
THE PARADOX OF THE NON-EXECUTIVE NOMINEE DIRECTOR UNDER THE COMPANIES ACT, 2013: A CRITIQUE

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ABSTRACT

The birth and evolution of the concept of the ‘non-executive nominee director’ under the Indian jurisprudence including its position as on date under the Companies Act, 2013 is replete with enigma. It is commonplace for non-executive stakeholders such as financial institutions and investors to seek appointment of NEDs to the board of directors of investee / portfolio companies to represent and safeguard their interests. However, the Companies Act, 2013 imposes dual responsibilities on such directors of acting in the best interest of the company along with safeguarding the interests of their nominator. Both these interests may often conflict and put the director in a precarious position. Blurred lines of executive and non-executive capacity further complicate the boundaries of where a non-executive role ends and an executive capacity begins. This article seeks to analyse these dilemmas and indicate good practices with a view to assist directors in effective discharge of their statutory obligations.

Background and Introduction

Appointment of non-executive nominee directors (“**NEDs**”) to board of directors of the investee companies (“**Board**”) by financial investors and lenders is a common practice in the investment world of today. The arguably ‘limited’ role of such NEDs is usually the subject matter of extensive negotiations and is legislated by complex contracts predominantly through the construct of ‘reserved matters / consent matters / veto matters / affirmative vote matters. The reserved matters are a list of such business matters that the company cannot undertake without the consent of the relevant nominee director. This list is also typically included in the articles of association of the companies.

While that is the common practice, NEDs oftentimes find themselves entangled in the following complexities inherent in the concept of NEDs as incorporated under the Companies Act, 2013 (the “**Act**”):

- (i) overlap / conflict of interest between their fiduciary duties to the company as a director and their duty to safeguard the interests of their nominator; and
- (ii) blurred lines of executive and non-executive capacity, which may cause the NEDs to inadvertently exceed the limited non-executive capacity into an executive capacity.

The Act describes ‘nominee director’ to mean any director nominated by any financial institution in pursuance of the provisions of any law for the time being in force, or of any agreement, or appointed by any Government, or any other person to ‘*represent its interests*’. S. 166 of the Act further prescribes that all ‘directors’ including NEDs must comply with the fiduciary duties therein in the best interest of the company (“**Common Duties**”). S. 166(4) of the Act specifically obligates a director to “not involve” in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company. Typically, the Act contemplates the role of the NED as limited to monitoring, review, and reasonable due diligence from an external perspective. However, undertaking such diligence excessively may cause the NED to flow from the “non-executive” capacity to the “executive” capacity. Such inadvertent venturing into the ‘executive’ capacity may cause the NED to qualify as an “*officer who is in default*” under the Act, potentially exposing him to

significant monetary and non-monetary consequences. There has been an exponential increase in the resignations tendered by NEDs without citing adequate reasons in the recent past.

This analysis seeks to investigate the statutory intention underlying NEDs with a view to assist potential NEDs and their nominating parties to effectively structure the roles and responsibilities of the NEDs.

The law-makers have, with a view to safeguard the reasonable interests of NEDs, expressly provided in S. 149(12) of the Act that any NED other than a promoter or key managerial personnel can be held liable only in respect of such acts of omission or commission by a company which has occurred:

- (i) with such NED's knowledge;
- (ii) attributable through processes of the Board; and
- (iii) with such NED's consent or connivance *or* where such NED had not acted diligently.

In addition to the above, the Ministry of Corporate Affairs, government of India ("MCA") issued circular 01/2020 clarifying that NEDs should not be arrayed in any criminal or civil proceedings under the Act unless the above criteria is met. It further clarified that evaluation of the nature of default is critical for allocation of liability and that typically, defaults such as filings with the registry, maintenance of registers, minutes, or compliance with statutory orders do not fall within the scope of liability of NEDs. It is only in the absence of whole-time directors or key managerial personnel that the NEDs may be held responsible for such actions. The MCA further expressly stated that all care must be taken to ensure that any proceedings are not unnecessarily initiated against NEDs, unless sufficient evidence exists to the contrary. In the case of doubt on involvement, guidance may be sought from the MCA and initiation of proceedings should be done only upon receipt of sanction from the MCA. Effectively, the MCA has clarified the requirement for a sufficient evidence-backed reason to initiate proceedings against NEDs.

The abovementioned MCA circular has recently been relied on by the NCLT Guwahati in its order in the matter of *North East Regional Agricultural Marketing Corporation Limited and*

Ors.¹, to exonerate non-executive directors from liability for non-compliance by the company and to observe as follows:

“The combined reading of Section 96 and Section 149(12) of the Act, alongwith MCA General Circular dated 02.03.2020, only whole-time directors and key managerial persons are liable as officers in default. Independent directors, non-executive directors and nominee directors are not officers in default and thus, cannot be held liable under Section 99 of the Act.”

S. 149(12) of the Act along with the above clarification issued by MCA is remarkable evidence of the intention of the legislature to boost comfort and confidence in NEDs. However, the broad scope of the terms ‘knowledge’, ‘attributability to Board processes’, ‘consent’, ‘connivance’, and ‘diligence’, which may expose a NED to liability, dilutes the effectiveness of the regulatory efforts. This is because in any given situation, merely attending a Board meeting or having namesake knowledge of a subject matter may also be adequate for NEDs to be roped into investigation, who are then ultimately at the mercy of interpretation.

Pertinently, therefore, the convoluted regime under the Act preserves the magic wand of interpretation within its womb, where the specific facts and circumstances of a case may lead to an interpretation of the exercise of the relevant capacity as being ‘executive’ or ‘non-executive’. Judicial precedents stand as a testimony to such multiple interpretations, depending on the complexity of the relationship of the NED with the control and operations of the company. Having said that, however, the regulatory scheme does provide NEDs enough safeguards to challenge any arbitrary action against them.

In line with the above-briefed statutory intention, courts have also been cautious in allocating liability to NEDs pursuant to their evaluation of the relevant underlying facts and circumstances. In *Pooja R. Devidasani v, State of Maharashtra & Ors.*², the Hon’ble Supreme Court of India (“SC”) has observed (*in context of the Negotiable Instruments Act, 1881*) that *while NEDs are no doubt a custodian of the governance of the Company, their role does not involve in the day-to-day affairs of the running of its business and only monitors the executive activity. Mere directorship does not create automatic liability, and the law has consistently held that only those who are responsible for the day-to-day conduct of business can be held*

¹ Order dated November 9, 2023 pronounced by NCLT Guwahati in the CP/13/441(1)/GB/2023 filed under S. 441(1) of the Act.

² (2014) 16 SCC 1.

accountable. In *SEBI v. Gaurav Varshney*³, the SC has further observed (*in a similar context*) that liability ultimately depends on the role one plays in the affairs of a company and not on designation or status.

In *AES OPG Holding (Mauritius) and Ors v. Orissa Power Generation Corporation Ltd. and Ors.*⁴, the Company Law Board, New Delhi has categorically observed that it is practically very difficult to visualise and list the matters which may constitute the day-to-day affairs of the company. In context of the then existing provisions under the Companies Act, 1956 and the relevant shareholders' agreement between strategic joint venture partners, the Company Law Board observed as follows:

"...The concept of fiduciary duty of a director in relation to a company is well recognised and established. In a nutshell, since a director is a trustee and also an agent, he cannot do anything, which would be against the interest of a company nor could he profit at the expense of the company. Conflict of interest would arise when a person owes allegiance to two or more entities/persons and is placed in a situation to take a decision which would affect the interest of all those to which/whom he owes allegiance. If a director of a company is placed in such a situation either he should reclude himself or he is duty bound to take the decision which would be in the interest of the company failing which he would be in breach of his fiduciary duties. It is more so in case of nominee directors when there is a clash of interest between the company and their nominators. ..."

Similarly, in the case of *Rolta India Limited v. Venire Industries*⁵, the Bombay High Court has observed that private arrangements or pooling arrangements which may bind the parties to vote in a particular manner do not, and cannot, override the statutory obligation of the Common Duties under the then existing Companies Act, 1956.

In *Ionic Metalliks v. Union of India*⁶, the Gujarat High Court observed that the extent of a non-executive director's rights and the scope of supervision by the shareholders is contained in the contract that enables such appointments, or relevant statutes. However, such NEDs must be particularly careful not to act only in the interests of their nominators but must act in the best interests of the company and its shareholders as a whole. The fixing of liabilities on NEDs in

³ (2016) 14 SCC 430.

⁴ 2004 SCC OnLine CLB 35.

⁵ 1999 SCC OnLine Bom 706.

⁶ 2014 SCC OnLine Guj 10066.

India does not turn on the circumstances of their appointment or, indeed, their nominators. Whether NEDs are required by law to discharge such duties or bear such liabilities will depend on the application of the legal provisions in question, the fiduciary duties involved, and whether such NED is to be regarded as being in control or in charge of the company and its activities. This determination ultimately turns on the specific facts and circumstances involved in each case, and this ruling has been relied on by many subsequent cases in their evaluation of the role of the NEDs in the relevant facts and circumstances.

In view of the above statutory and judicial analysis, an understanding of the concepts of “knowledge” and “diligence” become paramount. The jurisprudence surrounding non-executive directors emphasizes that NEDs are expected to possess the undefined ‘knowledge’ in relation to the affairs of the company which will typically include both: (i) actual knowledge which they have, and (ii) constructive knowledge which they ought to have had; in order to carry out their duties effectively.

Further, the undefined term ‘diligence’ effectively obligates the NEDs to ask questions and thoroughly review and monitor the affairs of the company which would typically involve reviewing financial statements, and understanding the corporate risks depending on the terms of the scope of responsibilities assigned to, and accepted by, the relevant NED. The legal standard of diligence is not limited to a passive role but requires active participation in the governance of the company.

It is effectively in this context that the term “*officer who is in default*” includes within its fold any director who is aware of or involved in the wrongdoing, either through knowledge or active participation in Board proceedings where the contravention occurred with his consent or connivance. While the Indian courts have largely maintained a balance between attribution of vicarious liability to only such directors who have an active role and a legal provision imputing liability, such balance has not been seen at an investigation and interrogation level, which exposes NEDs to preliminary reputational and other loss. Therefore, the actual day-to-day positions of NEDs in a company and the ultimate facts and circumstances have a direct and material impact on the accountability, independence, and liabilities of NEDs, which varies from case to case.

Accordingly, it is safe to conclude that NEDs enjoy statutory immunity against prosecutions brought against the Board, while they can be held liable under very limited circumstances. That

said, it is critical for NEDs and the persons appointing NEDs to have a clear understanding of the limitations on the role of NEDs in connection with the affairs of the company. The Act does not permit NEDs to serve as a mere 'yes-man' to the appointing authority of the NEDs. Further, extreme caution should be exercised while documenting the role of the NED in any agreement to ensure that such role is effectively in a non-executive capacity and is within the contours of the Act. If this role ventures into the realm of the executive capacity including through inadvertently making regular business matters 'reserved matters', then the immunities enjoyed by the NED under the Act may not be helpful and it may lead to unaffordable non-monetary consequences such as loss of reputation and imprisonment. Typically, nominators require companies to procure directors' and officers' liability insurance to cover for such risks. However, the documentation related to the role of a NED as well as the day-to-day involvement of the NED in the business of the company must be thoughtfully navigated to ensure that the NED's independence or judgment is neither unduly restricted, nor excessively permitted.