The Indian Journal for Research in Law and Management

Open Access Law Journal – Copyright © 2026

Editor-in-Chief – Dr. Muktai Deb Chavan; Publisher – Alden Vas; ISSN: 2583-9896

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WHEN CORPORATE DECISIONS BECOME LEGAL VIOLATIONS:DIRECTOR'S LIABILITY AND THE LIMITS OF MANAGERIAL DISCRETION

~ Gargi Kolhe

INTRODUCTION

A corporate decision can fail commercially without being legally wrongful. The director can approve a failed investment, enter an unsuccessful market or rely on forecasts that later prove inaccurate. Treating the mere outcome as evidence of liability would assess the director on a retrospective basis, instead of assessing whether the particular decision was legally permissible at that point of time.

Here, the relevant question is whether the decision was taken within the legal boundaries of managerial discretion. Did the director have the authority to act at the time of decision-making? Was the power used for a legitimate purpose? Was the director affected by any conflicting interest? Were material circumstances adequately considered? Were the mandatory statutory requirements obeyed?

The Business Judgement Rule reflects the continuing difficulty, while exercising managerial discretion, of distinguishing between actions taken with a bona fide intention and conduct that warrants director liability. The question here is narrower: how do existing Indian legal principles distinguish between legitimate commercial risk and conduct that can attract director liability?

A failed decision, by itself, does not establish wrongdoing if the director acted within their authority. In contrast, a commercially successful decision can also become legally defective if it is driven by an improper purpose, undisclosed interest, inadequate inquiry, statutory non-compliance or personal benefit.

This article examines five points at which this boundary can be crossed and develops a Decision-Liability Assessment Framework by applying existing legal principles to the circumstances in which directors exercise managerial discretion.

LEGAL FOUNDATIONS OF MANAGERIAL DISCRETION

Directors frequently make decisions that involve uncertain markets, investments, financing and corporate strategy. Therefore, the law does not focus on whether the decision produced the expected commercial result, rather, it focuses on whether the power used to make the decision was exercised within the duties and restrictions imposed by law.

Section 166 of the Companies Act, 2013[1] provides a statutory framework for director's duties by requiring directors to act in good faith, exercise due and reasonable care, skill and diligence and use independent judgement while restricting conflicts and undue gain. Sections 184 and 188[2] provides additional safeguards in situations involving a director's interest in a matter or transactions with related parties.

The Court has applied the principles to the manner in which directors exercise corporate power. In *Dale & Carrington Investment (P) Ltd. & Anr. v. P.K. Prathapan & Ors*. (2004)[3], the Supreme Court recognised the fiduciary character of director's power and held that it must be used in good faith, with due care and for proper purposes, including when the power is used to allot shares. In *N. Narayanan v. Adjudicating Officer, SEBI* (2013)[4], the Court held that directors must exercise due care and diligence and cannot disregard matters apparent upon reasonable examination.

These principles provide legal standards for assessing corporate decisions: authority and proper purpose, conflicts of interest, due diligence and statutory compliance. Failure in any one of these areas may take a decision beyond legitimate managerial discretion and may make the director liable, depending on the applicable legal provision.

FIVE FAULT LINES WHERE DISCRETION BREAKS DOWN

The five fault lines below identify circumstances in which director's commercial discretion may become legally restrained.

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[1] The Companies Act, No. 18 of 2013, Acts of Parliament, 2013, § 166 (India).
[2] The Companies Act, 2013, § 188.
[3] Dale & Carrington Investment (P) Ltd. & Anr. v. P.K. Prathapan & Ors. (2005) 1 SCC 212.
[4] N. Narayanan v. Adjudicating Officer, SEBI (2013) 12 SCC 152.

A. *Authority:* The first question is whether the director was legally entitled to make the decision in the manner in which it was made. Section 166(1) requires directors to act in accordance with the company's articles, while Section 179 governs the exercise of the Board's powers and specifies certain powers that must be exercised through resolutions passed at Board meetings.[5] *Dale & Carrington* recognises the fiduciary character of director's power and held that it must be exercised within the lawful scope and for proper purposes.[6] The practical question is whether the director could take the decision in the manner adopted? A commercially beneficial objective cannot cure a lack of authority and avoid a mandatory approval requirement.

B. *Purpose:* Establishing authority does not, by itself, ensure that the power was properly used. In *Dale & Carrington*, the Supreme Court held that the fiduciary power to allot shares cannot be exercised for an extraneous purpose such as maintaining or acquiring control of the company.[7] Therefore, the key question here is not only whether the director had the power, but also the purpose for which the power was used. Commercial justification cannot validate the conduct which includes personal control, diversion of corporate opportunities or any other improper purposes.

C. *Conflict:* Managerial discretion can become legally problematic when the director's personal interests conflict with the company's interests. In *Rajeev Saumitra v. Neetu Singh & Ors.* (2016)[8] the Delhi High Court examined Section 166 in the context of director's fiduciary duties, good faith and conflicts between their duties and personal interests. The practical distinction lies in the opportunity pursued for the company and the one appropriated for the director. An undisclosed interest can affect the legal character of the competing enterprise or benefit obtained by the director. Importantly, the company need not necessarily suffer a loss for conflict to become legally relevant.

D. *Information and Diligence:* Information focuses on what was reasonably available to the director, where diligence concerns got the director done with it. In *N. Narayanan*, the Supreme Court held that directors cannot shut their eyes to matters that should have been apparent upon examination of the company's affairs.[9] The distinction is not between a successful and

[5] The Companies Act, 2013, § 166(1), 179.
[6] Dale & Carrington, (2005) 1 SCC 212.
[7] Dale & Carrington, (2005) 1 SCC 212.
[8] Rajeev Saumitra v. Neetu Singh & Ors. 2016:DHC:618.
[9] N. Narayanan, (2013) 12 SCC 152.

unsuccessful decision but between a reasonable decision-making process and one that ignored evident material circumstances.

E. *Compliance and Undue Benefit:* Commercial description ends where a mandatory legal requirement applies. Section 188 regulates specified related party transactions and prescribes applicable approval requirements, while Section 166(5) prohibits directors from obtaining or attempting to obtain undue gain or advantage for themselves or their relatives, partners or associates.[10] For example, suppose a director enters into a transaction then fails to make a required disclosure or obtain prescribed approval, and the transaction later produces profits for the company. The commercial success does not override the separate questions of statutory compliance. Also, when the director obtains undue personal advantage, the company's benefit does not make that conduct legitimate. Once a mandatory legal requirement is engaged, commercial judgement cannot displace it.

COMMERCIAL FAILURE vs LEGAL WRONGDOING

This distinction becomes clearer when the decision is examined through different decision-making conditions.

For example, a Board has the power to enter into a new market, reviews its financial and regulatory information, considers foreseeable risks, obtains the required approvals and has no conflicting interest. Later, market conditions deteriorated unexpectedly and the company suffered a substantial loss. Here, the decision collapsed commercially, but this failure alone does not establish a legal violation.

In another situation, assume the directors became aware about serious financial and regulatory risks but still choose to ignore them before approving the investment. The outcome is the same as in the previous example, but now the legal inquiry changes: here, the key issue becomes whether the directors performed their duty of care and diligence.

Finally, suppose the investment succeeds, but the directors have an undisclosed financial interest which existed when the decision was made. The absence of commercial loss does not eliminate the resulting legal issue. All these examples establish that commercial failure and legal wrongdoing are different categories.

[10] The Companies Act, 2013, § 188, 166(5).

Therefore, outcome review must be distinguished from process review. Outcome review asks whether a decision produced the desired commercial result, while the process review asks whether the power was exercised within proper authority, for a proper purpose, with due diligence and in compliance with the law. For establishing director liability, the latter inquiry matters more. Here, the immediate task is identifying the legal conditions that distinguish permissible risk from wrongful conduct.

DECISION-LIABILITY ASSESSMENT FRAMEWORK

The given faults can be organised into a Decision-Liability Assessment Framework. The eight inquiries are aligned with the statutory and judicial principles, they do not form any new legal test or an independent source of liability.

1. *Authority:* Did the director have the authority to make the decision? This requires examining the company's documents, the Companies Act and applicable statutory and approval requirements.

2. *Purpose:* Was the purpose legally valid for which the power was exercised? In *Dale & Carrington*[11], the Court held that mere possession of corporate power does not legitimise its exercise for an improper purpose.

3. *Conflict:* Did the director have any personal interest in the decision that could affect it and was the interest disclosed or managed properly? Sections 166 and 184 makes this issue independently relevant irrespective of the commercial outcome.

4. Information: While decision making, which material information was reasonably available? The inquiry focuses on the information available at the time of decision-making rather than assessing the decision solely with hindsight.

5. *Diligence:* Under Section 166(3), did the director exercise the duties with due and reasonable care, skill, diligence and independent judgement?[12] A successful decision may still involve an un-authorised decision-making process, while an unsuccessful outcome may not involve any breach.

6. *Compliance:* Were the mandatory statutory requirements applicable to the transactions satisfied? Commercial convenience cannot be a substitute for required disclosure or approval.

[11] Dale & Carrington, (2005) 1 SCC 212.
[12] The Companies Act, 2013, § 188, 166(3).

7. *Benefit:* Did the director obtain any undue gain or advantage for himself or any connected person? As provided under Section 166(5)[13], this becomes independently relevant.

8. *Record:* Is there any concurrent evidence showing that the relevant information was considered, interests were disclosed and all required approvals were properly obtained. This inquiry is evidentiary rather than substantive, as documentation cannot cure an unlawful decision.

Rather than operating as a formula, the inquiries operate cumulatively. Authority and purpose examine the legal basis and objective of exercising the power, conflict addresses competing interests, information and due-diligence examine the decision-making process, compliance and benefit identify specific statutory restrictions and record helps to establish the reason behind what actually happened.

The framework finally asks: Was the director merely wrong in decision-making, or was there something legally defective about the exercise of corporate power?

Section 463(1) supports this distinction without creating any Business Judgement Rule. If a company officer is found liable for negligence, default, breach of duty, misfeasance or breach of trust, but the Court finds that the officer acted honestly and reasonably, it may excuse them wholly or partly on fair terms.[14] This is a discretionary provision and not an automatic protection for every honest commercial decision.

IMPLICATIONS FOR CORPORATE GOVERNANCE

The framework has a practical consequence: for addressing relevant legal and commercial considerations, corporate decisions should leave sufficient concurrent evidence. Wherever applicable, the basis of the decision, approvals and other relevant material information should be traceable from the company's record. Board minutes and related records can help to determine what information was available, what interests were disclosed, what approvals were obtained and how the decision was made.

This does not require comprehensive documentation of routine decisions, as the records cannot cure significant illegality. Their utility is for the establishment of evidence: they can help

[13] The Companies Act, 2013, § 188, 166(5).
[14] The Companies Act, 2013, § 463(1).

distinguish a commercial decision whose outcome failed from one whose decision-making process failed to comply with statutory requirements.

The objective is not to put an end to the commercial risk, but to distinguish between legitimate risk-taking and legally defective decision-making.

CONCLUSION

Directors cannot be expected to make every decision successfully or without risk or uncertainty, and some decisions will certainly fail. But calling something a “business judgement” does not mean that it falls beyond the law. The real question is whether the director used their power lawfully. A director may make a decision that later turns out to be commercially wrong, but cannot act without authority for an improper purpose, despite a conflict of interests, without reasonable care or against mandatory legal requirements. Business judgement allows the directors to choose, but it does not allow them to ignore the law. A failed decision can be lawful, while a successful decision can still be unlawful.