

De Jure

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Directors Liabilities - A Companies Act perspective Knowledge and Intent - Key to Determination of Liability!



With a surge in white collar crimes and increase in instances of fraud in companies in India, it becomes important to understand the implications of such events on the directors of the relevant companies including the independent directors. It is critical even for the directors who have been appointed in a non-executive capacity by private equity or other investors, banks and financial institutions on the Board of Indian companies, to be cognizant of potential liabilities under such circumstances.

The ensuing discussion gives an insight on Directors' liability under the Companies Act, 2013 ("**Companies Act**").

DIRECTORS LIABILITY UNDER COMPANIES ACT

The Companies Act broadly distinguishes the liability of directors and officers in default of Indian companies into civil and criminal liability. Failure to comply with certain provisions of the Companies Act attracts a civil liability in the form of fine, payable by the defaulting company, its directors and/or officers in default, for instance failure to file annual returns or failure in relation to maintenance of statutory registers, appointment of directors and key managerial personnel, requisite disclosures to be made in the explanatory statement to be annexed to the notice convening the general meetings. Further, a criminal liability may arise in the form of imprisonment of the officers in default of upto a maximum tenure stipulated under the relevant provisions of the Companies Act for certain non-compliances including default by a public company in relation to the issuance of prospectus, failure to inform the stock exchanges and comply with the relevant provisions by a company making a public offer, issuance of shares at discount, failure to repay the deposits within the stipulated time periods.

The directors may also face legal consequences upon invocation of certain rights by shareholders of the company under the Companies Act in certain circumstances. The Companies Act entitles shareholders of a company to initiate legal proceedings against the directors for breach of their duties. For instance, a shareholder of a company may approach the NCLT if, amongst others, the affairs of the company have been or are being conducted in a manner prejudicial to public interest or prejudicial or oppressive to the shareholder(s) or the interest of the company¹. Further, a stipulated number of shareholders can also initiate a class action suit to, amongst others, prevent oppression and mismanagement, restrain the company and its directors from committing a wrongful, illegal or fraudulent act or an act that is ultra vires the charter documents of the company².

WHO IS LIABLE UNDER COMPANIES ACT?



While directors being the decision makers in the day-to-day functioning, management and affairs of the company, are held responsible for the non-compliances or wrongful acts or omissions by the company, not all directors may be held liable under the Companies Act.

¹ Section 241 read with Section 244 of the Companies Act

² Section 245 of the Companies Act

³The Companies Act designates certain officers of a company as the key managerial personnel ("**KMPs**") comprising the chief executive officer or the managing director or the manager, the company secretary, the whole-time director, the chief financial officer or such other officer, in whole time employment, specifically designated by the company as the KMP.

⁴Further, for the purposes of imposing accountability, the Companies Act recognises certain officers who are primarily in charge of the day-to day affairs and management of the company, who have been classified as "*officer who is in default*". Such officers include (i) a whole time director, (ii) a KMP or in absence of KMP, directors specified by the Board as officers in default with the written consent of such directors to act in this regard, (iii) any person who is explicitly delegated by the Board with the responsibilities including maintenance, filing or distribution of accounts or records, or any person who authorises, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default or (iv) any person in accordance with whose advice, directions or instructions, the Board is accustomed to act (*excluding professionals*), (v) every director who has the knowledge of the contravention by way of receiving the proceedings of the relevant Board meeting, or participating in the relevant Board meeting without raising any objections or consenting to the contravention⁵.

LIABILITY OF INDEPENDENT AND NON-EXECUTIVE DIRECTORS

³ Section 2(51) of the Companies Act

⁴ Section 2(60) of the Companies Act

⁵ In view of this sub-section, a director could be liable as an "*officer in default*" even if such director has remained silent with respect to a non-compliance or wrongful act or omission by a company, by neither assenting nor dissenting to the wrongful act or omission, and if such director had the knowledge of the contravention by way of receiving the proceedings of the relevant Board meeting or participating in the relevant Board meeting.

The Companies Act is silent on the segregation of roles and responsibilities of the executive and non-executive directors. While Section 166 of the Companies Act prescribes certain fiduciary duties to be performed by the directors, it does not provide for a distinction between duties to be performed by executive and non-executive directors.

However, Section 149(12) of the Companies Act clarifies that the liability of an independent director and a non-executive director is limited only to the extent of such acts or omissions by a company which were undertaken with the knowledge of the relevant independent director and a non-executive director, attributable through the Board processes, and with his consent or connivance or where he had not acted diligently.

⁶Pursuant to a circular dated March 2, 2020, the Ministry of Corporate Affairs ("**MCA**") issued certain additional clarifications to all the Regional Directors, Registrar of Companies and Official Liquidators in relation to the liability of the independent directors and non-executive directors in light of Section 149(12) of the Companies Act. The MCA, amongst others, has clarified that the independent directors and ⁷non-executive directors can be arrayed in any criminal or civil proceedings under the Companies Act only if the criteria prescribed under Section 149(12) are fulfilled. The MCA has further clarified that the independent directors and non-executive directors of a company are not responsible for filing of information/ records with the registry, maintenance of statutory registers or minutes of the meetings, or compliance with

⁶ General Circular bearing number 1/2020

⁷ The MCA Circular dated March 2, 2020 clarifies that besides the non-promoter and non-KMPs, non-executive directors could include directors nominated by (i) Government on Board of the public sector undertakings, (ii) Public Sector Financial Institutions, Financial institutions, Banks having equity participation in companies or otherwise, directors appointed pursuant to any statutory or regulatory requirement as in case of directors appointed by NCLT

orders issued by statutory authorities unless specifically provided for, under the Companies Act or pursuant to orders of relevant statutory authorities.

In view of the aforesaid, the liability of the independent directors and non-executive directors is limited only to the extent of their knowledge made attributable through Board processes and/or any act or omission by the company with the consent or connivance of such directors or in instances where such directors have not acted diligently.

DIRECTORS LIABILITY FOR BREACH OF DUTIES

Section 166 of the Companies Act, amongst others, requires the directors of Indian companies to act in good faith in order to promote the objects of the company and work in the best interest of the company and its shareholders. Any director, committing a breach of his duties and contravening the provisions of Section 166 is punishable with a maximum fine of Rs.5,00,000.

DIRECTORS LIABILITY FOR FRAUD

⁸The Companies Act prescribes a punishment for any person including a director who is found guilty of fraud comprising imprisonment for a maximum term of ten years and/or a civil penalty in the form of a fine extending to three times the amount involved in such fraud subject to the stipulated monetary thresholds. The Companies Act also provides an inclusive definition of fraud which includes within its purview, any act, omission, concealment of fact, abuse of position with connivance in any manner, with the intention to deceive, gain undue advantage from, or injure the interests of the company, its shareholders, creditors or any other person, irrespective of whether there is any wrongful gain or loss.

⁸ Section 447 of the Companies Act



Directors are also liable for transactions undertaken by a company that are ultra vires the constitutional documents of the Company. Ultra vires acts in relation to a company are such acts that are not authorised by the Memorandum of Association and Articles of Association of a company.⁹ In the case of *Lakshmanaswami Mudaliar v/s L.I.C.*, the Supreme Court of India, observed amongst others that the directors of a company, who were involved in the Board meetings where the resolution of the ultra vires activity was approved, were personally liable to make good the amount belonging to the company which was unlawfully disbursed in pursuance of such resolution.

PRINCIPLE OF VICARIOUS LIABILITY

Vicarious liability arises when one person is made liable for acts or omissions of another. The principle of vicarious liability assumes relevance in determining the liability of the directors and KMPs under statutes other than the Companies Act, including the Indian Penal Code, 1860, Negotiable Instruments Act, 1881, Labour Laws, GST Act, 2017 and Income Tax Act, 1961.

⁹ AIR 1963 SC 1185

¹⁰The Supreme Court of India in Sunil Bharti Mittal v/s Central Bureau of Investigation held that in the absence of a specific provision of vicarious liability in a statute (*read the Indian Penal Code in this case*), an individual, who was acting on behalf of a company can be held jointly liable with the company only if there is sufficient evidence of his active role along with criminal intent.

¹¹Thereafter, the Supreme Court in Ravindranatha Bajpe v. Mangalore Special Economic Zone Ltd. and Ors. Etc., reinforcing the pronouncement of Sunil Bharti Mittal case, held that the chairman, managing director, executive director and certain other officers involved in this case cannot be automatically held vicariously liable unless there are any specific allegations and averments against them with respect to their individual role.

OUR VIEWS

The directors of Indian companies are personally held liable under the Companies Act. Thus, considering the nature of liabilities that could arise on directors under the Companies Act, it may be prudent for investors, banks and financial institutions and government companies who nominate directors on the Board of Indian companies in a non-executive capacity ("**Nominee Directors**"), to insert certain protective clauses in the relevant agreements (*pursuant to which such appointment is made*) for safeguarding the interest of their Nominee Director including by way of indemnities from the company and its promoters for any losses that the Nominee Director may suffer and/or a provision clarifying that the

¹⁰ 2015 4 SCC 609

¹⁰ Criminal Appeal Nos. 1047 and 1048 of 2021

Nominee Director would not be considered as an "*officer in default*" for the purposes of the Companies Act.

However, the term "*officer who is in default*" under the Companies Act has a wide connotation and is intended to cover not only the directors and officers who may construed to be directly involved in the alleged default under question but also those directors who had knowledge of such wrongdoings in any form (*including by way of being recipients of the minutes of the Board meetings during which the relevant resolutions, authorising the company to undertake such potential wrongful acts were passed*) and not having objected to the same. Thus, notwithstanding the protective clauses discussed in the foregoing paragraph, in so far as the Companies Act is concerned, non-executive directors (*including the Nominee Directors*) and independent directors, could also be considered as officers in default and liable under the Companies Act for alleged wrongful acts of the company if they had knowledge of the wrongdoings in any form. As far as non-executive directors are concerned, this could also be a possibility where the company does not have KMPs or whole-time directors.

In view thereof, apart from indemnities and other protective clauses incorporated under the relevant agreements, it would be prudent for directors to ensure that they are fully aware of, and undertake a fine reading of papers and documents furnished by the company as part of the agenda papers of the Board meetings, to seek clarifications, raise concerns and ensure that their views on such matters are taken on board and recorded in the relevant proceedings of meetings of the Board of Directors of the company.

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