Disqualification of Directors & Principles of Natural Justice

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Background

The disqualification of directors as a result of default in filing of annual returns and financial statements for 3 consecutive years has been an ongoing controversial issue under the Companies Act, 2013. The issue surfaced in 2017 when various Registrar of Companies (RoCs) started publishing the list of defaulting companies and the disqualified directors.

Section 164 of the Companies Act, 2013 provides for various scenarios when a person would be disqualified for appointment as a director. Section 164(1) sets out eight grounds of disqualification which are basically personal defaults or disqualifications of an individual director like being of unsound mind, insolvency, non-payment of call money, etc.

Section 164(2) on the other hand is wider in scope and a director attracts disqualification as a result of default by the company in which he holds directorship. The corresponding provision under the Companies Act, 1956 was Section 274(1)(g). However, this provision had applied only to directors who held directorships in Public Limited Companies. Unlike, Section 164(2) which covers all companies, specified defaults by Private Limited Companies did not attract the sword of disqualification.

In compiling the list of defaulting companies and disqualified directors the RoCs considered the companies that had defaulted in filing annual returns and financial statements for Financial Years 2013-14, 2014-15 and 2015-16. Since, the Companies Act, 2013 had come into effect only from 01.04.2014 a controversy arose as to which Financial Year should be considered as part of the 3 consecutive years, 2013-14 or 2014-15. On this issue various High Courts[1], including the Madras High Court, held that the Section 164(2) can only operate prospectively and the 3 consecutive years should be reckoned from Financial Year 2014-15. Thus, the issue of prospective applicability of Section 164(2) is fairly settled.

Natural Justice

The Madras High Court in ***Bhagavan Das*** case has held that the principles of natural justice should have been adhered to by issuing a proper notice to all the directors concerned.

RoCs continued publishing list of disqualified directors year on year, without issuing any prior notice. The list published by RoC Chennai and Coimbatore on 18.12.2018 was unsuccessfully challenged on this ground in a Writ Petition before the Madras High Court. However, the decision of the Single Judge was reversed by the Division Bench of the Madras High Court in ***Meethelaveetil Kaitheri Muralidharan vs. Union of India & Anr.***

Issues before the Division Bench of the Madras High Court

In the new digital environment where a businessmen can suddenly discovered denial of access or a person can discover that he has been disqualified to be a director by a backend exercise reflected in the portal or website, two key issues were identified by the Court.

(i) Whether a prior notice is required before disqualifying a director under Section 164(2)

(ii) Whether the RoC is empowered by the Companies Act, 2013 to deactivate the DIN of disqualified directors.

Issue No.1

The decision on issue no.1 was arrived at after the considering, inter alia, the following points:

(i) It is necessary to attribute the default of the defaulting company to specific directors in order to apply and enforce Section 164(2).

(ii) The only guidance that Section 164(2) contains is that such disqualification could apply either to current or former director of a defaulting company.

(iii) Rule 14(2) of the Appointment and Qualification of Director Rules specifies that defaulting companies shall file Form DIR-9 immediately upon the occurrence of default in complying with Section 164(2) with the names and addresses of the directors during the relevant period.

(iv) If Form DIR-9 is filed, the RoC can rely on the names and addresses of directors that were provided by the defaulting company. Even such a list would not be bereft of controversy especially when the statute and the rules do not set out the criteria for preparation of such list.

(v) The prescribed time limit for filing the financial statements would vary depending on the date of AGM and, as a corollary, the date of default in filing the financial statements would also vary, including with reference to whether it is the first AGM or a subsequent AGM.

(vi) For purposes of Section 164(2), the default has to extend across three consecutive financial years. Therefore, such determination of default would necessarily have to be preceded by the fixation of the relevant period.

(vii) In the absence of a clear statutory stipulation identifying the directors concerned during the relevant period of default would be complicated.

(viii) Illustrations of various scenarios and potential defenses that could be put forth by the disqualified directors were discussed to exemplify as to why a prior enquiry would not be an empty formality but would be necessary for purposes of enforcing Section 164(2).

Decision on Issue No.1

The High Court held that the determination of default by the company and the attribution of default to a particular set of directors certainly require a prior enquiry. Hence, the prior notice requirement is clearly not an empty formality as regards disqualification under Section 164(2). The exceptions to the natural justice rule, namely, the possibility of only one conclusion or the absence of prejudice would not apply in the present case.

Issue No.2

The decision on Issue no.2 was arrived at after the considering, inter alia, the following points:

(i) DIN is valid for the life time of the applicant and shall not be allotted to any other person.

(ii) Rule 11 does not provide for cancellation or deactivation upon disqualification under Section 164(2).

(iii) Deactivation of DIN would also be contrary to Section 164(2) read with 167(1) inasmuch as the person concerned would continue to be a director of the Defaulting Company.

Decision on Issue No.2:

The Division Bench of the Madras High Court held that the RoC is not empowered to deactivate the DIN under the relevant rules.

Contrary Views

Section 164 on first blush would appear to be a provision dealing with situations where a person would stand disqualified from being appointed or reappointed as a director. However, if the said provision is read in conjunction with Section 167(1)(a), there are other consequences namely vacation of office of director in all companies except the defaulting company.

The natural justice rule and the requirement of a prior enquiry gains significance as a result of the vacation of office which follows as a consequence of disqualification under Section 164.

It is pertinent to note that a contrary view has been taken by the Karnataka High Court in the case of ***Yashodara Shroff*** wherein it has been held that the disqualification under Section 164(2) is by operation of law on the occurrence of the circumstances mentioned therein and there is no necessity to give prior hearing or comply with the provisions of *audi alteram partem* before such consequences visit a director of such a company. Similar view has been adopted by various other High Courts as well[2]. However, all the other decisions involve the first round of publication of disqualified directors when the key issue was retrospective application of the provision.

In this context, the Madras High Court's decision is a path breaking decision as it is in the context of the second list of publication of disqualified directors in 2018 where the retrospective aspect was not a material issue.

Concluding Thoughts

Section 164 is a basket of disqualifications. While a majority of them are personal in nature and there is justification for consequences, Section 164(2)(a) is in the context of a compliance breach in procedure by the defaulting company. Section 164(2)(b) is a serious provision as it deals with a company defaulting in repayment of deposits or payment of interest or redemption of debentures on the due date. The matter is likely to reach Supreme Court at some point of time and the gravity of disqualification or the nature of disqualification would definitely have a bearing on the decision.

When one looks at the issue dispassionately there are four aspects that come into play. Section 164 which identify disqualifications of a director with reference to appointment or reappointment; Section 167 which refers to the vacation of office of directors in certain cases and the act of the RoC in publishing the names of disqualified directors and the DIN deactivation that was done.

Section 164 is a statutory provision which enumerates disqualification and there be no quarrel against a provision which seeks to ensure compliance of provisions of the Act; Section 167 deals with vacation of office by operation of law and this provision is equally important in the general scheme of things. The third and fourth aspects are however acts of the executive and such acts are not valid unless power has been conferred by statute. The object of publishing names is to ensure that companies would be in a better position to verify the profile of an individual who is being considered for appointment as a director. From that perspective the objective is clearly laudable. However, given the wide scope of Section 164(2), there is no distinction within the list. For example, a director could have resigned from the defaulting company even before the default occurred and the defaulting company would have equally defaulted in intimating the resignation of the director. There could be cases were an individual could be a director in a private company which was not active and a default by the said company in filing the annual return and financial statements could jeopardize important and prestigious directorships in other companies where there is no issue in compliance. Ideally, Section 167(1)(a) should be amended or read down to the effect that only if the defaulting company is a public limited company or public interest is involved in the form of loan taken from financial

institutions, vacation of office of director in other company should apply.

In so far as the fourth aspect is concerned, DIN deactivation is uncalled for since the object of Section 164 and Section 167 having been achieved by operation of law there is no further necessity for deactivating the one time unique identity created for the director.

The Madras High Court has set the tone for a number of issues which may have to be resolved in the light of the observations of the Hon'ble High Court. The GST law is rampant with backend technology based blocking of input tax credit; blocking of the facility of generating e-way bill which affects business; cancellation of registration; automatic interest levies without notice; etc. While the e-initiatives are important and reflect a huge change in governance, denial of access for whatever reason without notice or without following the principles of natural justice is clearly violation of fundamental rights.

The Supreme Court in the case of ***Mohinder Singh Gill Vs. Chief Election Commission (AIR 1978 SC 851)*** held that if an administrative action involves civil consequence the rules of natural justice must be followed. The Supreme Court defined 'civil consequence' as under

"But what is a civil consequence, let us ask ourselves by passing verbal booby-traps, 'civil consequences' undoubtedly cover infraction of not merely property or personal rights but of civil liberties, material deprivations and non-pecuniary damages. In its comprehensive connotation, everything that effects a citizen in his civil life inflicts a civil consequences."

As Prof. Wade in Administrative Law, 5th Edition at page 470 puts it, *the right of natural justice should be as firm as a right to personal liberty. This is a vital part of rule of law.*

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[1] *Madras High Court in Bhagavan Das Dhananjaya Das vs. Union of India* ***[LSI-235-HC-2018(MAD)]***

Karnataka High Court in Yashodhara Shroff vs. UOI & Anr. ***[LSI-322-HC-2019(KAR)]***,

Gujarat High Court in Gaurang Balvantlal Shah vs. Union of India ***[LSI-548-HC-2018(GUJ)]***

Allahabad High Court in Jai Shankar Agrahari vs. Union Of India And Another ***[LSI-27-HC-2020(ALLD)]***

[2] *Gujarat High Court in Gaurang Balvantlal Shah (supra),*

Karnataka High Court in Yashodhara Shroff (supra)

Delhi High Court in Mukut Pathak v. Union of India ***[LSI-621-HC-2019(DEL)]***