Payment of dividend – Sec-123 (Part-4)

Continued from Geeta Saar 60th edition

29. Liability of directors for wrongful payment of dividend

Although there are no statutory provisions in this regard, it should be noted that the directors of the company may be made liable for the wrongful payment of dividend. While resort to section 166 might be taken for determining the liability of the directors for the wrongful payment of dividends, it shall be evaluated in the light of various decisions of the courts.

To decide their liability, it is pertinent to discuss the exact role directors play in the company. It is important to identify in which capacity directors incur this liability. In some scenarios, directors are held to be the agents of the company and in some scenarios, trustees of the property. The liability would differ in both scenarios. Buckley on the Companies Acts *[13th Edition, Page 864, 865 quoted in V.S. Ramaswamy Iyer and Anr. vs Brahmayya & Co., Official Liquidators, Hanuman Bank Ltd. [1966] 36 Comp. Cas. 270 (Mad.)]* states that "The directors of a company fill a double character. They are (i) agents of the company, and (ii) trustees for the shareholders of the powers committed, to them. Expanding the latter ... instances of the powers are given, as, for instance, of the power of approving transfers of shares; of the power of allotment of shares; of the power of employing the funds of the company; of the power of making calls; or receiving payment of calls in advance; of the power of forfeiting shares, etc., and it is pointed out that as trustees they may be rendered liable for their misuse of their powers. It comes to this that the directors are trustees with reference to their powers of employing the funds of the company, and for misuse of this power they could be rendered liable as trustees. For the purpose of the present discussion it is unnecessary to consider what would amount to misuse, and when, in the case of imprudence in the exercise of powers, it would amount to actionable negligence or crassa negligentia."

"In Flitcroft's case, (1882) 21 Ch. D. 519 the directors of a limited company for several years presented to the general meetings of shareholders reports and balance-sheets in which various debts known by the directors to be bad were entered as assets, so that an apparent profit was shown though in fact there was none. The shareholders, relying on these documents, passed resolutions declaring dividends, which the directors accordingly paid. An order having been made to wind up the company, the liquidator applied under Section 165 of the Companies Act, 1862, for an order on the directors to replace the amount of dividends thus paid out of capital. Referring to the position of directors, Bacon V. C. observed: "One must have regard to the position of directors of a joint stock company. It is said they are not trustees. Answering that objection in general, I should say they are trustees and nothing else. They have interests of their own, but they are trustees of the money which may be collected by subscriptions, and of all the property that may be acquired; they have the direction and management of that property, and at the same time they have incurred direct obligation to the persons who have so entrusted them with their money. .... Then it has been gravely argued that because one of the respondents has become bankrupt, no order can be made against him or his estate, inasmuch as all

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that he did was to commit a tort. It is no tort whatever; it cannot be called a tort, nor is this an action for damages. If you establish that the man committed a breach of trust, you have only to count what is the amount of the liability arising out of that breach of trust, and there is the decree and the order made at once." On appeal, Jessel M.R., referring to the directors as quasi-trustees for the company, held that if they paid away the assets to the shareholders, they were liable to replace them. Brett L. J., referring to directors, … "They are trustees for the company, not for the individual shareholders. The liquidator represents the company, and is bound to discharge towards the creditors all the duties which the company owes them. . It is therefore his duty when such a breach of trust as this is discovered to get a return of the assets improperly expended that they may be applied in payment of debts. The act of the directors is impeached as a breach of trust, not on the ground of tort or misfeasance. There are persons who may be made liable under Section 165, without having been guilty of a breach of trust; but where the person charged under that section is a trustee, the act which brings him within the section is a breach of trust." *. [V.S. Ramaswamy Iyer And Anr. vs Brahmayya & Co., Official Liquidators, Hanuman Bank Ltd. [1966] 36 Comp. Cas. 270 (Mad.)]* It should be noted that this case dealt with a circumstance where the director had knowledge of irregularity. A director who can prove that he had no knowledge of the irregularities may escape the liability. However, there can be no general rule in this regard and every case stands on its own footing

Payment of money out of capital is always treated as a grave violation of shareholder trust. "In re Sharpe, In re Bennett, Masonic and General Life Assurance Company v. Sharpe, (1892) L.R. 1 Ch. D. 154 by the articles of association of a company incorporated in 1868, it was provided that interest on the money paid upon the share should be paid to the shareholders until otherwise determined by the directors; and that no dividend or bonus should be payable except out of the profits. No profits were made by the company; but the directors paid interest to the shareholders out of the capital of the company until 1878, when the Board of Trade interfered and the directors ceased to pay interest. On the company being wound up in 1886, the liquidator commenced an action in 1889 against the personal representatives of one of the directors, who had been functioning as such from 1869, till his death in 1883. The liquidator sought to make the estate of the deceased director liable for the money paid as interest to the shareholders out of capital, while he was a director. For holding that the payment of interest out of capital, when there were no profits, was ultra vires, notwithstanding the clause in the articles of association and that the directors being in the position of trustees, the Statute of Limitations was no bar to the action (being prior to 1890), Lindley L.J. observed; "As soon as the conclusion is arrived at that the company's money has been applied by the directors for purposes which the company cannot sanction, it follows that the directors are liable to replace the money, however honestly they may have acted." …. "Now a director of a company is certainly not a mere agent. It is his duty, amongst other things, to protect the company and to enforce its rights even against himself, and the conflict between his interest and his duty when he has misapplied the company's money prevents the Statute of Limitations from applying to an action brought against him by the company in order to recover such money. Although it is true that the company may be set in motion by other persons, it is by no means easy to do so, and these considerations

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have induced the courts to treat a misapplication of the money of a company by its directors as a breach of trust to which the Statute of Limitations has no application-- at least, while they are directors: see Flitcroft's case, which is a clear decision of this court on this very point. The liability of a director, in the case supposed, being treated as a breach of trust, I apprehend that the Statute of Limitations would not apply, even after a director had ceased to be a director." *[V.S. Ramaswamy Iyer And Anr. vs Brahmayya & Co., Official Liquidators, Hanuman Bank Ltd. [1966] 36 Comp. Cas. 270 (Mad.)]* The directors were made liable for their actions as director even after they ceased to be directors.

"When the Directors have declared dividend out of capital, it was against their duty towards the company. Upon death of the delinquent director, his estate was made liable to repay the amount. "In the case of the death of a director his estate remains liable for any breach of trust he may have committed (including any wrongful dealing with the company's property, such as a payment of dividend out of capital or sale of its assets at an under value)." *[Gore-Browne, Handbook of Joint Stock Companies, forty-first edition, at page 374 cited in V.S. Ramaswamy Iyer And Anr. vs Brahmayya & Co., Official Liquidators, Hanuman Bank Ltd. [1966] 36 Comp. Cas. 270 (Mad.)]* Hence, the director's estate was made liable for payment of dividend out of capital. The limitation period of bringing action was viewed leniently and action after death of director was also allowed.

Further, the remedies as stated in Halsbury's Laws of England *. [3rd Edition, at page 307, paragraph 616 quoted in V.S. Ramaswamy Iyer And Anr. vs Brahmayya & Co., Official Liquidators, Hanuman Bank Ltd. [1966] 36 Comp. Cas. 270 (Mad.)]* are, "A director who has misapplied or retained or become liable or accountable for any money or property of the company, or who has been guilty of any breach of trust in relation to the company must make restitution or compensate the company for the loss. Where the money of the company has been applied for purposes which the company cannot sanction, the directors must replace it, however honestly they may have acted . . . The estate of a deceased director has always been liable for his breaches of trust."

Additionally, the member who knowingly receives such dividend will be deemed to be the trustee of the company and will be made to repay the same. In many of the above cases, the directors themselves received such dividend and were made liable to repay the same.

"In re Denham & Co. [1884] 25 Ch. D. 752, it was held that it was sufficient if the Directors appointed a person of good repute, competence and skill to audit the accounts and had no ground for suspecting that anything was wrong; also that directors were not bound to examine entries in any of the company's books. Chitty J. held that the director before him was entitled to trust the auditors and that, since there was nothing which could have aroused the suspicion that the auditors were not doing their duties, the director was not guilty of such gross and wilful negligence as was equivalent to fraud, and was not liable." *[As quoted in Re: Tri-sure India Ltd. [1983] 54 Comp Cas 197 (Bom)]* In the said case, the director who trusted the expertise of auditors was not required to pay back the dividend.

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"In Dovey v. Cory [1901] AC 477, a director of a banking company relied on the judgment, information and advice of the chairman and general manager of the bank, by whose statements he was misled. It was held that, upon a true view of the facts before the court, he had not been negligent in the performance of his duties as a director. The argument was led by Halsbury L.C. to raise the serious question as to the responsibility of all persons holding position as directors, and how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree. He held in a celebrated sentence that "The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending of details of management." Lord Dovey said that a director was bound to give and exercise his judgment as a man of business on the matters which were brought before the board at the meetings which he attended and that he was entitled to rely upon the judgment, information and advice of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion." *[As quoted in Re: Tri-sure India Ltd. [1983] 54 Comp Cas 197 (Bom)]* Hence, the due reliance on expertise of others is an excuse from liability.

30. Liability of auditors for payment of wrongful dividend

A question might be that to what extent the auditors of the Company will be liable for the payment of wrongful dividend given their position of not controlling the decision to pay dividends. It has been held in many cases that the Auditors owe their duties to shareholders and they shall be made liable only if any negligence in performance of their duties has aided in the payment of dividend.

31. Punishment and Compoundability

This section does not prescribe any penal provision for contravention of the section. Hence, section 450 of the Act will be applicable. Accordingly, the punishment for contravention, the company and every officer of the company who is in default shall be punishable with a fine upto Rs. 10,000, where the contravention is a continuing one then the fine shall be Rs. 1,000 for every day of contravention. The offenses committed by company and officer, being punishable only with fine, are compoundable under section 441 of the Act.

(Concluded)

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