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DELHI HIGH COURT JUDGMENT ON DIRECTOR DISQUALIFICATION

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Introduction:

The Hon'ble Delhi High Court (Court), on 4 November 2019, pronounced its judgment on the issue of disqualification of directors of companies which had failed to file their returns / financial statements for a period of 3 (three) or more consecutive years, as prescribed under section 164 (2) (a) read with section 167 of the Companies Act, 2013 (Act).

Section 164 (2) (a) of the Act provides that a person who is a director of a company that has failed to file its financial statements or annual returns for a period of three consecutive financial years shall face disqualification. Further, section 167 provides that the office of a director shall become vacant in case such person faces any disqualification(s) under section 164.

Background:

The Ministry of Corporate Affairs (MCA) had issued a notification by which over 1,46,000 directors in Delhi and across the country were disqualified, as they were directors of companies which had failed to file their financial statements for a consecutive period of 3 or more years.

The list of such disqualified directors under section 164 (2)(a) of the Act was first published on 15 September 2017 (Impugned List) for default of concerned companies in filing of annual returns and financial statements for the financial years 2014-2016. Two other lists of disqualified directors were subsequently published with respect to defaults pertaining to the financial years 2012-2014 and 2013-2015. The MCA had also simultaneously de-activated the DIN of such directors on the ground that pursuant to a director being disqualified under section 164, such director would be deemed to have vacated his office in other companies in which he was a director and he could not act as a director for a period of 5 years. This was done in a sweeping action, and without giving any prior notice or hearings to many of the directors so disqualified.

The Impugned List (as well as the two other lists hereinbefore mentioned) was challenged by certain aggrieved directors (Petitioners). The Union of India and the Registrar of Companies (ROC), New Delhi were made Respondents to the Petition.

Grounds of Challenge:

The Petitioners challenged the Impugned List on 4 primary grounds, being:

- First, that the action of the Respondents in disqualifying the Petitioners was arbitrary, inasmuch as the Petitioners were not afforded an opportunity to be heard and that the same was in violation of the principles of natural justice;

- Second, that section 164 of the Act was a penal provision and, therefore, could not be applied retrospectively. It was submitted that section 164 came into force on 1 April 2014 but the Petitioners had been disqualified as directors for defaults committed for the financial years preceding 1 April 2014;

- Third, on a plain interpretation of section 164(2)(a) of the Act, the Petitioners could not have been disqualified to act as directors of *other* companies which were not in default in filing their annual returns and financial statements for a period of 3 consecutive years; and

- Fourth, that the defaults under section 164(2) of the Act results in the directors being disqualified from being appointed/re-appointed as directors, however, does not result in them demitting office as directors.

The Respondents' submission was that the disqualifying of directors was essential to clean up the system as the concerned companies appeared to be "shell" companies which did not carry out any business. The Respondents also submitted that the Petitioners had been given sufficient opportunity to rectify the default of failure to file annual returns for a period of 3 continuous years. The Respondents further stated that, in fact, to afford an opportunity to the Petitioners to belatedly file annual returns / financial statements, the Respondent No. 1 had introduced the Company Law Settlement Scheme, 2014, which allowed inactive companies to be declared "dormant" companies under section 455 of the Act. Similarly, a subsequent scheme, known as the Condonation of Delay Scheme 2018, was also introduced to afford an opportunity to defaulting companies to rectify defects by filing the requisite returns / financial statements.

Decision:

At the outset, the Court noted that the main controversy in the petitions involved the interpretation of the provisions of section 164(2) and section 167 (1) (a) of the Act.

On the issue of whether an opportunity to be heard was required to be given, the Court held that section 164 (2) (a) merely set out certain conditions which, if not complied with, would automatically disqualify a person from being appointed / reappointed as a director. Further, since the section did not contemplate any decision-making process in this regard, the rule of *audi alteram partem* would not apply to the instant cases.

On the issue of retrospective application of the Act, the Court held that the Respondents had not contended that the Act would have retrospective application. Therefore, the Court observed that it was an admitted position that the Act would have only prospective application.

The Court stated that the real question under consideration was whether the default committed in failure to file financial statements and annual returns for the financial years 2013-14 would amount to applying the provisions of Section 164(2) of the Act retrospectively. In that context, the Court observed that a statute cannot be said to be retrospective "*merely because it affects existing rights or because a part of the requisites for its action is drawn from a time antecedent to its passing*". In other words, the Court held that the defaults for the financial year ending 31 March 2014 *should* be considered while determining whether a director had incurred the disqualification under section 164(2) of the Act. This view is contrary to the view taken by the three High

Courts, namely the Madras, Karnataka and Gujarat High Courts in three other similar petitions.

With respect to the interpretation of section 164 (2) (a) and on the question of whether the words "*appointment*" and "*re-appointment*" had different statutory connotations *vis-à-vis* the said section, the Court held that it was clear that the legislative intent behind the Act was to disqualify defaulting persons from being appointed as directors as well as from being reappointed in the *other* companies in which said persons were directors.

On the issue of whether the directors incurring a disqualification under section 164(2) of the Act would be required to demit their office as a director in all companies in terms of section 167(1)(a) of the Act, the Court held that the rule of literal interpretation could not be applied for interpreting the provisions of section 167(1)(a) of the Act. Therefore, the Court, while relying on the decision of the Bombay High Court in *Kaynet Finance Limited v. Verona Capital Limited (W.P.(C) 9088/2018)*, read down the provisions of section 167 of the Act to apply only to cases of disqualification falling under section 164(1) of the Act and not section 164(2) of the Act. Accordingly, the Court held that the Petitioners would be disqualified to act as directors of the defaulting company but would not demit their office in other (non-defaulting) companies where they are directors. However, in view of the proviso to Clause (a) of section 167(1) of the Act inserted by the Companies (Amendment) Act, 2018, which became effective from 7 May 2018, if the directors suffer any of the disqualifications after 7 May 2018, such director would have to demit their office in all companies and not just the defaulting company.

On the final issue of whether Respondents were right in deactivating the DIN of the directors, the Court observed that neither any of the provisions of the Act nor the rules framed thereunder stipulate cancellation or deactivation of DIN or DSC on account of a director suffering a disqualification under section 164(2) of the Act. Therefore, the Court held the same to be unsustainable in law and directed the Respondents to reactivate the DIN and DSC of the Petitioners, while clarifying that the Petitioners would still be liable to pay applicable penalties under the Act.

Conclusion:

While the view of the Hon'ble Delhi High Court seems to be a pragmatic one, there is still a lot of divergence of opinion between not only the several other High Courts of the country, but also amongst lawyers and jurists alike. Furthermore, the judgment passed by the Bombay High Court in an earlier batch of petitions on similar issue had been stayed and is pending before the Hon'ble Apex Court. As such, the issue is clearly one which has scope for widespread implications, and it seems that the final onus is likely to fall upon the Apex Court to determine the issues with finality.

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