GOOD FAITH VS PROPER PURPOSE: RE- EXAMINING JUDICIAL REVIEW OF DIRECTORS' POWERS UNDER INDIAN COMPANY LAW

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I. Introduction

Directors often exercise powers such as issuing shares or restricting shareholder rights stating that they acted in the company's best interests. When these decisions are questioned, courts encounter the issue, whether it's enough that a director acted in good faith or must they have also acted in for the right reasons for the exercise of power to be valid?

Company law is thus faced with a doctrinal divide between the subjective standard of "good faith" and the objective constraint imposed by the Proper Purpose Rule.

Section 166 of the Companies Act, 2013, codifies directors' fiduciary duties and expressly requires them to act in good faith.[1] However, it does not explicitly mention the requirement that powers must be exercised only for their proper purposes. Although the Proper Purpose Rule is a well- established principle of fiduciary law in common law countries, its application on its own in the Indian legal system is unclear and underdeveloped. Consequently, courts tend to focus on the good faith of the directors than on the lawfulness of the purpose behind such decisions.

This paper holds that the Proper Purpose Rule is an application of the fiduciary duty in Section 166 but that Indian courts do not use it as a separate criterion but rather merge it with the subjective criterion of good faith. The confusion of the two standards undermines the way courts examine the decisions made by directors and permits the court to condone a decision actually made improperly.

II. Section 166: Codification without Doctrinal Clarity

A directors' fiduciary duties are encompassed in Section 166 of the Companies Act, 2013,

[1] Companies Act 2013, s 166.

which are largely drawn from principles developed under common law and equity. Section 166(2) requires directors to act in good faith in order to promote the objects of the company and to act in its best interests, along with those of its members, employees, shareholders and the broader community.[2] This provision reflects a fiduciary standard grounded in loyalty but articulated through the language of subjective belief. Complementing this, Section 166(3) introduces an objective element by requiring directors to exercise due and reasonable care, skill and diligence.[3] Section 166(4) prohibits directors from allowing personal interests to conflict with those of the company.[4]

Even though Section 166 appears comprehensive, it creates an important legal ambiguity. While it clearly imposes a duty to act in good faith, it does not explicitly differentiate between the state of mind of the director and the purpose for which a corporate power is exercised. Fiduciary law, as developed in common law jurisdictions, traditionally recognises both standards: directors must act honestly but must also exercise their powers only for the purposes for which those powers were conferred. Section 166 makes good faith central but says nothing about whether a power was used for its intended purpose.

III. Proper Purpose as an Objective Limit on Directors' Powers

The doctrine of equity has always maintained that a power could be employed for the intended purpose only and the proper purpose rule is one of the best examples of this principle in company law. It operates as a strict fiduciary requirement upon the directors, essentially showcasing that the issue is not only whether the directors were acting in good faith but whether they were employing a specific power of the corporation for the purpose for which it was granted. This rule traces back to the equitable principle against fraud on a power as expressed in *Duke of Portland v Topham*, where the House of Lords held that a power exercised beyond its proper object is void.[5] In company law today, this principle has been central in regulating the misuse of managerial power, particularly when directors use broad powers not for the purpose of furthering business but for changing corporate control.

The principle is most clearly stated in the case of *Howard Smith Ltd v Ampol Petroleum Ltd.* In that case, the directors had allotted shares by means of a power they undoubtedly had. The

[2] Companies Act 2013, s 166(2).
[3] Companies Act 2013, s 166(3).
[4] Companies Act 2013, s 166(4).
[5] *Duke of Portland v Topham* (1864) 11 HL Cas 32 (HL).

directors contended that the allotment was effected for the purpose of raising capital for the benefit of the company. However, the Privy Council found that one of the primary purpose of the allotment was to dilute the voting power of an existing shareholder.[6] The importance of *Howard Smith* is that despite the directors' good intentions to act in the best interests of the company, the exercise of power cannot be justified if the purpose is an improper one. The theory is more stringent than the good faith principle since it compels the court to ascertain where the power emanates from, what the correct use of such power ought to be and thereafter compare it with the intention of the directors.

The same test was reemphasized in *Eclairs Group Ltd v JKX Oil & Gas plc*. Here, the directors were utilizing a power of restriction contained in the articles of the company, seemingly in order to facilitate compliance with their disclosure requirements. The power seemed legitimate in itself and the use by the directors did not seem to be inconsistent with the provisions of the articles themselves. Nevertheless, it was found by the UK Supreme Court that there had been an improper exercise of the power since its true purpose was to influence the outcome of a shareholder vote.[7] The case is crucial because it demonstrates that even where directors act within the formal language of the articles and invoke an apparently legitimate rationale, the court will still examine the true purpose of the decision. *Eclairs* hence reinforces the reasoning in *Howard Smith*, i.e the proper purpose rule is not only aimed at addressing any apparent abuse but also encompasses other types of behavior such as those involving the self- protection and control- oriented conduct.

It is noteworthy from the views of Umakanth Varottil, a renowned scholar on this issue, that there is no displacement of common law fiduciary obligations through codification.[8] It is crucial to note that despite the codification of the directors' duties in Section 166, there was no provision made for the proper purpose test.

IV. Good Faith: A Subjective Standard in Judicial Review

The principle of good faith in company law has its origins in the concept of fiduciary obligations evolved under the principles of equity. These principles hold that when persons have been placed in positions where they wield power over the interest of another person, then

[6] *Howard Smith Ltd v Ampol Petroleum Ltd* (1974) AC 821 (PC).
[7] *Eclairs Group Ltd v JKX Oil & Gas plc* (2015) UKSC 71.
[8] Umakanth Varottil, 'The Evolution and Effectiveness of Independent Directors in Indian Corporate Governance' (2013).

they should exercise their powers with good faith in favour of the beneficiary. In company law, such principles govern the behavior of company directors. These can be found in statutes like Section 166 of the Companies Act, 2013. This provision in India is understood as an incorporation of pre- existing principles of common law and equity relating to directors.

Nevertheless, the judicial interpretation of good faith has also been majorly shaped by developments in tort law, particularly in the area of deceit and misrepresentation. In *Derry v Peek*, the House of Lords held that liability for deceit requires proof of fraud but an honest mistake in the matter will suffice as a defence against liability.[9]

Such an impact plays a crucial role in interpreting Section 166(2), where there is usually a subjective approach. In cases like *Dale & Carrington Investment (P) Ltd v P.K. Prathapan*, the courts consider whether the directors have acted in good faith for the company.[10] While this inquiry is important, it is not sufficient on its own, because it does not interrogate whether the power itself was exercised within its legally permissible limits. The difficulty arises from the fact that good intentions can become an end in themselves and if there is a good answer to give, then it overshadows everything else. This creates a limitation in the doctrine, as a decision may be honest in intention yet still constitute an improper exercise of power.

As a result, courts may focus on whether directors acted honestly, without independently examining whether the power was exercised for its proper purpose. This overlap is not just theoretical but affects how courts actually decide cases. Instead of examining whether a power was used within its legal limits, courts focus on whether the director believed they were acting correctly. This leads to greater weight being given to honest belief over the legality of the purpose, which weakens judicial scrutiny and allows improper decisions to go unchallenged.

V. Conflating Good Faith and Proper Purpose: A Doctrinal Failure

The relationship between good faith and proper purpose is not one of complete opposition. In many cases the two standards overlap: a director may act in good faith and also exercise a power for its proper purpose, for example where shares are issued genuinely to raise capital or where restrictions are imposed to ensure compliance with lawful governance requirements. The real difficulty arises not in these clear cases but where directors act honestly yet use a power

[9] *Derry v Peek* (1889) 14 App Cas 337 (HL).
[10] *Dale & Carrington Investment (P) Ltd v P.K. Prathapan* (2005) 1 SCC 212.

for an improper purpose. It is here that the failure to separate the two standards becomes most damaging. A director who genuinely believes that diluting a rival shareholder's stake is necessary to protect the company's long- term stability satisfies the good faith test entirely: there is no fraud or bad intent. Yet they have still deployed a share issuance power for a purpose it was never meant to serve. Indian law, by collapsing proper purpose into good faith, lacks the terminology to describe this person. It is not just a question of doctrinal vagueness but rather a structural problem with promoter- dominated firms, where the same individual often controls both the exercise of power and the narrative of good faith. Matthew Conaglen's foundational work on fiduciary loyalty offers a precise explanation for why this gap is structurally serious: fiduciary duties regulate the exercise of power itself, not only the state of mind of the person wielding it. Good faith speaks to conduct where it asks whether the director acted honestly. Proper purpose speaks to power where it asks whether the power was used within its legally intended limits. These are categorically different inquiries and treating one as a substitute for the other renders the law blind to the honest wrongdoer: the director whose sincerity is genuine but whose use of power remains illegitimate.[11]

The first problem with conflation is that good faith is inherently subjective and therefore easy to invoke as a shield. Once the inquiry is framed in terms of whether directors honestly believed that their actions were in the interests of the company, the standard becomes undemanding. Directors can almost always justify a contested decision by saying that they believed it to be commercially necessary, strategically prudent or beneficial to long-term corporate stability. A director may sincerely think that retaining a particular management structure is best for the company, but that belief cannot justify using a share issuance power to dilute a rival shareholder if the true function of the power is capital raising. Honesty of belief, therefore, cannot be treated as a substitute for legality of purpose.

The second problem is that while the proper purpose rule is objective, Indian law has not developed a structured method of applying it. Proper purpose requires courts to identify the source of the power, determine the legitimate end for which it exists and then compare that end with the actual purpose for which it was exercised. This inquiry is doctrinally distinct from asking whether directors acted honestly. In English law, the difference is clear: even an honest decision may be invalid if the power has been deployed for a collateral objective, such as altering voting control or neutralising a dissident shareholder. Indian judicial reasoning,

[11] Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010).

however, has not consistently articulated this as a separate and independent standard. Proper purpose is often treated as folded into the broader language of bona fides, rather than as a distinct discipline of fiduciary review. As a result, the law loses the analytical precision needed to distinguish lawful management from misuse of authority.

A third effect of this conflation is that the reviewing process of the decisions made by directors becomes overly lenient. It is natural that courts will refrain from interfering with commercial decisions; however, the general rule in company law holds that courts must not take the liberty of substituting the decisions made by directors as regards commercial strategy with their own judgment. Yet, such an approach poses problems for cases of fiduciary abuse of power if courts concentrate exclusively on whether directors could provide any commercially justifiable ground for their conduct. The process of fiduciary scrutiny then turns out to be nothing more than a superficial assessment of sincerity.

The fourth and most serious consequence is that substantive abuse of power may survive judicial review. This is especially evident in cases involving share allotments, voting restrictions, refusal to register transfers or other strategic exercises of board power. Such powers are formally valid and often broad in wording but they exist for defined corporate purposes. When directors deploy them to entrench control, manipulate internal power balances, dilute minority shareholders or pre-empt opposition, the misuse may be concealed beneath an apparently honest explanation. If courts accept good faith alone as sufficient, such conduct remains insulated from effective challenge.

This problem is acutely pronounced in the Indian corporate context, where listed companies are overwhelmingly promoter- dominated and the director exercising the power, the majority shareholder benefiting from it and the person whose honest belief satisfies the good faith test are frequently the same individual. In such a structure, good faith becomes self- referential i.e. a promoter- director who genuinely believes that consolidating control serves the company's interests will always satisfy a subjective honesty inquiry, precisely because their conception of the company's interests is inseparable from their own. The proper purpose rule, being objective, breaks this circularity in a way that good faith structurally cannot.

VI. Application in Practice: When Good Faith Masks Improper Purpose

The practical force of this doctrinal conflation can be seen most clearly in cases involving the exercise of directors' powers over shares and control. *Needle Industries (India) Ltd v Needle*

Industries Newey (India) Holding Ltd, a leading case on oppression and mismanagement, reflects the Indian courts' focus on whether directors acted bona fide in the interests of the company. However, the case also involved the exercise of share-allotment powers affecting control, a situation typically governed by the proper purpose rule.[12]

A similar concern, as briefly mentioned earlier, appears in *Dale & Carrington Investment (P) Ltd v P.K. Prathapan*, where shares were issued in a manner that diluted an existing shareholder's position and enabled the managing director to consolidate control. The Supreme Court declared the allotment to be invalid and ruled that the directors were to wield their powers for the benefit of the company and not for their own glorification. The case therefore illustrates how Indian courts often reach the correct result while expressing the issue primarily through the language of good faith rather than through a developed proper purpose analysis.

The same pattern is visible in *Bajaj Auto Ltd v N.K. Firodia*, where the refusal to register share transfers was scrutinised on the basis that directors must act bona fide and in the interests of the company.[13] In English law, cases such as Howard Smith and Eclairs confront this issue directly by asking whether the power was used for its intended purpose. Indian cases, by contrast, often identify impropriety through the vocabulary of bona fides without fully separating purpose from honest belief.

While Indian courts have not clearly adopted an objective standard, there are signs of movement in that direction. For instance, in *Mar Jacob Thoomkuzhy v Jeevan Telecasting Corporation Ltd*, the NCLT held directors liable for removing the petitioner from directorship and acquiring shares with the intent to take control of the company. The Tribunal emphasised that a director must act in a manner consistent with that of a 'reasonably prudent person'.[14] However, despite such developments, the predominantly subjective approach reflected in decisions like *Bajaj Auto* continues to remain the binding position in Indian law.

VII. Comparative Analysis between India and UK

UK company law separates these duties more clearly than Indian law. Section 171(b) of the

[12] *Needle Industries (India) Ltd v Needle Industries Newey (India) Holding Ltd* (1981) 3 SCC 333.
[13] *Bajaj Auto Ltd v NK Firodia* (1971) 41 Comp Cas 1 (SC).
[14] *Mar Jacob Thoomkuzhy v Jeevan Telecasting Corporation Ltd*, Company Petition No 57/2016 (NCLT Kochi Bench, order dated 12 July 2018).

Companies Act 2006 requires directors to exercise powers only for proper purposes[15], while Section 172 requires them to act in good faith to promote the success of the company.[16]

In *Saxon Woods Investments Ltd v Costa*, the court clarified that good faith is not purely subjective.[17] Even if a director believes their conduct benefits the company, the conduct must still satisfy objective standards of ordinary decent people and cannot include misleading the board or shareholders. Scholarly work by Ernest Lim similarly states that UK courts use a structured approach: they generally respect business judgment, but intervene where there is dishonesty, improper purpose, or misuse of power.[18]

In contrast, Indian law, under Section 166, does not clearly separate these standards. While fiduciary duties are codified, judicial reasoning often collapses proper purpose into the broader inquiry of good faith, focusing primarily on the director's belief rather than the legality of the purpose. This lack of doctrinal separation results in weaker judicial scrutiny, allowing decisions that may be honest in intention but improper in purpose to escape effective review.

VIII. My Perspective: Restoring Clarity in Directors' Duties

In my view, the central weakness in Indian company law is not that it ignores fiduciary abuse but that it addresses it through an insufficient framework. The most necessary reform is therefore conceptual clarity. Courts should expressly recognise that good faith and proper purpose are separate but complementary standards. The first asks whether directors acted honestly and loyally, the second asks whether the power itself was used for the purpose for which it exists. Indian courts should adopt a structured inquiry similar to the UK approach i.e. identify the power, determine its legally intended purpose and then examine the substantial purpose for which it was exercised. There is no need for a legislative change to achieve this, although it would be useful if Section 166 was clarified. The mere recognition of this by the courts would already have the effect of strengthening fiduciary obligations.

IX. Conclusion

This paper has argued that the distinction between good faith and proper purpose is not merely

[15] Companies Act 2006, s 171(b) (UK).
[16] Companies Act 2006, s 172(UK)
[17] *Saxon Woods Investments Ltd v Costa* [2025] EWCA Civ 708.
[18] Ernest Lim, 'Judicial Intervention in Directors' Decision-Making Process: Section 172 of the Companies Act 2006' (2018) 169 *Journal of Business Law*.

a doctrinal refinement but a precondition for meaningful judicial review of directors' powers under Indian company law. Section 166 codifies fiduciary obligations but does not articulate the independent constraint that powers must be exercised only for their proper purposes. Courts examine whether directors acted bona fide, yet do not separately ask whether the power was used for the purpose for which it was conferred. In a promoter- dominated corporate environment, that gap is structurally exploitable, not theoretical. As Conaglen's work states that good faith regulates conduct and proper purpose regulates power- these are categorically different inquiries.[19] Until Indian law treats them as such, fiduciary accountability will remain more formal than real.

[19] Matthew Conaglen, *Fiduciary Loyalty* (Hart Publishing 2010).