

Liability of Investor Directors

Private equity investors most commonly monitor their investments by appointing a director on the board of the investee company. Ever since the Satyam scandal, bringing directors under the scanner has been the topic in vogue. Whist accountability of directors is important, the recent trend directors coming under increased scrutiny is a cause for concern to the investor directors, given that they are not usually involved in the day to day activities of the company.

As per the Companies Act, 1956, ("Companies Act") regardless of whether the director plays an executive role, is independent or non executive, he/she has a fiduciary duty to the Company and is liable to be pulled up for the offences of the company. Though it is the executive directors who are commonly held liable, the Companies Act does not expressly create any distinctions between independent directors, executive and non executive directors in terms of their liability.

In order to curb the tendency to prosecute the diligent directors in the current regulatory environment, the Ministry of Corporate Affairs has come out with a timely circular [General Circular No. 08/2011 dated March 25, 2011], wherein the Registrar of Companies (ROC) has been asked to take extra care when independent and nominee directors have been identified as 'Officer in Default'. Guidelines have been issued to identify the 'Officers in Default'.

In essence, the circular states that the directors not charged with responsibility (such as independent directors (of listed companies), government nominees and public sector financial institution nominees) should not be held liable *for any act of omission or commission by the company or by any officers of the company which constitute a breach or violation of any provision of the Companies Act, 1956, and which occurred without his knowledge attributable through Board process and without his consent or connivance or where he has acted diligently in the Board process.* Board process has been explained in this circular as meeting of any committee of the Board and any information which the Director was authorised to receive as Director of the Board.

It is significant to note that this Circular singles out directors designated as independent directors as per SEBI provisions, Government nominees, and nominees of public sector financial institutions as the ones for whom extra precaution needs to be taken. Investor directors have not been separately identified, though they would be entitled to the provisions of the said circular, provided they exercise due care and are not employed in an executive capacity.

This Circular empowers the ROC with discretionary power and advises that there should be proper application of mind on the part of the ROC before identifying a person as an 'officer in default' by examining the Annual Return, Form 32 and DIN database available with the Registry.

Before taking penal action against a Director, the following compliances are required to be verified by the ROC:

- In case the director has informed the ROC about his resignation, and the company does not file Form 32 for the same, the Registrar should find out whether he has actually resigned;

- If the status (that he is a nominee) of the director is not reflected in the Annual Return, the same may be cross checked with the Annual Report of the company;
- Form 1AB should be checked if a specific person has been charged with the responsibility of complying with a particular provision. Timing of the offence is material to identify the director's responsibility.
- Special Directors appointed by BIFR are to be excluded from the list of officers in default.

Set out below are the persons who can be designated as an 'officer in default'.

- The Managing Director or Manager, and the Company Secretary appointed u/s 383A or the person charged with work of maintenance and preparation of Annual Accounts;
- If there is no Managing Director or Manager, every director and the Company Secretary appointed u/s 383A of the Act.
- Non executive directors, officers and employees not connected with the responsibility should not be arrayed as delinquent directors.

This Circular would also go a long way in reassuring the non executive directors who may fear cases being foisted on them despite exercising due care. Striking the right balance between penalizing errant directors and not creating an unduly harsh environment with the threat of prosecution hanging over the directors is crucial.

Apart from insisting on D&O insurance and a comprehensive indemnity clause, in the light of this circular, investors may also consider incorporating a clause, wherein the companies would have a person designated as a managing director, and the concerned persons should be identified and given specific responsibilities. Additionally, public documents such as Form 32 and the Annual Return of the company should make it evident that the said director (on behalf of the investor) is only a nominee and performs no executive role.