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DIRECTOR AND OFFICER LIABILITY IN INDIA

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Almost 25 years have passed since India ushered in a new era of commercial liberalization and reform. This continuous and gradual opening up of the economy, driven by a robust growth in domestic consumer demand, has resulted in an influx of foreign investment, which in turn has strengthened private Indian companies.

This impressive story of economic growth, however, also has its dark side. Like most jurisdictions, India is no stranger to corporate fraud and scams. Because of significant cultural differences in how Indian companies function vis-à-vis their international counterparts, Indian companies are often seen as less professional. Though the scenario may be changing, the "family business" outlook of many Indian enterprises and an occasionally lackadaisical approach to various compliance and disclosure requirements continue to prevail. Siphoning of funds through related-party transactions, accounting irregularities, and corruption are just a few of the common, unfortunate trends that are prevalent in Indian companies.

Be it Satyam, Lilliput, or NSEL, numerous instances of management and promoter-driven fraud have come to light. The concern surrounding director liability has also been highlighted by the arrests of Stefan Schlipf, the managing director of BMW India Financial Services, and William Pinckney, managing director and chief executive officer of Amway India, along with two other directors.

Director's Liability

The ubiquitous issue of corruption and the high risk of internal fraud raise serious concerns about the liability of corporate directors. American litigators who represent Indian companies or advise clients interested in becoming corporate officers in India would do well to brush up on the changing landscape of director and officer liability under Indian law. India has learned a lot in recent years, and its laws have gradually evolved in this context.

Director liability in India can be divided into two principal areas: (1) liability under the Companies Act of 1956 (the 1956 Act), which has now transitioned to the Companies Act of 2013 (the 2013 Act); and (2) liability under other Indian statutes.

There has been a seminal shift in the Indian corporate legal regime with the enactment of the 2013 Act and more recent amendments. For instance, penalties under the 1956 Act that were seen as ineffective have been significantly amplified under the 2013 Act. The 2013 Act also provides statutory recognition to the duties of a director, such as exercise of due and reasonable care, skill, diligence, and independent judgment.

One of the key concepts of the Companies Act is the meaning of the term "officer who is in default." Under the act, liability for default by a company has been imposed on an officer who is in default.

By virtue of their positions in the company, the managing director, the whole-time director, and the company secretary directly fall within the scope of this term. Under the 1956 Act, certain key employees such as the chief executive officer and chief financial officer did not directly come within the ambit of the term, which raised serious concerns because these personnel were viewed as key officials in any company. The 2013 Act corrects this anomaly and significantly expands the scope of the expression "officer in default." The term also includes the following:

1. any individual who, under the superintendence, control, and direction of the board of directors, exercises the management of the whole, or substantially the whole, of the affairs of a company;
2. any person on whose advice, directions, or instructions the board of

directors is accustomed to act, other than persons giving advice in a professional capacity; and
3. every director aware of wrongdoing by virtue of knowledge of or participation in proceedings of the board without objection.

A critical failure of Indian corporate law was further highlighted during various corporate and financial scams, such as the Harshad Mehta episode or the Satyam fiasco. Various investors also discovered that money had been siphoned off by promoters through related-party or customer-vendor transactions.

To address this issue, the 2013 Act now specifically defines "fraud" and states that a person who is guilty of it may be punished by imprisonment for up to 10 years, and where fraud involves the public interest, the minimum sentence prescribed is three years. Fraud, as defined under section 447 of the 2013 Act, includes any act or abuse of position committed with intent to deceive, to gain undue advantage from, or to injure the interests of a person, company, shareholders, or creditors, whether or not there is wrongful gain or loss.

Shareholder Disputes

In the context of various shareholder disputes, the increased liability under the 2013 Act could be a useful tool to increase pressure on defaulting directors, nominating shareholders, or promoters. In addition, while resignation may protect a director from subsequent defaults, an erstwhile director may still continue to be liable for any defaults that took place during his or her tenure, as now clarified under section 168(2) of the 2013 Act.

The 2013 changes to the act prompted concerns about the role, accountability, and responsibility of nonexecutive, nominee, and independent directors, who could be caught on the wrong side of the company's disputes.

Illustration by Sawsan Chalabi

For example, the alleged confession by Ramalinga Raju, then the chairman of Satyam Computer Services Ltd., to financial irregularities and accounting fraud in excess of one billion dollars led to a number of prosecutions. Since then, independent directors have been accused in several similar cases and have faced a severe backlash given their failure to detect the fraud. In another example, Nimesh Kampani, one of the leading investment bankers in India and founder of the JM Financial Group, faced arrest stemming from his role as an erstwhile independent director of Nagarjuna Finance, a company embroiled in fraud due to failure to return amounts collected from depositors.

Under section 150(12) of the 2013 Act, an independent director or a nonexecutive director can be held liable under the 2013 Act only for acts of omission or commission by a company that occurred with the director's knowledge—attributable through board processes—and the director's consent or connivance or where he or she failed to act diligently. This, to a certain extent, alleviates the concern surrounding independent director liability. However, questions such as whether a director acted diligently and whether knowledge could be attributed to a director by mere presence at board meetings still remain unanswered. Moreover, liability faced by independent and nominee directors under various other enactments remains a legitimate concern.

Directors may also face liability under other Indian laws. Such liability may not always be foreseeable, and actions such as the dishonor of checks, offenses under the Income Tax Act of 1961, violation of foreign exchange regulations, breach of securities regulations, nonpayment of provident fund contributions, violation of the Shops and Establishments Act, or food adulteration could result in liability that may not always be limited to the executive directors.

In addition, some statutes do not distinguish between executive and nonexecutive directors or base liability on the role a particular director was performing on the company's board. Consequently, liability may be difficult to foresee or predict.

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While it is difficult to provide any particular standard that will determine an individual's exposure to liability, a person will generally be held liable for wrongdoing committed by a company if he or she falls into either of the following categories:

1. any person who, at the time the offense was committed, was in charge of and responsible to the company for the conduct of its business; or
2. any director, manager, secretary, or other officer of the company:
   a. with whose consent and connivance the offense was committed, or
   b. whose negligence resulted in the offense.

The Indian Supreme Court has, in this context, ruled that a managing director is prima facie in charge of and responsible for the company's business and can be prosecuted for misdeeds by the company. But only those officers of the company who fall within the scope of the definition "officer who is in default" are covered. *See e.g.*, *Nat'l Small Indus. Corp. Ltd. v. Harmeet Singh Paintal & Anr.*, (2010) 3 S.C.C. 330 (India); *K.K. Ahuja v. V.K. Vora*, (2009) 10 S.C.C. 48 (India). A simple averment in a complaint that a director was in charge of and responsible for the conduct of the business of the company is sufficient to state a claim against an officer who is in default.

In cases of fraud, it may be difficult to have a clear line of demarcation as to whether the director could have prevented the fraud if he or she had used due diligence. While the role of nonexecutive directors may consist of providing strategic guidance, this more limited status may not protect them from liability. Nor will being a nonparticipant at board meetings. The law now requires directors to adopt an inquisitive approach and question the company's background information, how it was obtained, and the decisions that are taken based on such information.

With increasing global interest in Indian companies and a changing legal landscape, new players will continue to enter the domain unaware of the possible consequences. Consequently, director indemnification clauses in shareholder and director agreements should be cautiously and thoroughly negotiated. Directors' and officers' liability insurance is also a tool that is becoming increasingly popular in India. Such insurance and indemnification should sufficiently cover the director even after resignation.

The Indian economy presents myriad and growing opportunities, but would-be corporate directors and their lawyers should tread carefully. Rapidly modernizing laws on director and officer liability require their full attention. ■