AN ANALYSIS OF THE DUTIES OF DIRECTORS IN INDIA

1. INTRODUCTION

India's fiscal year 2022 alone has witnessed nearly two dozen high profile cases of embezzlement, misappropriation of funds, insider trading, falsification of accounts and other instances of corporate fraud. The Indian government has historically introduced several laws and regulations[1] in order to combat corporate fraud. These measures have helped unearth many incidents of promoter-driven and other types of corporate fraud. In light of this, it is critical for directors and officers of companies to thoroughly understand the legislative framework of directors' duties and liabilities in India and use this information to maintain a more effective vigil on their establishments and minimize the risk of occurrence of similar incidents in the future.

2. POSITION OF DIRECTORS UNDER THE INDIAN LEGISLATIVE FRAMEWORK

Although a company is recognized by law to be a legal person capable of entering into contracts, possessing assets and suing and being sued in its own name, it still is not a natural person and therefore all its activities are to be undertaken by the collective body of natural persons called the 'board of directors' who are vested with adequate powers to act on behalf of a company. The Companies Act, 2013 (the "**Act**") defines a director as "*a person appointed to the board of a company*".[2] The Act recognizes various types of directors including whole-time directors, non-executive directors, nominee directors and independent directors. In most scenarios, the whole-time directors and managing directors are seen as individuals who are responsible for the day-to-day affairs of the company by virtue of their whole-time employment with the company. While non-executive, nominee and independent directors are not concerned with the day-to-day affairs of the company, they do participate in board and committee meetings where key corporate decisions are discussed and acted upon. The law prescribes certain duties and liabilities for both such sets of directors under the Act, which are discussed below.

2.1 Director as an 'officer in default'

An 'officer in default' under the Act is a concept borrowed from the UK Companies Act, 1948 which codified the concept. The rationale behind the inclusion of such a concept was to ensure that only officers and directors who oversee management are held responsible for any contravention of the provisions. This was squarely adopted by the Indian legislature under the Companies Act, 1956, and is also retained under the Act.

As per the provisions of the Act, liability of any kind for default by a company is generally imposed on an officer who is categorized as being 'in default'. In this regard, as defined under the Act, the term 'officer who is in default', among other things, includes (i) a whole-time director, (ii) key managerial personnel or in case of no key managerial personnel, such director(s) as specified by the board in this regard, and (iii)

[1] Section 447 (Punishment for fraud) and 448 (Punishment for false statement) of Companies Act, 2013, Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 1995 & 2003, Prevention of Money Laundering Act, 2002, SEBI (Prohibition of Insider Trading) Regulations, 1992 and 2015, Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, Fugitive Economic Offenders Act, 2018.

[2] Section 2(34), Companies Act, 2013.

every director aware of wrongdoing by virtue of knowledge of or participation in proceedings of the board without objection, and where the contravention had taken place with his/her consent or connivance.[3]

Judicial precedent has layered this position significantly, and the courts have consistently held that in case of occurrence of a fraud or omission in the company, no officer or director can be held to be in default merely on the ground of his position as an officer or director. In order to hold a director liable, it is essential that (i) at the time of the commission of the offence, the director should have been responsible to the company for carrying out its operations, and (ii) there is an express statutory provision which holds the director liable for the wrongs committed by the company.

A reflection of this interpretation can be seen in the leading case of *Sunil Bharti Mittal* v. *Central Bureau of Investigation and Ors.*,[4] wherein the Supreme Court of India clarified the position and liability of directors by holding that a director can only be charged for an offence when (i) it is proved that he or she had an active role in the act, coupled with *mens rea* (i.e. knowledge or intention); and (ii) there is a statutory provision imputing the liability to the director for the said act. Although the case against Mr. Sunil Mittal was under the Prevention of Corruption Act, 1988 read with the Indian Penal Code, 1860 and not under the Companies Act, 1956, this was the first landmark decision in India which had laid down the principles to be followed to impose vicarious liability on a director. This decision has been relied upon in many subsequent cases where the question of director's liability was involved.[5]

Based on the above, it is clear that establishing a director's active role in the offence is a pre-requisite to hold them liable. However, practically, it appears that independent and non-executive directors are sometimes caught in a precarious situation because of the "offence by companies" clause. Such a clause is a standard vicarious liability provision in certain statutes,[6] which is used to attach the liability on directors for the acts and omissions of the company. The vicarious liability provisions have standard language providing that the director, manager, or any other person shall be held liable in the event where any contravention has been made by a company, and it is proved that the contravention has taken place with the consent or connivance of the director, manager, any other person.[7] However, such provisions do not make a distinction between the role played by whole-time directors and non-executive or independent directors.

Consequently, this may result in a situation, particularly in promoter driven entities, where non-executive or independent directors may not have attended a specific board meeting or may not have played any role in, or been aware of, a particular action or omission of a promoter director which led to a non-compliance, but the entire board of directors is penalised for such non-compliance by virtue of such director merely being named as a director in the records of the ministry of corporate affairs.[8] This may not be a strict liability

[3] Section 2(60), Companies Act, 2013.

[4] Sunil Bharti Mittal v. Central Bureau of Investigation and Ors., (2015) 4 SCC 609.

[5] Shiv Kumar Jatia v. State of NCT of Delhi Criminal Appeal No. 1263 of 2019 (decided by Supreme Court of India *on August 23, 2019*); *Sri Katta Subramanya Naidu vs State Of Karnataka Criminal Revision Petition No.432 OF 2013 (decided by Karnataka High Court on November 3, 2016), Sayanti Sen Vs SEBI, Appeal No. 163 of 2018 (decided by Securities Appellate Tribunal on August 9, 2019).*

6 An example of the vicarious liability provision can be seen under Section 42 of Foreign Exchange Management Act, 1999, which provides that "where a person committing a contravention of any of the provisions of this Act or of any rule, direction or order made thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly." *Also* see Section 66 of Insolvency and Bankruptcy Code, 2016; Section 27 of Securities and Exchange Board of India Act, 1992; Section 141 of Negotiable Instruments Act, 1881.

[7] *ibid.*

[8] An example of cautious interpretation can be seen in the case of Bhardwaj Thirvenkata Venkatavaraghavan v. PVR Ltd., 2019 SCC Online Del 6774.

in all cases, as for instance, under Section 141 of the Negotiable Instruments Act, 1881, where a person who is in charge or responsible to the company is liable and deemed to be guilty only if offence is committed with his consent or connivance, or due to any neglect on his or her part. However, in cases under the Act or proceedings initiated by statutory regulators such as Securities and Exchange Board of India ("**SEBI**") under its regulations or enforcement directorate for contravention of foreign exchange regulations, normally, show cause notices are issued to every director who is on the board of the noticee company and it is for the directors to convince the regulators about their non-involvement in the contravention or the action or inaction on the part of the company.

2.2 Liability of independent or non-executive directors

To address the aforesaid anomaly, the legislature codified Section 149(12) of the Act which provides that an independent director or non-executive director shall be held liable, only in respect of such omission or commission by a company which had occurred with his or her knowledge, attributable through board process and with his or her consent, connivance or where he or she had not acted diligently.[9] Further, to clear the ambiguity around the liability of a non-executive director, the ministry of corporate affairs issued the general circular no. 8 of 2011 dated March 25, 2011,[10] whereby it mandated that any legal proceedings against non-executive directors for any contravention or non-compliance by a company with the provisions of the Act, can be initiated only if the r the violation has taken place with his knowledge attributable through board process, with his consent or connivance and whether he acted diligently or not.. Thereafter, the ministry of corporate affairs had also issued various circulars from time to time clarifying the position of the non-executive directors while facing legal proceedings initiated against companies in which they are acting as directors.[11]

However, where the role of a non-executive or independent director is established clearly by virtue of attending board or committee meetings, or by virtue of being the chairman of such meetings, they can be exposed to the risk of being liable. For instance, in the matters relating to irregularities committed with respect to issuances of Global Depository Receipts ("**GDR**") by listed companies, the SEBI had held an independent director accountable. The independent director was the chairman of the audit committee that passed the resolution approving the GDR issue and had the authority to sign the ancillary documents executed as part of the entire GDR issue.[12]

It is notable that while the Act provides for the safe harbour norms, as specified above, for non-executive directors, in an attempt to maintain the balance of the duties and the liabilities imposed on them, however, it should be taken into consideration that the limited liability of non-executive directors does not reduce the level and magnitude of the duty of care owed by them to the company and all its stakeholders. Such duties of the directors are described in the section below.

2.3 Directors' duties

The duties of directors are codified under Section 166 of the Act.[13] Prior to the codification of these duties under the Act, the J. J. Irani Committee, in their report, suggested that while the United Kingdom

[9] Section 149(12), Companies Act, 2013.

[10] General Circular No. 8/2011, Ministry of Corporate Affairs (2011).

[11] General Circular No. 1/2020, Ministry of Corporate Affairs (March 02, 2020).

[12] In the matter of Kemrock Industries & Exports Ltd., Order No. Order/AP/SK/2021-22/11544-11547 (Mumbai, April 28, 2021). *See* also in the matter of GDR Issue of Nakoda Limited, Order No. WTM/GM/IVD/ID4/13687/2021-22 (Mumbai, October 14, 2021).

[13] Section 166, Companies Act, 2013.

recognizes a very wide spectrum of duties to be discharged by directors, the Act should provide only an inclusive (and not exhaustive) list of duties since no rule of universal application can be formulated in this regard. It is on the basis of this recommendation that section 166 was added to the Act.[14] Section 166 provides the following key duties of directors, including: (i) fiduciary duty (to act in the best interests of the company and its shareholders); (ii) duty of care (exercise reasonable care and skill in the performance of the duty); (iii) duty to comply with laws (ensure that the company complies with all applicable laws, rules, and regulations); and (iv) duty to act in the interest of stakeholders (take into account the interests of stakeholders, including employees, customers, suppliers, and the community).

The aforementioned duties can be divided into two broad categories, which are, (i) the (erstwhile common law) duty of care, skill and diligence; and (ii) fiduciary duties. The duty of skill, care and diligence requires a director to devote the requisite time and attention to the affairs of the company to the extent that may reasonably be expected from a person carrying out similar functions. In instances where the directors in question overlooked numerous red flags which could not have escaped the attention of a prudent person given that they were privy to such commissions, the courts have held that such directors were liable for breach of duty of care, skill and diligence.[15] Fiduciary duties, on the other hand, require the directors to prioritize the company's interests over their personal interests or the interest of individual members and creditors of the company. Herein, a person is said to be acting in a fiduciary capacity or holding a thing in trust for another.[16] Courts, in this vein, have held that a director of a company indisputably stands in a fiduciary capacity as regards the company, and he must act for the paramount interest of the company.[17]

In light of the similarity in provisions of the Act and the UK Companies Act, 2006 a reference can be placed to the United Kingdom's jurisprudence to gauge the meaning of duty of skill, care and diligence. In this respect, the near ancient *Re City Equitable Fire Insurance*[18] case is regarded as the most authoritative case on the subject of the duty of care and skill of directors, wherein the court observed that: (i) a director need not exhibit, in the performance of his duties, a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience; (ii) a director is not bound to give his or her continuous attention to the affairs of the company, and his or her duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he or she happens to be placed; (iii) in respect of all the duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. However, in case a director fails to act or avoid such activities which are part of his or her role as a director, then courts have been vigilant to hold the director liable for breaching their duty to exercise reasonable care.[19]

Basis the above, a director, therefore, will not be held liable if he or she took reasonable steps to seek information from the company on a particular subject matter, point out red flag issues, and also takes diligent steps including seeking opinions from independent experts to mitigate or address any red flag issues in a company.

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[14] ibid.

[15] N. Narayanan v. Adjudicating Officer, SEBI, (2013) 12 SCC 152.

[16] Sri Marcel Martins v. M. Printer and Ors., (2012) 5 SCC 342

[17] Sangramsinh P. Gaekwad v. Shantadevi P. Gaekwad, AIR (2005) SC 809.

[18] Re City Equitable Fire Insurance Co., (1925) 1 Ch 407

[19] Dorchester Finance Co Ltd v Stebbing, (1989) BCLC 498.

Having said that, interestingly, the director's duty of care, and other fiduciary duties are often conflated in certain situations. In this regard, it is to be noted that while on one hand fiduciary duty calls the directors to act honestly and in good faith while focusing on the interest of the company, on the other hand the duty of care imposes a legal obligation upon the directors and officers to be diligent in supervising and managing the company's affairs.[20] In simpler terms, the director's duty to exercise reasonable care focuses on the director's competence, whereas, fiduciary duties are concerned with the director's honesty and loyalty towards the company. Herein, all actions taken by directors in their official capacity should aim to benefit the company and their decisions should not be to cater to their self-interest. In essence, while fiduciary duty should involve avoiding conflict of interest and misusing corporate assets, the duty of care should involve practicing due diligence before taking decisions.

Such a fiduciary duty is also placed on the nominee directors. However, owing to the fact that a nominee director is appointed to safeguard the interest of the person nominating him or her, it can lead to a conflict of interest, which is highlighted below.

3. CONFLICT OF INTEREST FOR NOMINEE DIRECTORS

Pursuant to Section 166 of the Act, there is an obligation cast upon every director to act in the best interest of the company and not to compete with the company or be involved in situations which can amount to direct or indirect conflicts of interest. This is a fiduciary duty which is cast on all the directors of a company including nominee directors. Owing to the fact that the nominee director is appointed to safeguard the interest of the person nominating the director, it leads to an apparent conflict of interest which needs navigation.

The explanation to Section 149(7) of the Act provides that a 'nominee director' means a director nominated by any financial institution in pursuance of the provisions of any law for the time being in force, or of any agreement, or appointed by any government, or any other person to represent its interests.[21] Evidently, the Act recognizes that a nominee director should represent the interests of the person nominating them, however, at the same time, it also places a fiduciary duty on them to act in the best interest of the company. This situation has been explained in the case of *AES OPGC Holding (Mauritius)* v. *Orissa Power Generation Corporation Limited*,[22] wherein the court, in express terms, noted that a "conflict of interest would arise when a person owes allegiance to two or more entities/ persons, and is placed in a situation to take a decision which would affect the interest of all those to which/ whom he owes allegiance." The court further clarified that in case a director of a company is placed in such a situation, then either they should recuse themselves or they are duty bound to take the decision which would be in the interest of the company failing which they would be in breach of their fiduciary duties.

Thus, it is clear that, while in the normal course of affairs, the fiduciary duty of a nominee director lies towards the person nominating them, however, in case of a conflict of interest between the nominee director's duty towards the company and the director's duty towards the person nominating them, the duty towards the company shall prevail. This becomes important when investors have contractual veto rights on certain matters in relation to the company.

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[20] Peoples Department Stores Inc (Trustee of) v. Wise, (2004) SCC 68.

[21] Section 149(7), Companies Act, 2013.

[22] AES OPGC Holding (Mauritius) v. Orissa Power Generation Corporation Limited, (2005) Comp Cas 299.

4. CONCLUSION

The concept of directors' duty and liability is an important aspect of corporate governance in India. The Act lays down the framework for directors' position and liability. In light of this, investors and companies can consider addressing some of these concerns while drafting documents in relation to the rights and obligations of the investors and their nominee directors on the boards of companies.

One such aspect which can be addressed through drafting in documents is related to the nominee directors' conflict of interest while exercising their veto rights. Rather than providing veto rights to the investors' nominee director, such rights should be exercised by the investor as a shareholder. This (coupled in any case with a contractual 'observer' right) mitigates concerns regarding conflict of interest for the nominee directors who can either step back or step off as a significant conflict arises. Secondly, it is crucial to ensure that the director appointment forms filed with the registrar of companies clearly capture the designation of such director i.e., managing, alternate, additional, nominee or whole-time director, and the category of such directorship i.e., promoter, professional, independent or small shareholder's director.

It goes without saying that directors should seek necessary information or clarification relating to any agenda item before attending the board meeting to ensure that he or she is adequately informed before making decisions and providing their votes. Crisp and detailed explanations and legal advice from a counsel are critical since even non-executive directors are culpable where voluminous documents are placed before them as part of 'board process'. It is advisable that the concerned director must insist that the company records his or her assent or dissent to any specific agenda item proposed at a meeting of the board or a committee thereof. Additionally, the directors, particularly, non-executive directors should ensure that in addition to nominee director indemnification clauses being captured in the investment documents and charter documents of the company, a director and officers insurance policy is obtained by the company with a good coverage.

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