

Compensation for Loss of Office (Sections 318 – 321)

Compensation for loss of office not permissible except to managing or whole-time directors or to directors who are manager (Section 318)

Question 1

Can a company pay compensation to its directors for loss of office? Explain briefly the relevant provisions of the Companies Act, 1956 in this regard?
(May, 2000)

Answer

A company can pay compensation to its directors for loss of office as provided in Sections 318 to 321 of the Companies Act 1956. Under Section 318, such compensation can be paid only to managing director, director holding the office of the manager and to a whole time director but not to others. The compensation payable shall be on the basis of average remuneration actually earned by such director for three years, or such shorter period as the case may be, immediately preceding the ceasing of holding of such office and shall be for the unexpired portion of his term or for three years whichever is shorter. No such payment can be made, if winding up of the company is commenced before or commences within 12 months after he ceases to hold office if the assets of the company on the winding up, after deducting expenses thereof, are not sufficient to repay to the shareholders the capital (including the premium, if any) contributed by them. However, no payment of compensation can be made in the following cases:

- (a) where a director resigns excepting on the ground of amalgamation or reconstruction and holding the office of managing director or manager or other officer of such reconstructed or amalgamated company.
- (b) where the director vacates office under section 203 or section 283(1).
- (c) where the winding up of the company is due to the negligence of the director concerned.
- (d) where the director has been guilty of any fraud or breach of trust.
- (e) where the director has instigated or has taken part directly or indirectly in bringing about, the termination of his office.

Question 2

Mr. Doubtful was appointed as Managing Director of Carefree Industries Ltd. for a period of five years with effect from 1.4.2000 on a salary of Rs.12 lakhs per annum with other perquisites. The Board of Directors of the company on coming to know of certain questionable

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transactions, terminated the services of the Managing Director from 1.3.2003. Mr. Doubtful termed his removal as illegal and claimed compensation from the company. Meanwhile the company paid a sum of Rs.5 lakhs on ad hoc basis to Mr. Doubtful pending settlement of his dues. Discuss whether:

- (i) *The company is bound to pay compensation to Mr. Doubtful and, if so, how much.*
- (ii) *The company can recover the amount of ₹ 5 lakhs paid on the ground that Mr. Doubtful is not entitled to any compensation, because he is guilty of corrupt practice.*
(November, 2004, November, 2007)

Answer

According to Section 318 of the Companies Act, 1956, compensation can be paid only to a Managing or Whole-time Director. Amount of compensation cannot exceed the remuneration which he would have earned if he would have been in the office for the unexpired term of his office or for 3 years whichever is shorter. No compensation shall be paid, if the director has been found guilty of fraud or breach of trust or gross negligence in the conduct of the affairs of the company.

In light of the above provisions of law, the company is not liable to pay any compensation to Mr. Doubtful, if he has been found guilty of fraud or breach of trust or gross negligence in the conduct of affairs of the company. But, it is not proper on the part of the company to withhold the payment of compensation on the basis of mere allegations. The compensation payable by the company to Mr. Doubtful would be Rs.25 Lacs calculated at the rate of Rs.12 Lacs per annum for unexpired term of 25 months.

Regarding adhoc payment of Rs.5 Lacs, it will not be possible for the company to recover the amount from Mr. Doubtful in view of the decision in case of *Bell vs. Lever Bros. (1932) AC 161* where it was observed that a director was not legally bound to disclose any breach of his fiduciary obligations so as to give the company an opportunity to dismiss him. In that case the Managing Director was initially removed by paying him compensation and later on it was discovered that he had been guilty of breaches of duty and corrupt practices and that he could have been removed without compensation.

Question 3

A Managing Director was removed during the tenure of office and certain compensation was paid to him. It was later on found that during the tenure of his office that he was guilty of corrupt practices and the company felt that no compensation should have paid to him and therefore wants to recover the compensation so paid to him. Can the company succeed?

Answer

In *Bell vs. Lever Brothers, (1932)*, Lever Brothers removed their managing director of a subsidiary by paying him compensation. It was afterwards discovered that during his tenure of office he had been guilty of so many breaches of duty and corrupt practices that he could have been removed without compensation. An action was then commenced to recover back the compensation money. It was held that Bell was not bound to refund the compensation money and to disclose any breach of his fiduciary obligation so as to give the company an opportunity to dismiss him.