

# Director’s Liabilities: Prevention and Protection – Ports of Call for Relief

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Risks are present in every business. Companies have to factor risks in their operation to survive and thrive.

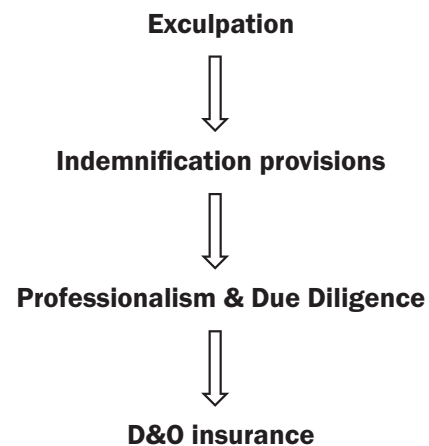
A company does not make decisions. The Board of directors, officers and managers make decisions on its behalf. In making these decisions, directors and officers not only place the company at risk from actions by an aggrieved party, but also place themselves personally at risk. A director's personal liability is unlimited placing all his personal assets at risk. Unlike the Company, he cannot take shelter under limited liability. Directors are jointly and severally liable. Directors are liable personally to pay losses following an act which is wrong, negligent, or which evidences insufficient skill and care in managing the Company's affairs. In the Indian context, Companies Act 2013 has defined the duties and liabilities of directors. It may be noted that while the primary source of liability for directors comes from The Companies Act 2013, provisions governing the issue of liability are found in various other legislations also.

### Is it that a Director is always held responsible?

Not always. There are safeguards. As long as directors are well informed of their duties, responsibilities and obligations and discharge them professionally and without any ulterior motive / criminal intent, keeping the interest of all stake holders, he has a safety net.

The Supreme Court in the case of *Shiv Kumar Jatia v. State of NCT of Delhi*, reaffirmed its views set out in the case of *Sunil Bharti Mittal v. Central Bureau of Investigation* where it inter-alia held that outside any vicarious liability provision, individual directors can be made accused only if there is sufficient material to prove their active role coupled with criminal intent. More on this subject can be read in the article: “*India: Director Liability: Supreme Court Quashes Case Against Managing Director*” - by Mohammad Kamran and Ashish Kabra, Nishith Desai Associates.

How does a director prepare himself to address this issue? Caution should be exercised from the time of acceptance of the position of a director. Broadly, the following mechanisms can help avert pitfalls or reduce their adverse consequences:



### Exculpation:

International Risk Management Institute(IRMI) defines Exculpatory clause as under:

Exculpatory Clause – “a provision in a contract that relieves one party of all liability to the other in connection with the performance of the contract. The enforceability of an exculpatory clause may be restricted by common or statutory law or by legal precedent in a given jurisdiction”.

In simple words, it means contracting out of liabilities. In the Indian context, Companies Act 2013 does not allow waiver of liability of directors. Directors cannot contract themselves out of accountability and liability in India. Limited form of exculpation is available in some jurisdictions. The benefit of this clause, wherever possible, is to thwart any claim at the admission stage itself and not allow it to transform into litigation which may result in avoidable costs.

### Indemnification Provisions:

It is becoming increasingly necessary to have appropriate provisions for indemnity in the bye-laws of the company or employment contract to enable directors and officers face litigation / investigations for business decisions taken in good faith. Indemnity provisions need to be clear and responsive. If they are loosely worded, they become prone to unintended interpretations. In these provisions, it is good to provide for

advancement of defence costs also, otherwise directors may be forced to cover all the litigation costs until they are absolved of any wrongdoing which process may sometimes take years. These provisions should be as broad as possible covering all sections of employees allowing indemnifications “to the fullest extent” permitted by law. Where necessary, over and above the general provisions, customised arrangements can be put in place. These should also provide for facility to the directors to seek professional advice where necessary – pre, during or post litigation.

Following a spate of investigations initiated against bankers in the recent past, the Indian Bankers Association (IBA) is understood to have worked out a plan to extend legal and financial support to serving / retired employees & officers, directors of the bank against cases arising out of bona fide execution of bank's work during their service period. It is a welcome sign that other organisations are also working on similar provisions.

#### **Due Diligence and Professionalism:**

There is no substitute for eternal due diligence. Some of the areas requiring attention are listed below:

1. Understand business operations: It is presumed that appointment of anyone as a director presupposes skillsets required for that position. A good understating of the processes involved in the business operations is essential.
2. Updating on all laws and rules governing the business operations: The old adage “Prevention is better than Cure” holds good here also. It is vital for directors and officers to be aware of their duties, responsibilities and liabilities under Companies Act and other applicable statutes. Compliance with the laws should not be seen as a tick box exercise. It should be observed in letter and spirit. With regard to any wrongful actions, passive negligence is as bad as active involvement.
3. Well-structured reporting mechanisms and controls have to be in place and monitored regularly for their efficacy. Litigation and non-compliance alerts and notices have to be monitored continuously. Apart from catching the early signals which helps in nipping them in the budding stage, course corrections become easy. Event triggered litigation emerging as a major concern for the Boards, consequences of all major events have to be assessed and remedial measures taken. It may be noted here that event triggered litigation is becoming a major source of D&O insurance claims now globally.
4. Unusual items on the agenda for the board meeting need to be thoroughly analysed. These can be potentially troubling items. They call for complete analysis and immediate action.
5. The institution of Independent directors should be respected and their inputs encouraged.
6. It is very necessary to pay adequate attention to the risk management policy and processes. Companies Act 2013 mandates formulation of “a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company”.
7. Since the primary responsibility of directors stems from the board process, it is crucial to review the minutes for the factual and unambiguous incorporation of the decisions taken. The importance of minutes in corporate governance is neatly explained by Justice Heydon:

*“It is fundamental to the running of (a) large and important ... organization ... that the records of its central decision making organ be correct, lest the foundation on which its future affairs rested be left to the vagaries of corporate memory and changing personnel”* (James Hardie High Court Appeal Decision – Australia)

#### **D&O Liability Insurance:**

Insist on a good Directors and Officers (D&O) Liability insurance policy with comprehensive coverage and adequate limit. While the earlier Act was silent on D&O insurance, Companies Act 2013 does mention it at a few places.

#### **Sec 197 (13):**

Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel:

Provided that if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration.

#### **Sec IV Code for Independent Directors - Manner of Appointments:**

(d) provision for Directors and Officers (D and O) insurance, if any;

The appointment of independent directors shall be formalised through a letter of appointment, which shall set out, besides other things, provision for D&O insurance, if any.

#### **How does a good D&O Liability Insurance Policy help?**

Persons appointed as directors are beginning to insist on a good D&O policy before assuming duties and rightly so. Its value is recognised as an additional layer of support. Globalisation of operations, increase in public interest litigations, mounting judicial scrutiny and event triggered actions are significantly increasing the risk of liability claims. This makes it very important for the directors to protect themselves against such risks. In fact the process of buying the D&O insurance may prove to be a process of discovery for an organisation to check its preparedness on various fronts.

A D&O liability insurance policy is not a replacement for sound professional management and corporate governance. But, a good policy helps in as much as it reduces the apprehensions and addresses the concerns of the Directors & Officers so that they can concentrate on their work to take the company on growth path in a sustained manner.

D&O insurance should be seen as complimentary to other tools and it can be another port of call. The other protection instruments are equally important particularly when the market for D&O insurance hardens which is what is visible in developed markets like USA and Europe now.

*Disclaimer: The information contained and ideas expressed in this article represent only a general overview of subjects covered. It is not intended to be taken as advice regarding any individual situation and should not be relied upon as such.* ■

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