a subjective standard, positing that if the shareholders are aware of the incompetence of the director, then they should face the consequences of appointing such a person.[160] This is, in our opinion, inappropriate because it unfairly places the responsibility of every decision made by a director upon the shareholder. This is exactly what is sought to be avoided in the governance structure created for companies, which separates management from ownership.

The reasonable man test also divorces itself from the substance of the decision, and only focusses on the decision-making process.[161] The relevance of the substance of the circumstance requiring decision is limited to the extent that it creates a sliding scale for the procedure that should be followed in such a decision. This, we argue, is desirable for two reasons. *First*, courts are generally not in a position to assess the merit of a business decision from the lens of a businessperson. Running a company with judicial wisdom is unlikely to lead to a successful corporation. Allowing judges to retroactively assess business decisions would thus seem improper.[162]

Second, the nature of the work that is to be done to run a corporation is inherently risky. Furthermore, it is axiomatic that risk is proportional to reward. This often means that directors are prepared to take higher risks for greater rewards. It would then be undesirable to know, as a director, that any decision taken would be retrospectively scrutinised by a court of law. An active intervention by the court would then take away the teeth of the director's powers and decision-making. It would lead to a scenario where every shareholder of a company that made losses would sue their directors for breach of duty of care, stifling the autonomy and enterprise of directors.

This marks the biggest distinction between the objective reasonable man's standard and the objective-subjective standard under the UK Companies Act. The standard in UK Companies Act sets a hypothetical minimum threshold of duty of care that can be increased based on the director's skill, expertise, and

160 C.A. Riley, *The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard*, Vol.62, Mod. L. Rev., 723-724 (1999).

161 For discussion, *see* Part II on "The Duty of Care: To Whom is it Owed?".

162 Howard Smith v. Ampol Petroleum, 1974 AC 821, 832; FidaaliMoizMithiborwala v. Majolica Properties (P) Ltd., 2017 SCC OnLine NCLT 20894, ¶31.

knowledge.[163] The business judgment rule, subjective rule, agency rule,[164] and UK Companies Act all wade, to different extents, into the substance of the decision. The business judgment rule entails an examination of substance to determine and an inquiry into whether the director's actions were grossly negligent in relation to the concerns of the shareholders. The subjective rule clearly requires the court to look into the director's substantive conduct to understand whether the director breached her duty, given her facts and circumstances. The agency rule is premised on the substance of the decision and entails a subjective element if the principal knew the agent's lack of expertise. The UK Companies Act, in its subjective-objective approach, requires the court to examine whether the decision was reasonable, and further, if the director possessed special knowledge, whether the decision was reasonable when subjected to a higher standard.

This is undesirable, and often courts realise the difficulty in assessing a decision retrospectively, and restrict the breach to cases in which omissions with respect to basic protocol and procedure were made.[165] Further, as stated above, supplanting business discretion with judicial wisdom is improper, since judges are not competent to make an assessment of the viability of a business decision. Let us take a scenario from the UK Companies Act where one were to assess whether a well-qualified director, upon whom a higher standard is applied, breached her duty of care. Placing a higher standard would essentially require the courts analysing rationality of business decisions through a judicial lens. Formulating a test which can fairly and consistently determine a breach of the duty of care would not be feasible, since no rubric can account for the different facts and situations that may arise in business decisions.[166]

Further, whether a decision was good or bad is often judged on the basis of the outcome.[167] In this situation, it would be unfair on directors, since it imposes an unfair standard of 'success'.[168] Success is often elusive even after following the most trusted of methods and ideas and is sometimes attained even when none of these are followed. Using it to assess the merit of a decision, then, would be

[163] David Cabrelli, *The Reform of the Law of Directors' Duties in UK Company Law*, University of Edinburgh Centre for Commercial Law, 2008, available at https://www.pure.ed.ac.uk/ws/portalfiles/portal/13215836/CABRELLI_D_PRESENTATION_FOR_UNIVERSITA_BOCCONI_ON_THE_REFORM_OF_THE_LAW_OF_THE_DIRECTORS_DUTIES_IN_UK_COMPANY_LAW.pdf (Last visited on March 21, 2022).

[164] *See generally* Pape v. Westacott, (1894) 1 QB 272; Farrer v. Lacy, Hartland & Co., [LR] 31 ChD 42 (CA).

[165] Dovey and the Metropolitan Bank (England and Wales), Ltd. v. Corey, 1901 AC 477, 488, HL; Mortimore, *supra* note 23, at ¶¶14.19-14.20.

[166] Great Britain, *Modern Company Law, for a Competitive Economy: Developing the Framework: A Consultation Document*, Department of Trade and Industry,2000, ¶3.69, available at https://discovered.ed.ac.uk/discovery/fulldisplay?vid=44UOE_INST:44UOE_VU2&tab=Everything&docid=alma991670835024 66&lang=en&context=L&query=sub,exact,Christian%20union%20--%20India (Last visited on March 21, 2022).

[167] Niek Strohmaier et al., *Hindsight Bias and Outcome Bias in Judging Directors' Liability and the Role of Free Will Beliefs*, Vol.3, Journal of Applied Social Psychology, 142, 144 (2020).

[168] *Id.*

unfair. Further, setting a higher standard of care may also inhibit unconventional management styles. Following new ideas and methods would be discouraged, since it may not be looked upon favourably through the metric of conventional or more accepted methods and ideas.[169] Directors will be discouraged from innovating and taking risks, with potentially high rewards, since the test is whether a particular course of action could have been safer. Thus, a minimum objective standard gives considerable room to the director to exercise their business acumen in the decision-making process.

On a separate note, it would be a challenge in itself to set a 'higher standard' for directors of greater knowledge, experience and skill. The test for an objective standard is rooted in ensuring that directors follow basic protocol when making decisions – such as exercising basic due diligence, consulting the board, shareholders, and experts. As a judge, it is easy to arrive at a decision on these aspects. However, a higher standard would necessarily require something 'more' from directors – beyond merely following procedure. This would then mean, that judges would have to look at the quality of the decision itself. Such an assessment would necessarily be subjective, and aided, at best, by taking opinions from experts in court.

Beyond the problem of being unable to set a fair, consistent, and just test to assess directors of higher abilities, setting 'a' test would be problematic in the first place. On what basis would it be determined, whether a director has failed to meet this higher standard? After taking basic precautions, every business decision is susceptible to success and failure, and neither fully indicates the merit in the decision. If judges were to state that the director should have considered factors such as the solvency of the company,[170] or correlated remuneration with an expectation of certain results,[171] the result would simply be a game of shooting in the dark, where judges would set the target themselves – the 'higher standard', in each case, based on the facts and circumstances – and decide whether it has been hit themselves – breached this 'higher standard'. Indeed, a judicial practice where judges establish the test and determine the breach would result in oddities, where it would be unlikely that judges create thresholds of a higher standard, only for them to conclude that the said thresholds have not been breached.

Some may raise the objection that since the reasonable man standard does not account for the disposition of the director in any case, it lets directors who take harmful decisions deliberately off the hook. One can envisage scenarios where directors, within the bounds of the reasonable procedure, are taking potentially harmful decisions against company interests. This can occur where directors make procedurally sound decisions with deliberate intent to deceive the company. While it is true that the reasonable man standard cannot specially adapt to hold

[169] Wade, *supra* note 153, at 471.

[170] Roberts v. Frohlich, 2011 2 BCLC 625, ¶98, ¶105.

[171] Secretary of State for Trade and Industry v. Baker, 1998 Ch 356; In re Baring (No. 5) [1999].

directors liable in such a scenario, in our opinion, such a case is sufficiently dealt with under provisions that punish fraud.[172] Fraud encapsulates acts, omissions, concealment of facts or abuse of position by a person or through another in connivance, with the intent to deceive, to gain an undue advantage, or injure the interests of the company, its shareholders, or creditors, or anyone else.[173] With a wide definition, the company is protected from all actions that may be within procedure but with an intent to deceive. Thus, wrongful actions left out by duty of care do not go unnoticed.

The reasonable man standard also incorporates within it general practice in the industry and corporation. Therefore, questions of whether delegation, shortcomings in supervision and non-attendance of meetings qualify as a breach of standard of care, may be directly assessed in each case, by reference to existing practices and rules. These rules may emanate from the statute, rules and notifications from the Ministry of Corporate Affairs or the Articles of the company.

The standard under the UK Companies Act applies similarly to such situations.[174] This is because the UK Companies Act standard is largely objective and can only be raised in case of special knowledge or skill. The standard is premised on a basic minimum standard of care built on reasonability. The analysis under the subjective rule, agency rule and business judgment rule would all lack similar clarity, due to considerations of the skill of the director and good faith. To illustrate, consider the facts of the Marquis of Bute's case.[175] In this case, a bank had become insolvent due to misappropriation by a paid officer of the bank. This misappropriation took place under the nose of Marquis of Bute, the president of the bank who was also in the board of directors. The question before the court was whether Marquis had breached his duty of care by failing to identify the misappropriation.

In the case, the court applied the subjective standard and refused to hold that Marquis breached his duty of care, since Marquis was appointed as president when he was merely six months old. By virtue of his appointment, he was a member of the board of directors in the company. He clearly lacked any knowledge, skill, or experience due to his age. This would be incomparable to any ordinary director who possessed reasonable knowledge and skill. Therefore, even if he had attended a meeting in the thirty-nine years of his leadership, he would have failed to notice any misdeeds in the company. Any ordinary director would ideally take notice of such misdeeds while exercising care. The reasonable man standard would hold Marquis liable for failing, since he failed to conform to a basic minimum standard of being properly aware and informed of the happenings

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172 The Companies Act, 2013, §447.

173 *Id*.

174 Mortimore, *supra* note 23, at ¶¶14.07-14.08.

175 Cardiff Savings Bank, In re, (1892) 2 Ch 100.

at the bank. The reasonable man standard is oblivious to the special dispositions of the director. It neither increases nor decreases the threshold for duty of care. The minimum standard would, thus, be applicable even to Marquis.

The UK Companies Act rule would lead to a similar conclusion. This is because the UK Companies Act can only increase the threshold of minimum standard of care. The business judgment rule may perhaps hold him liable, although a finding of bad faith would certainly be difficult. This is because the business judgment rule proceeds with a presumption of good faith and permits lapse in procedure. For the business judgment rule to not be violated, any justification for the course of action pursued by the director would suffice. The analysis will then boil down to whether the court views Marquis' incompetence as a justification for improper procedure. The agency rule would lead to Marquis not being liable. Agency rule brings an objective threshold which can be reduced if the principal knew the agent's want of skill. Here, the board members were aware of the lack of skill and experience of the person they had appointed and therefore, the duty of care will not stand violated.[176]

VII. CONCLUSION

In an era of growing corporate impact, it is important to identify and evaluate the degree of responsibility placed upon the directors that operate companies by the law. In this paper, we have analysed two key legislative gaps in relation to the duty of care owed by directors in India.

First, the people to whom the duty of care is owed. In this context, we have waded through arguments based on §166, and have concluded that the duty of care, skill, and diligence under §166(3) is only owed to companies in India. This is due to the textual interpretation of §166, the legislative intent, and the nature of duty under §166(3).

Second, we have examined the standard of duty of care for directors in India. Since the Indian Companies Act and judicial rulings remain inconclusive on the standard of duty of care, we have identified and explored different standards of the duty of care to identify one that would be most desirable in the Indian context. In doing so, we have identified the shortcomings of the subjective and subjective-objective standards of care, and proposed that the objective 'reasonable man' standard derived from the law of torts be applied. The standard we propose to apply only looks at the procedure and protocols adopted by the director in the circumstances to determine whether the duty of care has been breached. We argue that this standard is most desirable because it gives considerable discretion to the directors by keeping the substance of the decision outside its ambit. At the

[176] The Contracts Act, 1872, §212.

same time, the directors are held accountable since they have to follow reasonable procedure.

In conclusion, it would be fair to say that §166(3) leaves much to be desired. There are extensivegaps in the law and these gaps, when filled, do not form a potent tool to regulate the decisions of directors who operate companies and hold them accountable. Therefore, a significant rehaul of the Indian Companies Act and §166(3) is required to increase its relevance as a mechanism to increase the answerability of directors for the decisions they make.