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VINOD KOTHARI & COMPANY

The cushioned crown of thorns: Liabilities of Independent Directors in light of MCA Circular

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A company, on incorporation, acquires its own independent personality distinct from the members constituting it and becomes a legal person in the eyes of law. However, being artificial person, a company cannot act on its own. It has to act through natural persons, that is, its officers commonly referred to as Directors. The Directors stand in a fiduciary position with the company and are expected to manage the affairs of the company in a manner beneficial to the interest of the company and its stakeholders.

Director's liability arises because of their position as agents or officers of the Company as also for being in the position of trustees or having fiduciary relation with the Company or its shareholders.

Non-executive directors (NEDs) or independent directors (IDs) are those not charged with the day-to-day affairs and management of the company and are usually involved in the planning and decision making activities. The appointment of NEDs and IDs provide specialized knowledge and skill to the company contributing in better corporate governance performance. Statutory obligations under Clause 49 of the Listing Agreements require a balanced blend of Board comprising of both EDs and NEDs. However, this requirement is restricted to listed companies only. In the Companies Act, 1956, the domain of IDs is limited to remuneration committees only.

However, Companies Bill, 2009 provides recognition to NEDs/IDs and thereby, tries to bring consistency between the Companies Act and the listing Agreements.

As far as the culpability is concerned, there is no distinction between EDs and NEDs to determine the penal consequences. Any director, who is an officer in default within the meaning of section 5 of the Companies Act, will be liable to be prosecuted. Whether a NED is actually liable or not will be a question of evidence and proof will be resolved at the stage of trial. Going through the entire process of prosecution is in itself a turbulent experience and could act as a serious disincentive to join the board by NEDs where they are not even involved in the day to day management of the company.



Officer-in-default under Companies Act

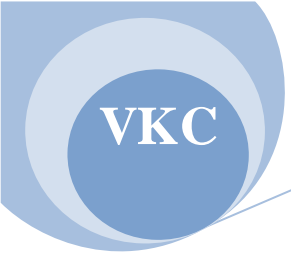
When directors fail to perform their statutory duties under the Companies Act, 1956, they bring themselves within the mischief of the penal provisions of law. Under the Act, directors are generally liable for various acts of omission and commission. The Act defines the term “Officer-in default” under section 5 of the Companies Act, 1956 to mean:

- (a) the managing director or managing directors;*
- (b) the whole-time director or whole-time directors;*
- (c) the manager;*
- (d) XX*
- (e) XX*
- (f) XX*
- (g) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors:*

The liability of the Managing Director when compared with the other directors as “officer-in-default” is comparatively higher. Whether a particular director (not being the Managing Director) could be proceeded against or not is a matter of evidence. However, normally, the presumption as to the culpability of the Managing Director as the officer-in-default is much stronger and almost conclusive in nature.

Duties of NEDs

A board of directors acts as a whole and although some of its members may be given additional powers by the articles or by resolution, the general duties and responsibilities are the same for each director. There is no distinction between the position of executive and non executive directors. If a breach of duty is to be attributed to a board on the basis that all of its members were present at a meeting which had approved a wrongful act, then the liability of each director is joint and



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several and no allowance is made for the fact that some are part timers and may have acquiesced in a situation which they did not fully understand.

The duties of directors include the following:

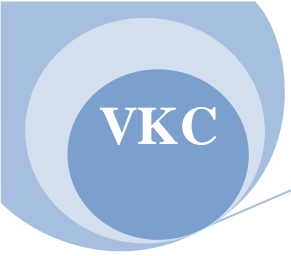
- Fiduciary duties
- Duty to exercise skill and care
- Statutory duties

As discussed above, directors have a fiduciary relation with the company and NEDs are undoubtedly subject to similar fiduciary duties as EDs such as the duty to act in good faith and for proper purposes, duties of no conflict etc. Nonetheless, there is considerable uncertainty in determining how these duties applied to NEDs. Though NEDs are not involved in the daily business of the company, their duty to act in good faith cannot be said to be satisfied if they simply rely on the information provided by others.

In the landmark ruling in Australian Corporate Governance, *Asia Securities and Investment Commission v. MacDonald*¹, the Court noted at the outset that the position in relation to NEDs is unclear. It was discussed that all directors, including non-executive ones, should have known that there was a possibility that the statements in the Announcement were false and/or misleading. Significantly, the Court decided that non-executive directors could not simply rely on the information provided by the management or by the executive directors.

From the above ruling, it is clear that NEDs will not be held to have satisfied their duties by arguing that they relied in good faith on certain information provided to them. Particularly when the information concerns an important management decision, there appears to be a duty on non-executive directors to confirm the veracity of the information independently.

¹ (No 11) [2009] NSWSC 287



Whether Non-executive/Independent directors to be held liable?

In cases where the company has no Managing Director/Whole-time Director, all directors including NEDs remain liable for any omission or commission of acts, however in cases where the company has whole-time directors, the liabilities of NEDs are limited for ensuring compliance with specific provisions of the Act which cast an individual responsibility on the director concerned to act as such. As for example, compliance with the provision of section 217, 299, 300, 305 of the Act etc., is an individual duty of the directors concerned and they remain liable for non-compliance with the same. The recommendations of various committees that NEDs and IDs should be freed from criminal and civil liabilities and should also be indemnified against costs of litigation have not received any recognition in the increasing corporate governance responsibilities of the Board.

While as board members, independent and non-executive directors have the same legal duties and obligations as executive directors, however, because of their limited involvement in day-to-day running of the company, it is undesirable for the law to expose the non executive directors to personal liability.

In *KK Ahuja v. VK Vora*² case, the Supreme Court observed that to be liable, a person should fulfill the legal requirement of being a person in law, responsible for the conduct of the business of the company. He should also be in charge of the business of the company. The law lists such persons as managing directors, whole-time directors, managers, company secretaries; but there is no mention of non-executive directors.

The apex court has provided a two-pronged test to examine whether a person can be deemed responsible. The first is a legal, statute-based test where it has to be proved that the person is responsible for the conduct of the business of the company.

The second is a fact-based test, where through specific instances, the complainant

² 2009 (3) JCC (NI) 194

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has to allege that the accused was in control of the day-to-day business. If a person does not satisfy the first test, neither is he required to meet the second test nor can he be held liable.

However, with the changing scenario, high courts and the apex court has given their judgments against the independent directors and making them liable for certain offences. The exception to the myth that only executive or directors in charge of the management are liable for any offence is the ruling of *Union Carbide of India* where the chairman Mr. Keshub Mahindra, non-executive director, was booked by the Central Bureau of Investigation (CBI) under the same sections as the managing director, executive director, works manager and others directly involved in the day-to-day running of the company. Even in this, he was singled out. Mr. Mahindra was the only non-executive director of the company to be so charged.

The Bhopal trial court was informed that UCIL always had a managing director or whole-time directors. This implied that the executive powers of management were not on nonexecutive directors. Besides, UCIL had several other nonexecutive directors who were privy to the same information as he was. Yet, Mahindra was singled out and the prosecution never explained why.

The well-known industrialist was charged with the same offence - causing death by a rash and negligent act under Section 304A of the Indian Penal Code (IPC) - as operator S. I. Qureshi who refused to promptly act despite being informed about the gas leak at the plant.

The charges against Mr. Mahindra included the following:

1. Offence punishable under Section 304(II) R/W Section 35 of the IPC for causing death by not taking adequate steps for avoiding the escape of gas from the UCIL plant;
2. Offence punishable under Section 326 R/W Section 35 IPC for causing grievous hurts by not taking adequate steps for avoiding the escape of gas from the UCIL plant;

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3. Offence punishable Under Section 324 R/W Section 35 IPC for causing hurts to many people by not taking adequate steps for avoiding the escape of gas from the UCIL plant;
4. Offence punishable Under Section 429 R W Section 35 IPC for likely causing death to animals by not taking adequate steps for avoiding the escape of gas from the UCIL plant

The learned solicitor general relying upon various documents including MOA, AOA and annual returns of the company whereby Mr. Mahindra has been shown as the chairman of the company stated that the accused even though stationed at Bombay shared the criminal knowledge of the other personnel of the company who were actually handling the Bhopal plant.

The learned counsel appearing for the accused vehemently contended that taking the case of the prosecution at the highest as reflected by the contents of the charge sheet and the supporting material it could not be even prima facie said that the concerned accused were guilty of offence of culpable homicide not amounting to murder as envisaged by Section 304 Part II, IPC with which they are charged.

During the course of the trial, Mahindra's lawyers repeatedly pointed to the fact that there was nothing on the ground to definitely point at his direct negligence leading to the tragedy. He could not be convicted in a criminal case merely because he was the chairman or director of a company. None of this appeared to cut any ice with the court.

The onus of proving a charge is on the prosecution. However, the judge seems to have drawn a presumption against Mahindra, which eventually led to his conviction. "A chairman without any knowledge of the company activities, how can (he) preside over the meetings of the shareholders and higher officials," the judge noted.

But the judgment seemed to impute that the chairman of a company - in this case a nonexecutive chairman - ought to be omnipresent, omnipotent and omniscient.



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Similarly, in the *SMS Pharmaceuticals versus Neeta Bhalla*³ case, the Delhi High Court said liability depends on the role that the person plays in the company and not on the designation or status.

Thus, the independence of a director is of no importance and his liability will be seen with regard to the work delegated to him by the company.

A relief to NEDs/IDs through the recent circular of Ministry

Recently, the Ministry has come out with a Circular⁴ relieving the non executives against the penal actions to be taken against them. The Circular says that penal action can only be initiated against the non-executive directors when the ROC, after taking due care, has come to the conclusion that such directors are the officers in default and has not acted diligently in the Board process. The non-executive directors cannot be prosecuted if the violation of the law or any omission is on the part of the company or by any other officers of the company and which have occurred without his knowledge and consent.

The directors who can be held liable are:

- Independent Directors in listed companies
- Government nominees in PSUs
- Nominee directors of public sector financial institutions
- Government director

The Special Directors appointed by BIFR under section 16 (6)(b) of SICA 1985, shall be excluded from the list of the officers in default if the director has done any act in good faith and in discharge of his duty.

The Circular provides a relief to NEDs in the sense that the culpability is to be confirmed and verified by the ROC before issuing any notice to NEDs as officer in

³ (2005) 8 SCC 89

⁴ Circular no. **8/2011 No.2/13/2003/CL- V** dated 25th March, 2011

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default. The Circular, however, does not go as far as proposals discussed in the context of the Companies Bill, 2009 that call for complete immunity to independent directors from prosecution. By conferring discretion on the RoC (to be exercised in an informed manner), the Circular adopts a principles-based approach by avoiding the rigidity involved in complete immunity. This would continue to spur non-executive directors to perform their role diligently, but at the same time protect them against prosecution risks in the event of their innocence.

Measures to be taken by the RoC before initiating any proceeding against NEDs/IDs

The Circular imposes greater obligations on the RoC to verify relevant information and records before initiating prosecution against independent or nominee directors. The Circular moves away from the erstwhile regime where RoC could potentially adopt a trigger-happy approach while initiating criminal prosecution of directors to one where the RoC is compelled to exercise “proper application of mind”.

The verification that is to be carried out by the Registrar may be in the following nature:

- Before initiating any proceeding against any director, the Registrar must ensure that such director was on the directorship of the company during the default. This may be verified by checking whether the company has filed any form 32 for resignation of the director or not and if not, whether the concerned director has forwarded a copy of his resignation letter.
- The designation of the director must be confirmed before proceeding with any prosecution formality. If the same is not reflected in the Annual Return or any other documents of the company, the Registrar may cross check with the Annual Report filed by the company.
- The Registrar must make certain that the director was an officer in default at the time of occurrence of the default. He can check the Form 1AB filed by the company to ascertain whether any person has been charged by the Board under Section 5(f) with the responsibility of complying with some particular



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provision or in case any director has been specified by the Board under Section 5(g) of the Act.

After examining the records, annual returns, form 32, form 1AB, DIN database, if the Registrar has any doubt as to whether any officer can be held liable or not, he should refer the case to the Regional Director.

Whether relieved in real sense?

The circular though has given relief to the independent directors; it has confirmed that even if such directors are not involved in day to day management of the company, they can still be prosecuted if the RoC is of the view that the directors has acted in good faith and are the officers in default for any default. It means that even the non-executive directors will also be considered as officer-in-default for any act which has taken place with his knowledge attributable through Board process, with his consent or connivance and where he has not acted diligently. When prosecution is to be filed against any Government Company, its directors, the Registrar should seek prior authorization in terms of Section 621 of the Act.

The non-executive directors along with any other director can be regarded as delinquent directors for default under section 209(5), 209(6), 211 and 212 of the Act if they have been delegated the responsibility of complying with the above sections. However, the Registrar, before causing any action against the non-executive directors, must examine whether the violation has taken place with his knowledge attributable through board process, with his consent and whether he acted diligently or not.

Whether the impact of the circular on pending matters also?

It has been clarified in the circular itself that the circular will have its effect retrospectively and could benefit past instances also. All the pending cases against the directors must be relooked in the light of the circular. If any director against whom any case is pending not found guilty for the offence in the parlance of the Circular, any further proceedings against him will be dropped. The Regional

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Director will point out such case in which the proceedings are proposed to be discontinued and shall refer the cases to the Ministry with his specific recommendations.

Liability under Negotiable Instrument Act, 1881- liability in case of dishonor of cheques

Under section 141 of the N I Act, apart from the company itself, the following persons are deemed to be guilty of the offence and shall be liable to be proceeded against and punished:

- Every person who at the time the offence was committed, was in-charge of and was responsible to the company for the conduct of the business of the company;
- Any Director, Manager, Secretary or other officer of the company with whose consent and connivance, the offence under section 138 had been committed;
- Any Director, Manager, Secretary or other officer of the company whose negligence has attributed to the offence under section 138 being committed by the company

In *Rohit Chunubhai Mehta v Gujarat State Fertilizer Co. Ltd*⁵, the Gujarat High Court rejected the application made by the accused for dropping the proceedings initiated under section 141 of NI Act. The accused included the NEDs as well. The learned counsel appearing for the accused submitted that the whole body of directors of a company cannot be said to be in charge of the day-to-day management and running of the business of the company and cannot be attributed knowledge of everyday working of the company and, therefore, cannot be impleaded for prosecution. The application was rejected on the submissions of the learned counsel representing the complainant that in view of the admitted well-known sickness of the accused company to such an extent that its entire networth was wiped out and it was declared sick by the B.I.F.R. in the year 1993, it was not open for the directors to contend that the cheques to the tune of Rs.5 crores could have been issued against

⁵ (2004) 3 GLR 1952

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supply of raw materials without the knowledge, consent and connivance of the board of directors.

*In S.M.S. Pharmaceuticals Ltd. v. Neeta Bhalla and Another*⁶, the question before the Supreme Court in this case was whether liability under section 138 and 141 of the NI Act arise on account of holding office by the director as such. The Court held that the conditions contained in sec 141 are intended to ensure that a person who is sought to be made vicariously liable for an offence of which the principal accused is the Company, had a role to play in relation to the incriminating act and further that such a person should know what is attributed to him to make him liable.

The conclusion is inevitable that the liability arises on account of conduct, act or omission on the part of a person and not merely on account of holding an office or a position in a company. Various High Courts have also ruled on similar lines.

Relief under section 633

Under section 633 of the Companies Act, a director can claim relief in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust in cases where:

- (a) The court is of the opinion that though he is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and having regard to all the circumstances of the case, he ought fairly to be excused,
- (b) A director apprehending any claim might be made against him in respect of any negligence, default, breach of duty, misfeasance or breach of trust, he may apply to the High Court for relief and the High Court on any such application shall have the same power to relieve him as it would have had under sub-section (1) of the section.

⁶ (2005) 8 SCC 89