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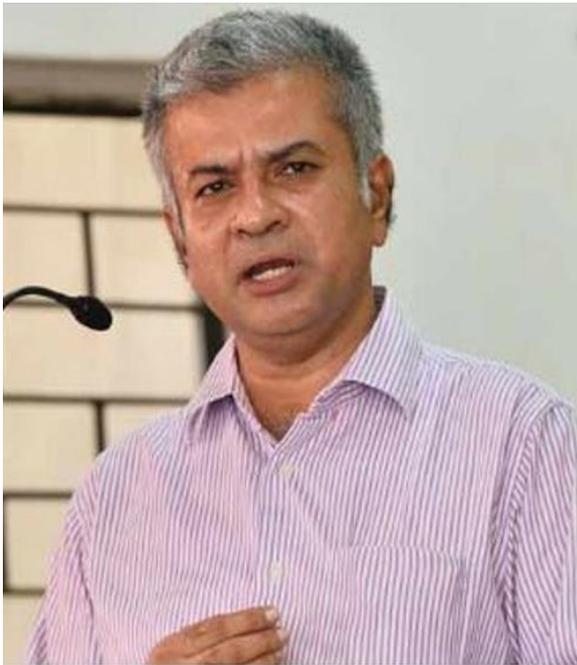
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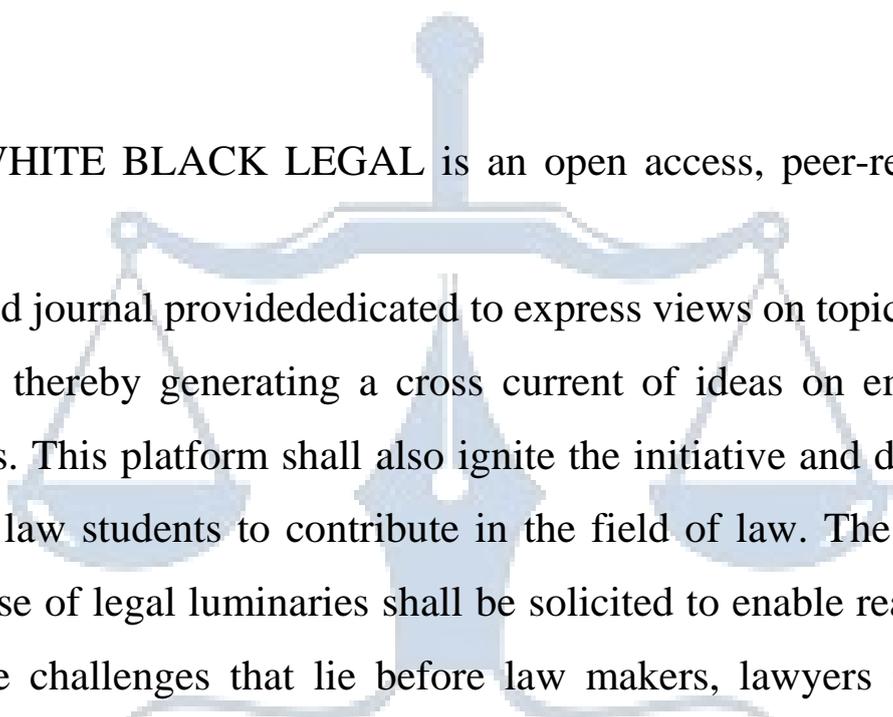


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With this thought, we hereby present to you

THE DOCTRINE OF INDOOR MANAGEMENT IN CORPORATE LAW AND ITS EVOLUTION THROUGH JUDICIAL DECISIONS

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INTRODUCTION

A XYZ company issued cheque to PQR. The XYZ company had Articles of Association which mentions that, if the company issues a cheque, two directors have to sign it along with secretary. But the appointment of directors and secretary were not proper. In such situation, PQR can file case against ABC company because directors and secretary appointment are company's internal management duty and PQR need not enquire into this matter before receiving the cheque. Company should pay cheque amount. This was Mahoney v. East Hollyford Mining¹ case. Indoor Management principle was applied here.

Doctrine protects outsiders from acts committed by the company. It is important for a person to have knowledge about the articles of Memorandum and Association of company before transacting. However, a person need not know about the internal matters and irregularities surrounding it. One of the prominent exception to this is Constructive Notice Principle.

The case Oakbank Oil Co. v. Crum² explained about constructive notice doctrine. It was held in this case that the person who involves in a transaction with company is completely aware and has full understanding about the Memorandum and Articles of Association of company. If a person sues a company due to his inadequate knowledge about contents of AOA and MOU, company shall not be liable and all the consequences shall be faced by the person suing it.

¹Mahony v. East Holyford Mining Co. 6 H.L.C. (1875).

²Oakbank Oil Co. v. Crum (1882) 8 A.C.65.

ROYAL BRITISH BANK Case³: Foundation To Indoor Management Doctrine

FACTS: Turquand was director of the company, he took a loan from bank. When it was time to repay the loan, the shareholders denied saying that the directors were not authorized to take loans. The company's articles mention that directors can take loans after passing the board resolution. Bank lent the amount assuming that the resolution would be passed and bank also cannot check if the resolution is really passed as it is an internal affair of company.

ISSUE: Whether creditor (bank) can recover the loan amount even though there is irregularity surrounding board resolution?

ARGUMENTS OF THE BANK: Bank believed that Turquand who is the managing director had the authority to borrow. Bank also believed that the company would have followed its articles and passed a resolution. Bank contended that indoor management applies here. Since bank is a third party its interests should be protected.

ARGUMENTS OF RESPONDENT: Minute book of company did not have an entry about the borrowing which is mandated by the company's articles. Since the records are not proper and inaccurate, company cannot be liable. It need not repay the loan amount. Bank should enquire into the company affairs before lending since it was not done, it is an unauthorized borrowing.

JUDGMENT: Court ruled in favor of the bank. It is the company's duty to abide by its rules. Bank did not know about the irregularity in passing the resolution hence it cannot be denied of its right to recover the loan amount.

This is a landmark case of the doctrine, also famously called Turquand's rule.⁴

APPLICABILITY OF THE DOCTRINE

If directors and officers commit any of these offences then Indoor management principle shall apply:

- Misappropriation of funds of the company and its property.

³Royal British Bank v. Turquand (1856) 119 ER 886 : (1843-60) All ER Rep. 435 130.

⁴Ibid.

- Not performing their fiduciary duty.
- Taking part in transactions that are in conflict with the interest or self-dealing.
- Breaching the confidentiality of shareholders, stakeholders or the board.
- Not disclosing important information to shareholders or board.

DOCTRINE OF INDOOR MANAGEMENT IN INDIA: THROUGH LANDMARK CASES

(1) Lakshmi Cotton Mills v. Jute Mills⁵

A creditor can presume that all necessary formalities for a transaction are correct when a transaction is entered into which is not against/banned by articles or company's charter. Such transaction cannot be declared void just because a resolution is not passed by the board which is an internal mechanism.

(2) Official Liquidator Manasube v. Commissioner case⁶

When a person wants to contract with a company, it is expected that he reads the MoA and AoA. It is not compulsory for a person to check about company's internal matters like legality or regularity of directors acts.

APPLICATION OF DOCTRINE OF INDOOR MANAGEMENT TO GOVERNMENT AUTHORITIES

In the case of MRF v. Manohar Parrikar⁷, a notification was released by the government stating that there will be 25% rebate of tariff in power supply to certain industrial consumers. These notifications were challenged in the court for not complying with the constitutional provisions. Since the decision was not concurrent with that of finance department, it could not be considered as state government's decision. Respondent relied on indoor management doctrine.

Court stated that irregularity is an exception that exists for Indoor management. As there is confusion around the issue of notifications, the doctrine cannot be applied. However, the doctrine is applicable to government authorities.

⁵Lakshmi Ratan Cotton Mills Co. Ltd v. J. K. Jute Mills Co. Ltd, AIR All 311 (1957).

⁶ Official Liquidator Manasube & Co. (P.) Ltd. v. Commissioner of police [1968]38 Comp Cas 884 (Mad).

⁷ MRF Ltd. v. Manohar Parrikar, (2010).

EXCEPTIONS TO THE DOCTRINE

(1) Forgery

If any officers of the company commit forgery then company is not liable because such transactions are void ab initio.

In Ruben and Great Fingall case⁸, the company's secretary of the Defendants company had distributed share certificate to the Plaintiff. These share certificated had the company's seal and forged signatures of two directors. The Plaintiff sued the company questioning the genuineness of signatures. It is the duty of company to check its authenticity as it forms part of internal matter of the company so the company is liable. It was ruled that indoor management doctrine does not include forgeries. The judge in this case, Lord Loreburn held that it is not compulsory for an external person to know or be aware of internal matters of any company while transacting and any irregularity that arises out of it.

(2) Knowledge of inconsistency

When an outsider/third party who is transacting with the company is aware that a certain person is not having authority to do a particular act but still continues to transact. Such a person cannot take advantage of the doctrine. Sometimes such an outsider could be involved in the internal affairs.

In E.D. Sassoon & Co. against T.R. Pratt (Bombay) Ltd.⁹ Case, A company had transferred money to B company for B's assets without following the rules in Articles of Transaction. Both the Plaintiff company and Respondent company had same directors so the judgment was that the lender had knowledge about the loophole. One cannot rely upon Indoor Management doctrine and the transaction was declared illegal. In Howard v. Patent Ivory case¹⁰, director borrowed 3500 pounds from another director. There was a rule that director cannot borrow more than 1000 pounds without the matter being discussed in the annual meeting (AGM) of the company. Ruling was that the company is not liable because the Plaintiff was director and he is very well aware about the transaction rules.

(3) Negligence

If the outsider does not do proper investigation about the company and is negligent about the suspicious activities happening in the company that are quite visible then

⁸ Ruben v. Great Fingall Ltd., 44 SLR 616, (1906).

⁹T.R.Pratt (Bombay) Ltd. v. E.D. Sassoon & Co.Ltd. (1936) 1 A.I.R. 62 (BOM).

¹⁰Howard v. Patent Ivory Co (1888) 38 Ch D 156.

doctrine does not apply.

In the Anand Bihari Lal¹¹ case an accountant had transferred property without authority. Court ruled against the Plaintiff stating that the Plaintiff was negligent to find out the Power of Attorney for such transfer so his claim is not valid.

(4) Officer acting in excess of his authority

Company gives certain powers within which each of its employees can act. If any employee acts beyond that authority, company cannot be held liable.

In the case of Kreditbank Cassel¹², the branch manager had signed certain bills of exchange. He signed them on behalf of company to a person who he owed money personally. The manager had no authority or authorization of the company to perform such an act. Court ruled that if a person holding an authoritative position in the company acts beyond his executive power then company is not liable.

(5) Lack of knowledge about MoA and AoA/ Constructive notice principle

A person cannot claim that he/she is unaware of the contents present in companies documents like Memorandum of Association and the Articles of Association which are usually published on public platforms and are easily available to public. These are considered to be information given to the world.

In the case Rama Corporation v. Proved Tin¹³ articles had a mention that director can delegate his powers to someone else. Rama who entered into contract with the director was unaware of this fact and issued a cheque. Later it was found that the power was not delegated. Indoor management doctrine could not be relied upon.

(6) Existence of Agency

In a case Varkey Souriar v. Leraleeya Banking, the court said that if there is a question about existence of an agency itself and not about the certain power exercised by the agency then doctrine does not apply.

CONCLUSION

Third parties who transact with the company are protected under the Indoor Management doctrine. It is a counter measure to Constructive Notice principle. If a person wants to take advantage of the doctrine he/she should have good knowledge and understanding of company's documents such as Memorandum of Association (MoA) and Articles of Association (AoA).

¹¹Anand Bihari Lal v. Dinshaw & Co, 48 BOMLR 293 (1946).

¹²Kreditbank Cassel v. Schenkers Ltd., All ER 421 (1927).

¹³Rama Corporation v. Proved Tin and General Investment Co. (1952) 1 All ER 554.

However, this principle of Indoor management is not absolute, it has certain exceptions as discussed. It protects only certain third parties only and the type of companies they transact with. There should be balance in using this doctrine so it promotes business.

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