

VICARIOUS LIABILITY OF
NON-EXECUTIVE
DIRECTORS UNDER
COMPANIES ACT, 2013

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INTRODUCTION

India's aspiration of becoming a five trillion economy depends on growth and success of entrepreneurial endeavours. To make it happen, we need a robust legal infrastructure that is pro-business and fulfils the requirement of financial regulation that helps in mobilizing capital, managing risk, monitoring performance and a suitable mechanism for facilitating business with good external environment and internal good governance.¹ These governance issues highly depend on the co-ordination between different stakeholders. First task for ensuring corporate governance can be in providing a legal infrastructure that helps ensure efficiency of institutions with transparency and responsiveness. The responsiveness can be brought by bringing accountability of the decision makers.² Directors as leaders of the company carry the entrepreneurial vision of the company. They take leadership roles and should be accountable for the actions undertaken by them. In management, there is an assumption for accountability of leaders who undertake actions and decisions. The directors by their position being the leaders may be required to explain and be answerable to the consequences within the scope of their roles, responsibilities, and duties. Moreover, a director of a company is also an agent who is appointed by the shareholders to manage the affairs of the company and works to scale the vision of the company and aspirations of other stakeholders. Therefore, there are many expectations from a director of a company. These expectations come with powers of independent judgment, supervision etc. The directors owe huge responsibilities, given their central role in fulfilling objects of the company. However, scope of duties and responsibilities are complex, wide and is not defined by a straight-jacket formula and thus 'problems of vicarious liability'³ come to play.

Vicarious Liability can be better known as derivate liability or secondary liability. It is imposed based on relationship between the parties. This is a classic concept in law which is also used for inflicting liability on the directors of the company towards the company or outsiders (example: creditors) for the acts of the company or its employees.

¹JOHN ARMOUR AND DAN AWREY, *PRINCIPLES OF FINANCIAL REGULATION* (Oxford University Press 2016).

²DR. J.P. ARYA, *Transparency and Accountability in Governance: A Way Forward to New India'* IX CPJ LAW JOURNAL (2019).

³ Nigam Nuggehalli, *Vicarious Criminal Liability for Corporate Officers in India: Problems and Prospect* (June 2021), <https://azimpremjiuniversity.edu.in/SitePages/pdf/Vicarious-Corporate-Criminal-Liability%20.pdf>

Further, in economic theories these liabilities are priced i.e., they have monetary penalty rather than criminal sanction. However, we have various provisions for imposing vicarious criminal liability in law on the directors. Although as a general principle, there is no concept of vicarious liability in criminal law.

Nonetheless, the vicarious liability suffers from a latent defect because of dilemmas in corporate governance. These dilemmas exist because the duties and liabilities are not well-defined. Moreover, these liabilities can be inflicted in three ways, first on mere causation of the act, second on *de minimis* contribution and third on substantial or total contribution which may or may not have static or dynamic mental elements. Some dilemmas may be when can a vicarious liability be inflicted i.e., on mere causation of act by virtue of designation of director or by *de minimis* contribution or only when there is a substantial contribution in such act or omission.⁴

Moreover, the dilemmas can be extended to a question that we may ask to ensure the liability i.e., whether the acts or omissions so committed are ‘non-proxiable’ (cannot involve proxies). Determining the standard of proof and scope of liability can be either on lower threshold of dereliction of duties or higher threshold of intentional conduct or in between these extremes.⁵ Furthermore, we shall explore the extent of connection with the act of directors and the actions of the company, or its employees required for imposing vicarious liability on non-executive directors.

EXPECTATIONS FROM A NON-EXECUTIVE DIRECTOR: DUTIES AND RESPONSIBILITY

Under the Companies Act, 2013 and other legislations the vicarious liability provisions have a standard language for vicarious liability of directors. We might think of some questions like what the nature of liability of directors is? Whether their express involvement is necessary to establish liability in evasive financial transactions? Whether the directors can be criminally liable for dereliction of their duties? When can personal liability be imposed on the directors? When can

⁴MARKUS D. DUBBER, TATJANA HÖRNLE AND JAMES G. STEWART, *COMPLICITY* (The Oxford Handbook of Criminal Law 2014)

⁵Umakanth Varottil, *Director Liability Under the New Regime* (30.April,2021), <https://indiacorplaw.in/2014/06/director-liability-under-new-regime.html>.

the non-executive directors be held liable? etc. To explore this further, we must first understand what is expected from a director.

We know that the mightiest of economic offences were some scams in the past involving fraud, criminal breach of trust, tax evasion, money laundering, cheating etc not only affects the nation but it affects globally. Few well-known examples can be Enron scam in U.S.A or Satyam Computers Scam in India etc⁶. If we take the example of Satyam scam, although the auditors having knowledge of the offence was proved but Mr. Ramalinga Raju allegedly succeeded in hiding the schemes he had to defraud from entire board of directors of Satyam. This led to a complete overhaul of Companies Act, 2013.

This expectation got codified under Section 166 of the Companies Act, 2013 as duties of directors which can be said as too wide in its ambit. The duties are not mere expectations whose breach has no consequences, but the breach may lead to fine of one lakh to five lakh rupees.⁷ However, it is pertinent to note that there is no distinction between the duties of an executive or non-executive director. So, we might think if it implies that if the business of the company fails and the company goes into insolvency the director can be liable since the director has not applied reasonable skills, due diligence and his actions were not in best interest of the company. To the contrary, the Insolvency and Bankruptcy Code, 2016 makes it clear that directors are not liable for their business decisions or judgment *per se* but if the insolvency was a result of wrongful trading or fraudulent trading by the directors.⁸ Also given under Section 339 of the Companies Act, 2013.

Section 166 provides that directors should not involve themselves in conflict of interests situations, Also, directors “*shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company*”

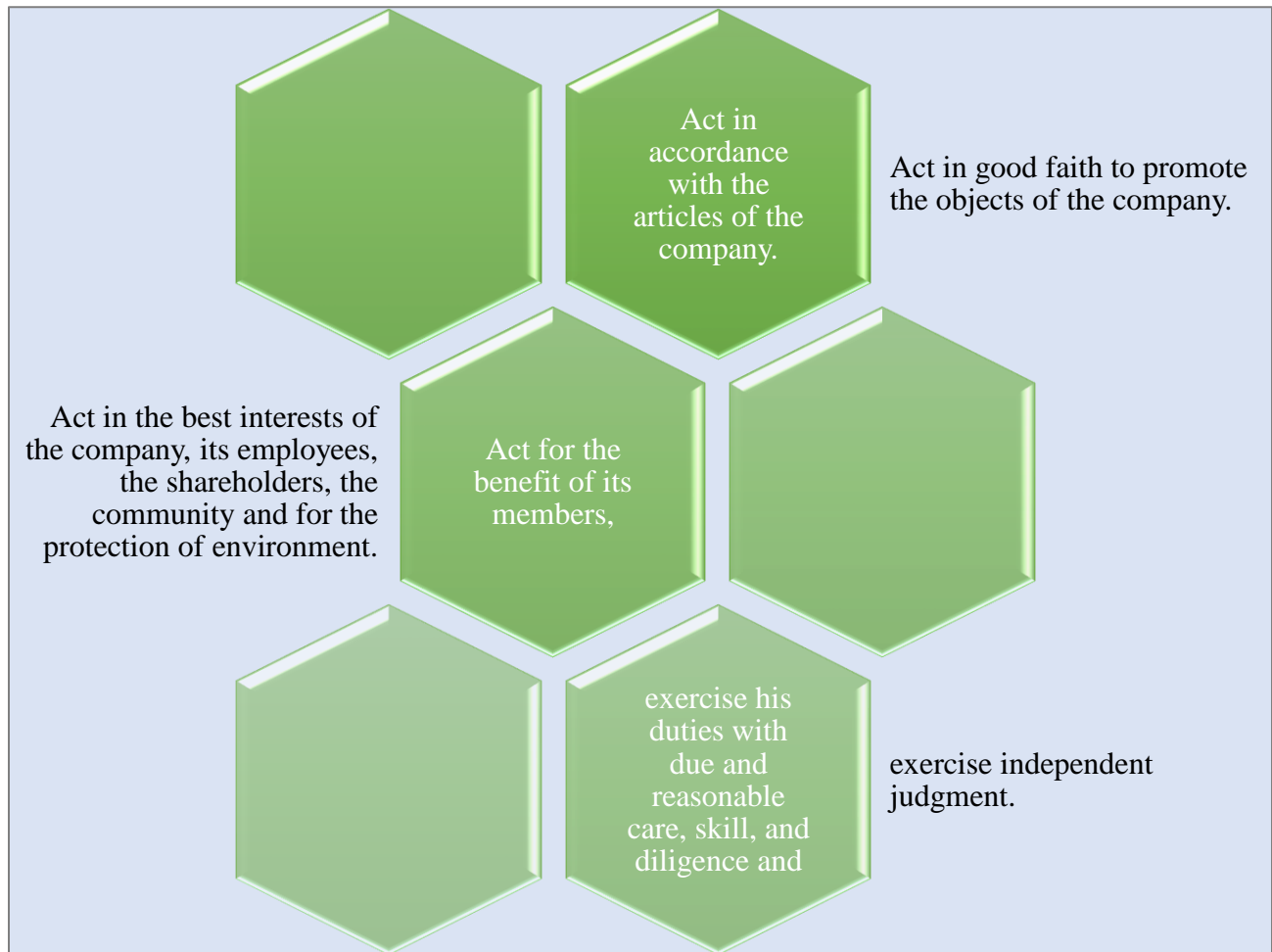
⁶Bhumesh Verma and Himani Singh, *Corporate Governance Archives*, SCC BLOG (13.June,2021), <https://www.sconline.com/blog/post/tag/corporate-governance/>.

⁷The Companies Act, 2013 Section 166 (vii).

⁸Vinod Kothari, *Note on Fraudulent and Wrongful Trading –Consultants*, VINODKOTHARI.COM (12.April,2021), <http://vinodkothari.com/2018/11/note-on-fraudulent-and-wrongful-trading>.

and “*shall not assign his office*”⁹ as a delegate cannot further delegate (*delegatus non potest delegare*). Also, provides for some positive actions in the figure below.

Duties of Directors under Section 166 of the Companies Act, 2013



Section 179 of the Companies Act on the meeting of directors also does not distinguish between the executive and non-executive directors in powers of board.¹⁰ Therefore, we can conclude there is a complex web of duties, roles, and responsibilities that stakeholders expect from a director.

⁹All-About the Directors of A Company, TAXMANN BLOG(7.June,2021), <https://www.taxmann.com/post/blog/6595/all-about-the-directors-of-a-company>.

¹⁰Bharat Vasani and Esha Himadri, *Vicarious Liability of Non-Executive Directors: A Case For Reform In Law / India Corporate Law*, CYRIL AMARCHAND MANGALDAS BLOG(1.December ,2020), <https://corporate.cyrilamarchandblogs.com/tag/non-executive-directors>.

INDEPENDENT DIRECTORS IN INDIA: A ‘NON-EXECUTIVE ‘EXECUTIVE’

Independent Directors are the non-executive directors of the company who are required to observe the company as an outsider, make independent judgment and ensure that voices of the vulnerable stakeholders are also accounted.¹¹ Their role is engineered by the JJ Irani Committee to constitute significant part of nomination, remuneration and audit committee of the company to ensure their participation in these areas. The independent directors appointed must not have any pecuniary interest in the company, nor his family member or relatives to ensure impartiality or independence i.e., ‘financial and familial independence’.¹² They are appointed according to the (Appointment and Qualification of Directors) Rules, 2014 and the provisions of the Companies Act, 2013 and governed by the Code of Conduct specified.

The independent directors have a term of five years and can be reappointed on passing special resolution but cannot hold office for more than two consecutive terms. This special resolution problem more recently arose in the Kirloskar Brothers Limited which led to a hurdle in reappointment of independent director because of the promoter’s votes mostly. This problem questions the independence of independent director as the independence is dependent on the person who the independent director would normally question during his tenure of directorship.

The idea of having independent director was to ensure that these directors be critical of the management being a non-executive director. However, this premise has failed as the market has assumed the role of independent directors as an omnipresent character in inspector or monitor role. It is expected that the director is informed about each malfunction in inner operations and external environment. Sometimes, they are also viewed as persons giving alternate strategies for running the company.¹³

¹¹Debanshu Mukharjee and Astha Pandey, *The Liability Regime For Non-Executive And Independent Directors In India A Case For Reform*, VIDHI CENTRE FOR LEGAL POLICY(10.June,2021.) <https://vidhilegalpolicy.in/wp-content/uploads/2019/09/Final-Director-Liability-Report-September-19-2019.pdf>.

¹² REINIER H KRAAKMAN, SOFIE COOLS AND GEN GOTO, *THE ANATOMY OF CORPORATE LAW* (Oxford University Press 2017).

¹³Vikramaditya Khanna and Shaun J. Mathew, *The Role of Independent Directors In Controlled Firms In India: Preliminary Interview Evidencer*(2010)*National Law School of India Review* (2 May 2021), <http://www.jstor.org/stable/44283713>.

Moreover, in the recent times we observed many examples where the resignation of directors was a signalling effect to failures of corporate governance but not its first indicator in big giant companies including a bank like Yes Bank.¹⁴

Although there are Code of Conduct prescribing independent director's roles, yet we see that the scope of duties, roles and responsibilities of an independent director has come assumed that they should know about all actual or suspected violations or fraud.¹⁵ Majorly, the independent directors have a role to ensure fairness in major transactions and business decisions. Their role is red flagging on unfair systems and processes. To ensure the value addition which independent director does in corporate governance, the sanctity of independence should be maintained so that these directors do not remain puppets of the promoters who suffer the brunt of too many liabilities and onerous responsibilities.

These issues brought crisis and studies show unwillingness of professionals to become a part of independent director institution. SEBI took a note of problems in its consultation paper on regulation of independent directors released in March 2021. SEBI highlights the areas of reforms like appointment and removal procedures, disclosures in resignations, composition of committees etc.¹⁶ However, on the onerous liabilities of these directors, SEBI does not attempt a 360-degree reform. Also, streamlining of roles and responsibilities would require more stringent definitions of their roles. Nevertheless, we can say attempt by SEBI is drop-by-drop improvement in independent director institution and needs to develop before a major governance failure. The paper also brings proposals where it promotes good governance with participation of minority to establish communication between governing and the governed (Independent directors and the minority shareholders). This premise's success remains due for the test of time and corporate complexities. Moreover, it is not a very new step since oppressions and mismanagement is also a part of the Companies Act, 2013 but as a remedial measure for the minority.

¹⁴*YES Bank Director Resigns Citing Governance Issue Shares Drop 5%*, THE ECONOMIC TIMES (13.June,2021), <https://m.economictimes.com/markets/stocks/news/yes-bank-director-resigns-citing-governance-issue-shares-drop4/articleshow/73186842.cms#:~:text=YES%20Bank's%20independent%20director,not%20driven%20by%20the%20board.>

¹⁵Saumya Upadhyay, Interview with Adv. Bhumesh Verma, (Managing Partner CorpComm Legal) (2021).

¹⁶*Consultation Paper on Review of Regulatory Provisions Related To Independent Directors*, SEBI (4.June,2021), [https://www.sebi.gov.in/reports-and-statistics/reports/mar-2021/consultation-paper-on-review-of-regulatory-provisions-related-to-independent-directors_49336.html.](https://www.sebi.gov.in/reports-and-statistics/reports/mar-2021/consultation-paper-on-review-of-regulatory-provisions-related-to-independent-directors_49336.html)

SAFE HARBOURS TO DISTINGUISH: IS IT TOO SAFE TO PLAY DIRECTOR'S ROLE?

The directors can absolve themselves from liability if they show that they were honest and reasonable. There are provisions where directors can obtain indemnity if they prove no fault in their conduct. Furthermore, D&O Policies mostly adopted by the corporate giants indemnify for the director's liability with exceptions such as fraud, intentional crimes, wilful misconduct etc.¹⁷

The Extent under Companies Act, 2013

Section 2(60)(vi) of the Companies Act, 2013 provides the phrases "*participation in such proceedings without objecting to the same*" or "*where such contravention had taken place with his consent or connivance*" which implies that the meetings of the company can be used as an evidence to determine liability of non-executive directors in such cases. For example, if we take a conjoint reading of this provision with Section 35 of Companies Act, 2013 relating to misstatement in prospectus, then the non-executive directors may claim a relief if they did not approve of it.

Also, the Companies Act also provides under Section 149(12) a safe harbour provision which provides that "*a non-executive director ...shall be held liable, only in respect of such acts of omission or commission...which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.*"

Moreover, Section 463 of the Companies Act is like a protection to business judgment of directors which provides that "*in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an officer of a company, it appears to the court hearing the case that 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 that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the court may relieve him, either wholly or partly, from his liability on such term, as it may think fit.*"

¹⁷Umakanth Varottil to Saumya Upadhyay, 'Suggestions on The Research through LinkedIn' (2021).

Reading Section 463 and 149(12) conjointly leads us to three conclusions that the Companies Act makes it clear that the liability so imposed on the directors are designed to include only those liabilities:

First for which the directors had knowledge of the act or omission, *second* there was some intentional conduct shown by the directors in bad faith and *third* when they failed in discharging their duties.

We already saw that neither Section 166 nor Section 179 prescribing the duties and powers of the board distinguish between the executive and non -executive directors. However, a test under Section 463 and 149(12) tries to ensure that the liability is not by mere designation.

Section 447 and 448 providing for fraud, false statement also makes it clear that the proceedings cannot be initiated under these provisions unless the director had the knowledge of such contravention.

These provisions give an understanding that the statutes present the legislative intent that the directors can only be made liable when there can be attribution that they had knowledge of the contravention.

Safe Harbours under Other Statutes

Most of the other statutes also refer to the standard language of vicarious liability imposing sections which we discuss later in this paper. However, there is a need for harmonisation of various statutes which impose vicarious liability on the directors like the Negotiable Instruments Act, 1881, FEMA, 2000 etc. which does not distinguish between executive and non-executive directors. For example: Section 141 of Negotiable Instruments Act, 1881.

VICARIOUS LIABILITY OF DIRECTORS: PROVISIONS IMPOSING LIABILITY

Different statutes that impose or absolves liability on directors have standard terms to indicate vicarious liability which may involve either of the two elements or both:

1. **Inculpatory Responsibility Test**¹⁸ which provides for terms like ‘in charge of’ and ‘responsible to’, or consent, connivance, negligence etc.

2. **Exculpatory Scienter Test** which provides for provisions that may be used to exclude the liability of director or the safe harbours for the liabilities using terms like the director acted in ‘good faith’, exercised due diligence’, ‘acted diligently’, the act as done ‘without the knowledge’ of the director.¹⁹

THE THRESHOLD OF VICARIOUS LIABILITY

Despite the safe harbours and jurisdiction of the lower courts, directors often run for Section 482²⁰ petitions when summons or warrants are issued to them. This often happens with independent directors whose roles and responsibilities are over-assumed. Thereby, Vicarious liability can be seen as illiberal because it attempts to impose liability for the acts done by someone else. The Supreme Court has taken a view that no liability can be imposed on a director except when the statute provides.²¹In *J.K. Industries Limited and Anr. v. Chief Inspector of Factories and Boilers and Ors.*²² the Court for analysing the liability of director the Supreme Court held that liability vests on the person having ‘ultimate control’.

Moreover, the Supreme Court has analysed interplay of various statutes and interpreted the liability provisions on factual and legal parameters:

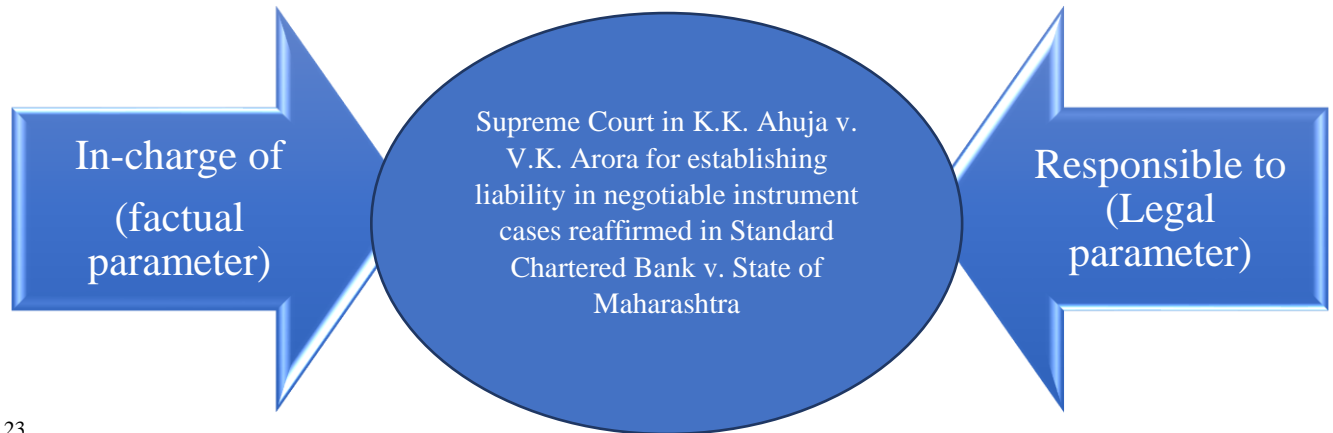
¹⁸The Holy Grail of Jurisprudence in Indian Corporate/Competition/Insolvency Laws',(2 June 2021)
<https://www.youtube.com/watch?v=BnlqNKqFdhA>.

¹⁹*Ibid.*

²⁰Inherent Powers of High Court to quash under the Criminal Procedure Code, 1973.

²¹ S.K. Alagh v. State of U.P &Ors, 5 SCC. 662(2008).

²² C. Agarwal v. Payment of Wages Inspector of M.P. &Anr, 8 SCC 104(2005).



23

Recently in *Shailendra Swarup v. Enforcement Directorate*²⁴ the Supreme Court absolved a non-executive director from liability on the threshold of knowledge and not negligence. This threshold of determining the liability ignores the seldom applied law on negligence. However, negligence has been in the statute books.²⁵ In U.S.A. law the threshold lies in negligence and not gross negligence. It seems to be an antithesis to business judgment rule.

Also, under Section 463, the director can seek remedy under a criminal liability but not under civil liability in negligence cases. The statutory interpretation inclines towards the threshold of negligence and not just knowledge or any other deeming fiction. However, true allegiance to the statutes is difficult because law establishing vicarious liability is at the developing stage in India. Negligence's prime essential is a breach of duty which can only be established when duties and roles are well-defined and compartmentalised with little or no overlaps. A universal application of know-all rule for the directors only helps finding scapegoats for absolving liability of the real defaulting directors.

Supreme Court View on Vicarious Corporate Criminal Liability

India in the past has observed many frivolous criminal complaints on technical violations etc. This had caused reputational loss and damage to the directors of the company. Moreover, these inconveniences adversely affect the business and decision making, growth and image of the company. Despite the clear law stated by the Supreme Court on initiation of proceedings and

²³ S.M.S. Pharmaceuticals Limited v. Neeta Bhalla, 8 SCC 89(2005).

²⁴Shailendra Swarup v. Deputy Director, Enforcement Directorate 2020 SCCOnline SC 600.

²⁵Prof. Rahul Singh, *The Holy Grail of Jurisprudence In Indian Corporate/Competition/Insolvency Laws* (2.June,2021), <https://www.youtube.com/watch?v=BnlqNKqFdhA>.

summoning, it is often observed that the directors are summoned on various occasions. The law under Section 204 of the Criminal Procedure Code, 1973 states that ‘*sufficient ground for proceeding*’ against a director must exist for summoning. In *Sunil Bharati Mittal v. Central Bureau of Investigation*²⁶, the apex court held that these grounds for proceedings should not be mere designations but a sufficient prima facie evidence that the directors have the knowledge or involvement in the acts or omissions by the Company.²⁷ This principle was later followed in *HDFC Securities Limited v. State of Maharashtra*²⁸, *Sushil Sethi v. State of Arunachal Pradesh*²⁹, *Shiv Kumar Jatia v. State (NCT of Delhi)*³⁰.

Civil Liability and Personal Liability

In cases of breach of fiduciary duty of the directors³¹, *ultra vires* acts³², negligence and acts caused by *mala fide* intentions by the directors³³ are personally liable for losses they cause to the company. Let us understand this with an example under the Insolvency and Bankruptcy Code, 2016. Suppose X, a director enters a contract to defraud the creditors due to which assets of the company lose their value. Such acts make X personally liable. Recent trends show that a rise in problems also occur due to increasing scope of personal liability of directors. An adoption to D&O policy may help manage the risk if the director could establish his acts being in good faith.

SCOPE OF DUTIES, ROLES, RESPONSIBILITIES: IS THERE A NEED TO STREAMLINE?

Undoubtedly, the key managerial personnel of the company have more penetration over the operations and affairs of the company. Therefore, the various provisions of vicarious liability make it clear that the directors are liable for the acts which they have knowledge about but not otherwise. However, a question haunts the directors that deeming fiction created under law

²⁶ *Sunil Bharati Mittal v. Central Bureau of Investigation* (2015) 4 SCC 609.

²⁷ MCA Circular No. 1/2020 dated March 02, 2020.

²⁸ *HDFC Securities Limited v. State of Maharashtra* (2017) 1 SCC 640.

²⁹ *Sushil Sethi v. State of Arunachal Pradesh* (2020) 3 SCC 240.

³⁰ *Shiv Kumar Jatia v. State (NCT of Delhi)* (2019) 17 SCC 193.

³¹ See *Dale & Carrington Investment (P). Ltd. v. P.K. Prathapan* [2004] 62 CLA 245 (SC). Also, in *Sanramsinh P. Gaekwad v. Shantadevi P. Gaekwad* (2005) 11 SCC 314 it was held that if the directors “take undue benefit or has ulterior motive, solely to make a pecuniary benefit or gain for himself” then the directors have committed a breach of their fiduciary duty to the company.

³² MAMTA BHARGAVA, *A-Z Concise and Condensed Corporate Laws* (Corporate Law Advisor 2017).

³³ A RAMAIYA, *Guide to The Companies Act* (LexisNexis Advanced Online 2020).

imposes certain liabilities on a director. This deeming fiction gets stretched too far because the roles and responsibilities of non-executive directors may include knowledge about the affairs of the company. Most of the times, due to the role we assume of independent directors as inspectors and not independents and thus bring conflict in understanding the different perspective in which Independent Directors do their work. Hence, the liability imposing provisions even though they have sufficient legislative intent to show that the director who do not have control over the alleged contravention should not be liable but still they are made liable due to non-harmonious construction of clauses in different statutes. Moreover, if the roles of directors are well-defined then the seldom used threshold of determining liability through negligence would develop. This would balance the interest of stakeholders where directors would remain accountable for the scope of their responsibilities and be absolved from onerous liabilities bothering them.

CONCLUSION

“Liability depends on the role one plays in the affairs of a company and not on designation or status.”³⁴

It is true that liability always depends on the roles, duties, and responsibilities a director plays in the company, yet the liability is not clear under the Companies Act, 2013. It is so because there are many ambiguities in the role and responsibilities of directors itself. Moreover, the roles, responsibilities, and duties should not stretch to oblige a director deeming them to have all knowledge of the contravention. We noted that universalization of roles and responsibilities is yielding unfavourable outcomes. Differentiation in roles and responsibilities based on knowledge, access of information, qualification is important to streamline liability. If the liability of a directing mind is streamlined and the role of independent director is made limited to an outside observer efficiently and independently asking right questions to the board and not be responsible for day-to-day operations of the company much of the expectations from a director can be fulfilled. Similarly, these would ultimately help directors in being responsible for the activities under their control even for a lower threshold like negligence.

Further, the D&O Policy makes indemnification of liabilities of directors and officers, corporate legal liability, employment practices liability. A practice of wide adoption by not only top

³⁴ S.M.S. Pharmaceuticals Limited v. Neeta Bhalla, 8 SCC 89 (2005).

companies but also as a common corporate culture can help establish a favourable environment for entrepreneurial professionals and overall governance. It can be an extension to business judgment protection to companies where directors can truly focus on business more rather than protecting themselves.

Furthermore, Criminal liability is being seen as a dissipating concept worldwide for establishing liabilities. It is also being observed in India with the recent 2020 amendment to the Companies Act, 2013 making it move from an illiberal corporate governance to bit of ease in doing business but moving to a priced civil liability ensuring accountability is due yet for officials who default with *malafide* intentions.

ADDITIONAL INFORMATION

Data collection includes telephonic interviews with experts:

- Advocate Bhumesh Verma, Managing Partner CorpComm Legal.
- CS Sujoy Sircar, (20+ Years' Experience).

LinkedIn Chats: (Expert Interviews)

- Umakanth Varottil, Associate Professor of Law, National University of Singapore.
- Other Professionals in the field