



The Directors' & Officers' Indemnity Agreement: Why every director needs one?

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The legal position and vulnerability of Directors and CXOs

Two main principles of Company law define the legal position of the directors and the dangers they face under the various laws prevalent in India. Firstly, being the highest decision-making body in a company, they are considered the brain and “alter ego” of the company, and secondly, that the liability of a director continues (for the offences committed during his tenure) even after he resigns or retires. Currently, there are twenty-eight laws prevalent in India under which the directors can be and have been prosecuted.

Unfortunately for the directors, most laws which define “offences by companies” have an omnibus section holding the directors liable for such offences. The liability is not just for their alleged active participation in illegal acts but also for their alleged consent to and connivance in those illegal acts and omissions. Most importantly, the directors are held equally liable for their alleged negligence in preventing such illegal acts and omissions.

Therefore, any legal action, civil, criminal or governmental, against a company, will first be faced by the directors. Then, depending upon the nature and severity of the alleged illegal act, and their individual role, some directors may successfully defend such legal actions. Executive Directors, CEOs, COOs and CFOs are unlikely to be acquitted easily. Even the independent directors can be prosecuted under such laws and therefore likely to suffer the same expenses and trauma suffered by other directors. Alarming, the jail sentences under some laws range from minimum six months to a maximum of ten years.

The general scheme of director's liability under the Indian laws

The Indian Penal Code (IPC) is the main criminal law in India. Although in criminal law there is no concept of “vicarious liability” the IPC creates a “constructive liability” where an illegal act or omission of several persons, with the guilty intention or knowledge, amounts to an offence committed by each of them. For each such act or omission, each individual is personally liable for the entire illegal act or omission. When the offence is committed partly by an act and partly by omission, it will collectively constitute an offence. So, whilst in theory any director can argue that he did not share any such common intention for committing any offence, the fact remains that prosecution cannot be avoided altogether.

An individual committing an offence on behalf of a company can be charged, together with the company, for his active role with a criminal intent. He can also be charged if that particular law has a deeming provision (like the Companies Act) which holds guilty all “persons in-charge of and responsible to the company for the conduct of its business” for fraud, whether deliberate, or happens with the connivance or neglect of such persons.

Specifically with respect to the functioning of the companies, the courts have held that the Board of Directors (BOD) decides the policy of a company which is executed by the managers at various levels. Duty of care of the BOD and of its Managing Director is of general supervision and not a direct 'hands on' role in the day to day affairs of each department.

However, for not complying with the applicable laws, the BOD, can be prosecuted for the various illegal omissions, irrespective

of the extent of their individual responsibility for such omissions. This is because they are deemed to share common knowledge about their negligence, making those omissions punishable. The same is true for CXOs. In their defence, the directors must prove that the contravention happened without their knowledge.

Apart from this, two laws, [the Securities Exchange Board of India Act of 1992 (SEBI) and the Rules made thereunder and the Prevention of Money Laundering Act of 2002, (PMLA)] have greatly increased the chances of innocent and uninformed directors getting prosecuted because of the illegal actions or inadvertent omissions of their fellow directors in the company.

Of these, a lot has been written about the SEBI Act 1992, thereby increasing the general awareness of its provisions. Less is known about the PMLA which was introduced in 2002, but has been more frequently used by the government from 2015.

The PMLA is a special law for preventing and punishing the generation of monetary proceeds of a “scheduled offence”. It takes within its ambit 31 laws, many scheduled offences under those laws, and all “persons in-charge of and responsible to the company for the conduct of its business”.

It prohibits activities like knowingly, directly or indirectly indulging in, assisting in, being a party to, or actual involvement in any activity connected with the “proceeds of crime”. Proceeds of crime means property derived from criminal activity relating to a scheduled offence, and property which may directly or indirectly be derived as a result of criminal activity relating to the scheduled offence. The activity connected with the proceeds of crime continues till a person directly or indirectly enjoys the proceeds of crime.

Most of the Enforcement Directorate cases that are reported in the newspaper are under the PMLA.

The D&O Indemnity Agreement is the only viable, comprehensive and internationally accepted solution

The shareholders, customers, vendors and workmen have, in the last decade or so, become very aware of their rights and the corresponding legal remedies available to them. Consequently, the directors of companies have started receiving legal notices far more often than they used to. Similarly, the number of legal cases, both civil and criminal, filed against the directors, have increased alarmingly. It is an unfortunate fact that many times such legal notices and cases are used as psychological tools for quick recovery of dues or for mounting pressure to get a favourable decision from the same directors.

In a typical manufacturing set-up, there are workmen (who are covered by the Labour laws) and there are executives, CXOs and directors. The Labour laws in India ensure that a workman receives substantial compensation for injuries suffered at work i.e., burns, partial or permanent disablement and death. However, there is no corresponding law which provides for any

compensation to directors and CXOs for the injuries they suffer at work i.e., criminal prosecution, civil suits, bad publicity, loss of reputation, embarrassment, fines and sometimes imprisonment causing resultant mental trauma.

Although some companies have the directors' and officers' insurance policies, they are inadequate and do not really provide the flexibility and comprehensive promise of compensation that is needed by people in senior positions like directors and CXOs. In such cases, the directors are left to pay for their own defence, for fines imposed on them, and with no compensation if they suffer imprisonment prescribed under any of the laws that provide for imprisonment. More importantly, once the director has resigned or retired, the liability for actions and omissions done during his tenure continues but the compensation for expenses and trauma is totally unavailable as no insurance policy covers the director after he ceases to be a director. Considering human nature, the management of a company unwilling to extend such insurance cover to a director who has moved on (after resignation or retirement) and does not add value to the company.

The only and far-reaching solution is a comprehensive Directors' & Officers' Indemnity Agreement between the company and the director, wherein the company promises to cover all the expenses and fines incurred by a director in defending himself in court cases related to his work with the company. It also compensates the director for the loss of reputation and mental trauma suffered by him as a result of court cases related to his work as a director. This cover is available to the director for a period of seven years after he resigns or retires. The amount of compensation is pre-agreed depending on the seniority and tenure of the director.

The commercial and legal logic on which this D&O Indemnity Agreement is based is that every director works long hours for the interest of the company and not for himself. Therefore, if any court case arises as a result of his employment with the company, the company should compensate him for his legal expenses, fines and jail sentence if imposed on him, and also compensate him for the mental trauma suffered by him from such court cases.

The only exceptions to this compensation are obvious offences like rape, murder or theft, and breach of the Code of Ethics, if committed by the director.

A company which extends the cover of such a D&O Indemnity Agreement to its directors, clearly recognizes their value and yearns to retain the experience and expertise that comes with such directors. ■

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