Executive Summary

- Since directors and the board play a pivotal role in corporate governance, the law foists duties and liabilities on them;

- The Companies Act, 2013 has brought about a paradigm shift by considerably enhancing directors’ duties and liabilities;

- The directors’ duties are now codified and extend to considering the interests of stakeholders other than shareholders;

- Directors are, however, entitled to various protective measures in the form of mitigating factors either conferred upon them by law or through practical mechanisms they may establish.
The board of directors as an institution plays a prominent role in corporate governance. It is responsible for directing and overseeing the business and management of the company. Given this pivotal role of the board, directors are considered as fiduciaries in that they are required to act in the interest of various constituencies in a company such as shareholders and other stakeholders. Accordingly, the law foists directors with duties and liabilities as instruments that modulate their conduct.

Directors’ duties and liabilities have garnered substantial attention in India lately. The new Companies Act, 2013 (the 2013 Act) is a landmark piece of legislation that clarifies, redefines and enlarges the ambit of directors’ duties and liabilities. This legislation is being supplemented by revised corporate governance norms that have been announced by the Securities and Exchange Board of India (SEBI) with a view to creating consistency between the 2013 Act and SEBI’s governance norms that apply to public listed companies. While several provisions of the 2013 Act relating to directors are effective from April 1, 2014, the revised SEBI norms pertaining to corporate governance are expected to be effective from October 1, 2014.

A discussion of these issues cannot be timelier as Indian companies, their boards and managements prepare themselves to encounter heightened standards of director conduct.

**Codification of Directors’ Duties**

Hitherto, directors had negligible guidance under company law as regards their duties and liabilities. The preexisting Companies Act, 1956 (the 1956 Act) did not explicitly stipulate directors’ duties, which made it necessary to fall back on common law principles (to be articulated by courts while delivering specific decisions). The statutory uncertainty was compounded by the absence of significant cases of director duties and liabilities before Indian courts.

This somewhat unsatisfactory situation has been mended in the 2013 Act, which is rather explicit about directors’ duties (somewhat similar to the codification of directors’ duties under the UK Companies Act of 2006, section 172). The new provisions not only provide greater certainty to directors regarding their conduct, but also enable the beneficiaries as well as courts and regulators to judge the discharge of directors’ duties more objectively.

**Duties of Directors under the 2013 Act (section 166)**

- To act in accordance with the articles of association of the company;
- To act in good faith to promote the objects of the company;
- To act in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment;
- To exercise duties with due and reasonable care, skill and diligence and to exercise independent judgment;
- To not be involved in a situation of direct or indirect conflict with the interests of the company; and
- To not achieve any undue gain or advantage.

These duties can broadly be classified into two:

(i) duty of care, skill and diligence; and

(ii) fiduciary duties.

The duty of care, skill and diligence requires directors to devote the requisite time and attention to affairs of the company, pursue issues that may arise through “red flags” and take decisions that do not expose the company to unnecessary risks. Fiduciary duties, on the other hand, require the directors to put the interests of the company ahead of their own personal interests. Rules that prevent conflict of interest and self-dealing on the part of directors are integral to this set of duties.
Shareholders versus Stakeholders

Despite India’s socialist origins, historically the company law imposed limited duties on directors to take into account any interests beyond those of shareholders, such as creditors, employees, consumers and the community. The directors were required to act in the interests of the company, which was considered synonymously with shareholders. In a major departure from this orientation, the 2013 Act explicitly requires the directors to act in the best interests of the company, which include employees, the community and the environment. Hence, it may not suffice for boards to simply work towards creating or enhancing shareholder value. Non-shareholder constituencies’ interests must be taken on board as well in the decision-making process. This approach is consistent with the strong emphasis of the 2013 Act on corporate social responsibility (CSR) in a form that is tantalizingly short of being mandatory.

While this approach expands the scope of the beneficiaries of board actions, it also complicates decision-making by directors. For example, it is not clear how directors ought to decide a course of action if there were to be a conflict between the interests of the shareholders on the one hand and non-shareholder constituencies on the other. The natural tendency may be to prefer shareholder interests, but that may end up being woefully inadequate in this latest dispensation. Nevertheless, questions remain as to whether these non-shareholder constituencies may accrue justiciable rights against the board in case of a breach of duties to act in their interest. Boards must be prepared to deal with this dichotomy, which may arise in several situations, including while planning their strategy for CSR, which has now turned into a legislative reality.

Independent Directors

Apart from the duties discussed above, which are applicable to all directors, the 2013 Act indulges in extensive legislation on board independence as it spends several pages (and an entire schedule) to deal with independent directors, their functions, roles, duties and liabilities.

Some of the Roles, Functions and Duties of Independent Directors (Schedule IV of the 2013 Act)

- To help bring independent judgment to the board;
- To safeguard the interests of all stakeholders, particularly of the minority shareholders;
- To balance the conflicting interests of stakeholders;
- To strive to attend all board and committee meetings and to participate actively and constructively;
- To pay sufficient regard to related party transactions; and
- To report concerns about unethical behavior, fraud or violation of code of conduct or ethics policy of the company.

Quite clearly, the roles and duties of the independent directors have witnessed significant expansion into areas such as, among others, specifying approved CSR activities, approving and ensuring appropriate disclosures of related party transactions, recommending independent auditors and carrying out board evaluation. In the new regime, the independent directors have been assigned the role of arbiters among various constituencies in a company. For example, they have been specifically assigned the role of safeguarding the interests of minority shareholders, perhaps an indication of the strong influence played by controlling shareholders in Indian companies. They are also required to balance the interests of various stakeholders, including non-shareholder constituencies.

While the 2013 Act helps clarify the roles, responsibilities and duties of independent directors, it is extremely prescriptive in nature. This may enhance the level of monitoring of listed companies, which is crucial for corporate governance. The downside of the prescriptive nature of the law, of course, is that it makes the role of independent directors quite onerous. Indeed, the micromanagement of boards through the entry of governmental regulation into the boardroom could instill fear in the minds of independent directors that may dissuade them from taking up the position. Thus, in the current scenario, independent directors do assume an important--albeit somewhat unenviable--position in the governance of
Indian companies.

**Liabilities of Directors**

Being fiduciaries, directors are exposed to liabilities as a consequence of a breach of their duties. While liabilities may arise under various statutes, the focus here is on liabilities arising under company law. The first set of liabilities is statutory in nature, being specifically set forth in the 2013 Act. These could be either civil liability (requiring directors to make payments to victims or the state) or criminal liability (resulting in fines or imprisonment). The approach in the new regime has been to impose stiffer penalties in case of a criminal offence so as to constitute a strong deterrent on director conduct that falls short of the desired standards.

**Examples of Statutory Liabilities of Directors**

- For misstatements in prospectus (sections 34 & 35);
- For breach of solvency declaration (section 68);
- For breach of directors’ duties (section 166);
- For fraudulent trading (section 339); and
- For offences where no specific punishment is prescribed (section 450).

The second set of liabilities could arise from claims made against the directors either by the company or the shareholders for breaches of directors’ duties. Since directors owe the duties to the company, at the outset it is the company that can bring a claim. Where the company is unable (or does not wish) to do so, it is open to the shareholders to bring a derivative claim on behalf of the company to recover monies for breach of directors’ duties. These claims are quite robust in theory, but are riddled with tremendous difficulties in practice. Most of these relate to the speed and cost-effectiveness of bringing these actions. Given the excessively high rates in pendency of cases before the Indian courts, it is unlikely for the shareholders or the company to bring a suit, and even more, to enforce a successful claim against directors. It is not surprising that India displays a poor track record of civil claims against directors that have resulted in payouts by them.

To obviate the difficulties that arose under the pre-existing law (particularly on the procedural count), the 2013 Act institutes mechanisms that are novel in the Indian context.

The first is the establishment of a class action mechanism that allows a group of shareholders (constituting a minimum of 100 shareholders or those holding 10% shares in the company) to bring a suit on behalf of all affected parties, which includes claims for compensation from directors for any fraudulent, unlawful or wrongful act or any omission or conduct on their part. More importantly, the 2013 Act devices a mechanism to sidestep the regular court system by enabling such suits to be brought before a yet-to-be-constituted National Company Law Tribunal (NCLT) that is expected to be speedier, more efficient and cost-effective. Once these remedial mechanisms are in place, it is likely that directors may be subject to greater scrutiny through the use of civil liability suits by companies and shareholders. To ensure that this does not transform the directors’ liabilities regime in India from a scenario where directors face almost no lawsuits for breach of duties to one where they might face numerous lawsuits, the law provides for certain mitigating factors (see below).

**Mitigating Factors**

The severity of the liability provisions is softened by certain mitigating factors that operate in favour of directors. *First*, there are certain relief or safe harbor provisions. For instance, in any proceedings, a director could seek relief on the ground that he or she acted honestly and reasonably and that having regard to all the circumstances of the case, such director ought to be excused. This relief available under the 1956 Act has been continued in the 2013 Act as well.
The newer legislation, however, creates a new safe harbor provision for independent directors. In order to balance the extensive nature of the duties and liabilities imposed on independent directors, the 2013 Act seeks to limit their liability only to matters directly relatable to them. An independent director is liable “only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently.” (section 149(12)). This is to insulate potential liability for independent directors for acts of which result from no fault of their own.

While such a provision for limitation of liability is useful, much would depend upon the manner in which courts interpret it based on the specific facts and circumstances of individual cases.

Second, it may be possible for directors to obtain indemnities from the company. Under the 1956 Act, companies have been constrained from providing such indemnities, as they are not permitted to indemnify directors for negligence, default, breach of duty and the like. The 2013 Act, however, does not contain such a restriction, which may confer greater flexibility on directors to seek indemnities from the company in case they have to meet any liabilities, particularly if no fault can be attached to the directors’ conduct.

Third, and related to the previous, the 2013 Act implicitly recognizes the right of the company to obtain directors’ and officers’ (D&O) insurance policies by paying a premium. The practice of obtaining (D&O) insurance has already become prevalent in Indian companies, especially among the larger ones, and is only likely to grow in future in view of the expansive liability regime under the new law. While obtaining adequate level of D&O insurance policies would be prudent for all boards and directors, care should be taken to ensure that policies are accompanied by specific exceptions for fraud, wilful misconduct and other forms of intentional criminal conduct.

Way Forward

As we have seen, the new liability regime imposes onerous duties and liabilities on the directors of Indian companies, particularly on independent directors. At the same time, mitigating factors have been built into the law to make sure that these more onerous duties and liabilities do not unduly discourage the appropriate persons from serving on corporate boards. Only time will tell whether the new regime is able to achieve the required balance. Meanwhile, however, directors would be well advised to (a) carefully assess the amount of time and effort they can expend on corporate boards and (b) avoid the risks associated with too many directorships. As a concomitant, boards must consider remunerating the directors appropriately to attract the required talent by making it worthwhile for them to assume the increased levels of involvement and risk. Boards and directors may also establish practical measures (see below) so as to operate in a manner that is commensurate with the needs of the new era.

Practical Measures to be Established by Boards

- Adequate participation by directors in the affairs of the company;
- Encouraging directors to raise relevant questions and seek proper explanation from management;
- Maintaining regular communication between board and management;
- Establishing internal monitoring and reporting systems;
- Placing reliance on relevant employees and experts – on the basis of good faith and in the absence of reason to suspect wrongdoing;
- Pursuing any “red flags” that are waved;
- Clarity in voting by directors on specific items in board meetings, and recording them accurately in the minutes;
- Enhancement of board evaluation mechanisms that may improve director performance;
- Appointing separate legal counsel, investment banker or valuer on crucial transactions such as a large merger or a related party transaction.
Select References
Companies Act, 1956;
Companies Act, 2013;
Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (Jan. 2003);
Hemant Goyal, *Duties and Liability of Directors – An Indian Laws Perspective*, Mondaq (Jan. 22, 2013); and

About NSE CECG
Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The ‘Quarterly Briefing’ which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.