

## **VARIOUS LIABILITIES, RELIEFS, DEFENCES AND PROTECTIONS TO THE DIRECTORS OF COMPANIES UNDER INDIAN LAWS**

A company is legally separate and distinct from its members. It is ultimately an artificial creation and it acts through its servants or agents. The decisions of a majority of its members in general meetings are regarded as the acts of the corporation. The majority acts through the Board of Directors. Board of Directors, as a whole, is generally delegated all powers of the management and it may sub-delegate any of these powers to individuals directors or other servants and managers. There is a relationship akin to agency between the corporation and its board as well as the servants or agents that are delegated with specific responsibilities. These Corporate executives are assigned with immense power which must be regulated not only for public good but also for the protection of those whose investments are involved. A director must however exercise his expert skill and knowledge for the company. He should exercise skill and care in carrying out their managerial functions. In addition to fiduciary duties there are some statutory duties also that have been provided under the Companies Act, 1956. A director has to perform his functions with reasonable care. If the directors unable to perform their duties they can be held to be liable under the provisions of this Act. At the time of winding up of a company the liquidator has a vital role to play. But since the directors are the key officers of the company they are also having some liabilities which are as under:

### **LIABILITY TO THE COMPANY:**

Directors owed the following liability to the company:

**Duties of Skill and Care:** Unless the Articles of the Company provide otherwise, the directors are responsible for the management of the company. They should exercise skill and care in carrying out their managerial functions. However, a mere error of judgment will not amount to a breach of the duty of care which a director owes to a company. A professionally qualified or expert person who is a director must however exercise his expert skill and knowledge for the company.

**Liability for negligence:** A director has to perform his functions with reasonable care. He has to attend with due diligence and caution the work assigned to him. Directors may not know the nature of the company's trade, because all that the law expects from them is that if they know they must use the knowledge for the benefit of the company. Accordingly the directors were held guilty of negligence when they participated in a transaction without trying to know whether the transaction was really for the purposes of the company or they were authorized by the Board in that respect, and it was no defence for any director to show that he believed that he was bound to sign because the other directors wanted it or that he joined under protest or that even without his joining, the other directors were determined to carry out the transaction. Directors were also held liable where they released the company's funds for paying the debt without trying to know whether anything was really due and for purchasing the assets without knowing whether there was any real transfer of those assets. Liability for negligence also followed where without any board resolution being properly passed a single member was allowed to manage a part of the company's business and he miscondacted himself. S.201 renders void any provision in the company's articles or in any agreement which excludes liability for negligence, default, and misfeasance, breach of duty or breach of trust. Directors would decidedly be liable for omitting to do what they could have done in the circumstances. Where the president of an investment company improvidently invested in companies in which he was interested and caused loss, his fellow directors were held liable because they had left the investment of the company's funds to the president's unfettered discretion and exercised no supervision over him.

**Defense for the directors- statutory provision [s.633]-**

Section 633 gives a defense to the directors as special protection against a liability that may have been incurred in good faith. Where it appears to the court that the director sued, "has acted honestly and reasonably, and that having regard to all the circumstances of the case....he ought to fairly to be excused, the court may relieve him either wholly or partly from his liability on such terms as it may think fit. Three circumstances must be shown to

exist. The position must be such that the person to be excused is shown to have acted honestly, secondly, reasonably, and thirdly, having regard to all the circumstances he ought fairly to be excused. In a case before the Orissa High Court, where the annual general meeting of a company could not be held in time on account of the dissolution at the material time of the Company's Board of Directors by a court order, the court granted relief against liability for default.

**Duty to attend board meetings:** If some persons are guilty of gross non-attendance, and leave the management entirely to others, they may be guilty by this means if breaches of trust are committed by others. The defendants were directors of a trust company whose by-laws required monthly directors' meetings. A meeting was omitted because of the absence of several directors upon vacations. Losses resulted to the trust company which would have been prevented had the directors met and exercised proper supervision over certain loans. Held, that the directors are accountable to the trust company for such losses.

**Misuse of corporate information-** Exploitation of unpublished and confidential information belonging to the company is a breach of duty and the company can ask the director in question to make good its loss, if any. Any knowledge or information generated by the company is the property of the company, commonly known as intellectual property. Turn over of business, profit margins, list of customers, future plans, any personal use of such knowledge is equivalent to misappropriation of property. Use of such information can be restrained by means of an injunction. Any gain made by the use of inside information has to be accounted for to the company.

#### **FIDUCIARY AND COMMON LAW DUTIES:**

Directors owe a number of fiduciary and common law duties to the company. These duties include:

- Duty to act with honesty
- Duty to account for any profit made

- Duty not to exploit corporate opportunities to their own advantage.
- Duty to ensure that the capital of the company is used only for the legitimate business.
- Duty not to use the company's assets for the benefit of a rival concern
- Duty to repay the company any profit they make on shares in the company

### **LIABILITY FOR BREACH OF TRUST-**

Good faith requires that all the endeavors of the directors must be directed to the benefit of the company so that the ultimate benefit should be gone to the legitimate shareholders of the company. Thus where a director of a company, being also the member of another company, earned business from the other company by providing some business facility of his company, he was held liable to account for such profits, although the company had itself not lost anything and also could not have earned the bonus. But there is some situation where directors may make personal use of company's opportunity and where the corporation is insolvent and defunct; its officers are free to act for themselves, since such condition is ascertainable and not easily feigned. Where the opportunity is outside the scope of corporate business, or where the corporation has shown no interest in the property, an officer may buy for himself. There is no breach of duty if a director competes with his company or holds some interest in the rival company or is a director in a competing company. If a company had given special training to a director, he may be restrained by the company from using those special skills for the benefit of the rival company. A director who acquires property while in office will, however, be liable to account for his profit upon resale if two elements are present. He must have acquired property only by reason of the fact that he was a director and in the course of the exercise of the office of director.

### **LIABILITY UNDER SEBI (INSIDER TRADING) REGULATIONS, 1992-**

For prevention of use of unpublished price sensitive information for money making through stock market The Securities and Exchange Board of India has formulated SEBI (Insider Trading) Regulations, 1992. Since directors are given the shares of the company

in which they are the directors of the company and they also have the right to sell the shares of the company after a lock in period. When director decide to sell their shares however acquired or to buy more shares, their trading comes to be governed by the legislation on insider trading.. “If the director has access to unpublished price sensitive information, such as information on future earnings, figures, security issues, assets disposal and purchases, etc., which if it were made public would have a significant effect on the share prices, it is illegal for them to trade on such information.

### **TORTIOUS LIABILITY OF DIRECTORS: -**

Directors as such are not liable for the torts or civil wrongs of their company. To make a person liable for a tort, e.g. for negligence, trespass, nuisance or defamation it must be shown that he was himself the wrongdoer or that he was the employer or principal of the wrongdoer in relation to the act complained of, or that the tort was committed on his instructions.

### **STATUTORY LIABILITY OF THE DIRECTORS UNDER THE COMPANIES**

#### **ACT:-**

Provisions of the companies act 1956 directors have burdened the directors with some statutory liabilities. These liabilities are as mentioned below:

**Misleading Prospectus-** If a prospectus contains some untrue statement and if on the basis of which a person has subscribed the shares of that company then the directors of the company are liable to compensate the person who has subscribed shares on the faith of the prospectus, which contained untrue statement. The Director should compensate every such subscriber for any loss or damage he may have sustained by reason of such untrue statement in an action in tort and also under section 62 of the Act to pay compensate. If the Director discovers a mistake in the prospectus, it is his duty to specifically point it out. The Director may also have to face criminal prosecution for untrue statement in the prospectus. He may be imprisoned for two years and fined Rs.5000.

**Inducement to invest-** The Directors are liable to criminal prosecution for inducing or attempting to induce a person by statement or even forecast which is false or misleading to enter into or to offer to enter into any agreement to buy shares of the company. They shall be punishable with imprisonment for a term which may extend to five years, or with fine which may extend to Rs.10,000, or with both.

**Maintenance of proper books of accounts: -**

Where directors manage a company then each director shall be responsible (if there is no managing director) that the company should maintain and keep proper books of account. Default or non-compliance will make the Director punishable with imprisonment for a term not exceeding six months or fine of Rs.100 or both. In the event of winding up, failing to keep proper accounts will make him punishable with one-year imprisonment and for falsification of book imprisonment for eight years.

**Liability for Unauthorized Contracts-** The directors of the company are authorized to enter into the contracts on behalf of the company subject to the articles of the company. The contract will be binding on the company. But share holder can impose some restrictions upon the powers of the directors to make contracts. But the directors may be held personally liable for any loss caused to the company as a result of the unauthorized transaction. The directors' actions can be ratified by a separate, special resolution of the shareholders, which will relieve the directors from liability.

**Reduction of members' below the minimum:** If at any time the number of a company reduced, in case of a public company or, in the case of a private company, below two and the company carries on the business for more than six months while the number is so reduced, every person who is a member of the company and knows of the fact shall be severally liable for all the debts of the company contracting during that time.

**Personal Liability of Directors:**

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A director may incur personal liability towards the company if:

- He acquires non-cash assets of the company or the company acquires such assets from him without also obtaining the approval of the shareholders. The contract may be set aside, and the company may recover any of its loss, or his gain, from the director;
- The company makes a payment by way of compensation to a director for loss of office without details of it being disclosed to and approved by the shareholders. The payment is unlawful, and as such can be recovered from the director;
- A payment is made to him (by the company or some third party) on the transfer of the whole or any part of its undertaking by way of compensation for loss of office or in consideration of his retirement, again without shareholder approval. The payment is held on trust for the company and as such can be recovered from him.

The directors of a company incur a personal liability in the following circumstances:

- Where they contract in their own names;
- Where they use the company's name incorrectly, e.g., by omitting the word 'Limited';
- Where the contract is signed in such a way that it is not clear whether it is the principal (the company) or the agent who is signing, and
- Where they exceed their authority, e.g., where they borrow in excess of the limits imposed upon them

### **LIABILITY TO SHAREHOLDERS**

While a director owes fiduciary duties to the company, he owes no such duty to the shareholders. He does, however, owe to the shareholders - collectively, not individually. They could be liable for improper use of corporate assets that exist for the benefit of all shareholders or for favoring one group of shareholders over another in a takeover battle.

**Liability for Infringement of Personal Rights** If the directors override the rights which the company's Articles confer upon the shareholders, by causing the company to act in a

manner inconsistent with those rights, they will incur a liability, in damages, to the shareholders for procuring a breach of contract.

**Statutory Liabilities** A director may incur liability for losses suffered by shareholders resulting from non-compliance with legislation. For example for breach of statutory pre-emption rights, misrepresentation in the prospectus or for any dishonest disclosure to the shareholders

### **LIABILITY TO CREDITORS AND OUTSIDERS:**

**Liability on Contracts:** Where the directors enter into a contract on behalf of the company, in the unlikely event of the company itself not being bound by that contract, the director may incur liability to the other party.

### **Potential Liability of Directors for the Breach of Fiduciary Duty to Creditors:**

Officers and directors of an insolvent company owe fiduciary duties to creditors, and are under a heightened duty to maximize value in connection with the inevitable break up of the company. After determination of the insolvency of the company, officers and directors are charged with a fiduciary responsibility of protecting the interests of creditors based on an "informed business judgment" standard of care.

### **The Liability of Directors on Corporate Insolvency**

When a company goes into insolvent liquidation a director of the company may be exposed to a risk of personal liability. The liquidator of the company has the right to investigate the affairs of the company, including the actions of the directors. If there has been any breach of statutory duty or there have been unlawful payments such as loans or compensation, the liquidator will claim against the director. Specifically, there are a number of provisions in the Insolvency Act 1986 which provide for the potential liability of directors, both in the period leading up to liquidation and during the liquidation itself. These include the following matters.

**(a) Fraud, etc in anticipation of winding-up.** It is a criminal offence to conceal or destroy the company's property, books, records and the like within 12 months before insolvent liquidation (or up to 5 years if done with intent to defraud the creditors). The court may also order repayment, restitution or the payment of compensation by the directors;

**(b) Concealment from, and failure to co-operate with, the liquidator.** It is a criminal offence not to hand over property, books, etc to the liquidator, or deliberately to make a false Statement of Affairs;

**(c) Fraudulent trading.** If a liquidator proves that a company carried on its business with the intent to defraud creditors, the court may order the directors responsible to contribute to the assets of the company. This is also a criminal offence.

#### **LIABILITY FOR THE ACTS OF OTHER DIRECTORS:**

Generally IN the absence of negligence, a director is not liable for the breach of duty by other directors of which he was ignorant. However, where a director is under a duty of care, imposed by his contract or by the general law, to supervise the activities of another director and he fails to do so, or where he knowingly participates to some degree in or sanctions conduct which constitutes a breach of duty, he will be just as liable for those wrongful acts as the other director.

#### **RELIEF TO THE DIRECTORS FROM LIABILITY:**

There are a number of ways in which a director may be relieved from liability which would otherwise be incurred for breach of duty.

- Some breaches may be remedied through the director's conduct being disclosed to a general meeting and being ratified by the shareholders passing an Ordinary Resolution except the following:
  - Any breach involving a failure of honesty on the director's part;

- Any breach of duty which results in the company performing an act which it cannot lawfully do e.g by reason of some prohibition imposed by statute or the general law
  - Any breach of duty which results in the company performing an act not in adherence with the company's articles;
  - A breach of duty bearing directly upon the personal rights of the individual shareholders;
  - A breach of duty involving "fraud on the minority"
- If shareholders of the company unanimously approve the relieve of the directors of the company from their liability for any breach of duty the directors can be relieved from such duty.
  - Any contract between the directors and the company, or any similar provision in the Articles which attempts to exempt the directors from liability for negligence, default or breach of trust towards the company is void. However, directors may exclude their liability to third parties by means of an express contractual provision or a disclaimer.
  - The court has power to relieve a director from some civil or criminal liabilities for negligence, default or breach of trust if it is satisfied that the director has acted honestly and reasonably and in all the circumstances he ought fairly to be excused.

#### **PROTECTION TO THE DIRECTORS FROM LIABILITY:**

The following protections available to the directors of the company:

- The company can, in the following circumstances, indemnify a director in respect of his legal costs. This indemnity may be *ex gratia*, or it may be contained in the director's service contract or in the Articles The power to indemnify is limited to the two cases namely costs incurred by the director in successfully applying for judicial relief re non-payment for shares by a nominee of the company and costs incurred by the director in successfully applying for judicial relief.

- For an independent director, the best way out before landing in a legal mess, of course, is to be a whistle-blower. To point out the minutest of irregularities and make sure they are recorded in the minutes of the meetings.
- A director can obtain insurance to cover certain of his personal liabilities, including the costs of litigation in which he becomes involved in or arising out of his office. A company is permitted to pay the director's premiums on this type of policy.
- The directors have been protected by the business judgment that is applied for the mistakes in the mistakes in judgment by the directors. As long as the director or officers has acted according to the duties of loyalty, obedience and diligence, then the director or officer may be protected by the Business Judgment Rule.

*Please Contact If Any Query*

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