

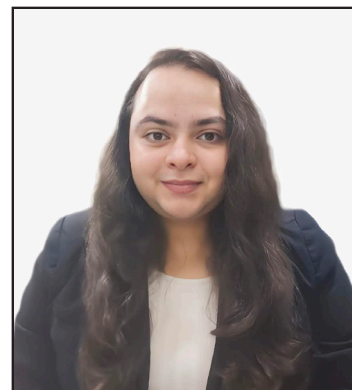
# Navigating Liability: The Evolving Legal Position of Independent Directors in Listed Companies



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## I. Background

Over the past decade, the role of independent directors in listed companies has come under increasing scrutiny within the Indian corporate governance framework. While they are statutorily positioned as gatekeepers of integrity and accountability, several high-profile corporate frauds and enforcement actions have raised a critical question: how far should an independent director be held liable for acts or omissions committed by the company?

Despite protective provisions under the Companies Act, 2013 (the “Companies Act”) and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (the “LODR”), independent directors continue to face litigation from private parties and government authorities alike, and are often penalised for corporate offences without clear evidence of wrongdoing or direct involvement. This disconnect between their statutory role and practical liability exposure has triggered debate within corporate boards, legal circles, and policy institutions.

## II. Who is an Independent Director?

An independent director is a non-executive board member who contributes objectivity and detachment to corporate governance, particularly in safeguarding minority shareholder interests and ensuring board accountability. The definition of an independent director is positioned around the principle of - independence from the management and promoters of a company. The definition of an independent director is given in the following statutes as below.

### Companies Act, 2013:

Under Section 149(6): An independent director is a person other than a managing director, whole-time director, or nominee director who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience. One of the main requisites of an independent director is that not only should he not be the promoter of the company or its holding, subsidiary, or associate company, but he should also not be related to the promoter or other directors of that company or its holding, subsidiary, or associate company. Further, he should not have any pecuniary relationship, other than receiving remuneration as such director or engaging in transactions not exceeding ten percent of his total income or such amount as may be prescribed from time to time, with the company, its holding, subsidiary, or associate company, or their promoters or directors, during the two immediately preceding financial years or during the current financial year. The Companies Act further mandates that the relatives of an independent director cannot be indebted to the company, its holding, subsidiary, or associate company, or their promoters or directors, in excess of such amount as may be prescribed during the two immediately preceding financial years or during the current financial year. They also cannot give any guarantee or provide any security in connection with such indebtedness, nor can they have any other pecuniary transaction or relationship with the company, its holding, subsidiary, or associate company amounting to two percent or more of its gross turnover or total income, whether individually or in combination with other pecuniary transactions.

Neither the independent director nor any of his relatives can be a key managerial personnel or an employee of the company or its group entities in the past three financial years, nor can they hold (whether individually or together) two percent or more of the total voting power of the company.

The Companies Act further mandates that, neither the independent director nor any of his relatives can be an employee, proprietor, or partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of:

- a firm of auditors, company secretaries in practice, or cost auditors of the company or its holding, subsidiary, or associate company; or
- any legal or consulting firm that has or had any transaction with the company, its holding, subsidiary, or associate company amounting to ten percent or more of the gross turnover of such firm.

#### ***i. SEBI (Listing Obligations and Disclosure Requirements) Regulation, 2015:***

Under Regulation 16(1)(b): The SEBI LODR also prescribes criteria that is similar to those under the Companies Act for the qualification of an independent director. As per the SEBI LODR, an independent director is a non-executive director (other than a nominee director of the listed entity) who, in the opinion of the board, is a person of integrity, possesses relevant expertise and experience, is not less than 21 years of age, and is not related to the promoters or the management.

The regulation lays down specific disqualifications to ensure that independent directors remain free from conflicts of interest and external influence. Some of the key disqualifications include: holding any managerial position in the listed entity; being an employee, proprietor, or partner in the firm of financial auditors or a law firm that advises the listed entity; holding, together with relatives, two percent or more of the total voting power of the listed entity; or being a material supplier, service provider, customer, lessor, or lessee of the listed entity.

### **III. Board Composition and Independent Director Requirements**

Regulation 17 of the LODR prescribes mandatory board composition requirements for listed entities, including a minimum number of non-executive and independent directors. Where the chairperson of the board of directors is a non-executive director, at least one-third of the board shall comprise independent directors. Where the listed entity does not have a regular non-executive chairperson, at least half of the board shall comprise independent directors.

Regulation 18 of the LODR mandates that the chairperson and at least two-thirds of the members of the audit committee must be independent directors.

Section 149(4) of the Companies Act also requires that every listed public company must have at least one-third of the total number of directors as independent directors.

### **IV. Statutory Liability of an Independent Director Under Different Legislations**

Despite their intended role as neutral overseers, independent directors do not have complete immunity from legal liability. Various legislations impose responsibilities on independent directors in certain circumstances, sometimes expressly, and at other times, by implication. The frameworks governing such liabilities are below.

#### **i. The Companies Act, 2013:**

Under Section 149(12), an independent director or a non-executive director (not being a promoter or key managerial personnel) shall be held liable, only in respect of such acts of omission or commission by a company, which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance, or where he had not acted diligently. This provision was introduced to prevent indiscriminate prosecution of independent directors and reinforce their oversight role, and not daily operational accountability.

#### **ii. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015**

While the LODR lays out specific obligations for independent directors, particularly with respect to their role in audit committees, the liability of an independent director is very similar to that imposed by the Companies Act. Regulation 25(5) of the LODR reiterates Section 149(12) of the Companies Act, to provide, that an independent director shall be held liable, only in respect of such acts of omission or commission by the listed entity which had occurred with his/her knowledge, attributable through processes of board of directors, and with his/her consent or connivance or where he/she had not acted diligently with respect to the provisions contained in SEBI LODR.

#### **iii. Securities and Exchange Board of India Act, 1992 (as amended by the Securities Laws (Amendment) Act, 2014)**

Section 27(1) of the Securities and Exchange Board of India Act, 1992 provides that when a company commits an offence, every person who was in charge of and responsible for the conduct of its business at the time, is deemed guilty and can be prosecuted and punished. However, such a person can escape liability if they prove that the offence was committed without their knowledge or that they had exercised due diligence to prevent it.

#### **iv. Ministry of Corporate Affairs Circular**

The Ministry of Corporate Affairs ("MCA") vide its General Circular No. 1/2020 dated 2 March 2020 ("MCA Circular 2020"), clarifies, inter alia, that independent directors should not be subjected to prosecution or adjudication under the Companies Act, unless the alleged default occurred with their knowledge (as evidenced through board processes), with their consent or connivance, or due to their failure to act diligently, in accordance with Section 149(12) of the Companies Act. It directs authorities such as the Registrars of Companies to undertake detailed

documentary scrutiny, and to refrain from initiating proceedings against independent directors unless clear evidence of culpability exists.

## V. Judicial Determination of Liability of Independent Directors

From the above interpretation of the relevant statutes, it is clear that an independent director shall be held liable for any act of omission or commission committed by the company, if the alleged act has occurred with the knowledge of the independent director which is attributable through board processes, and which has been undertaken with consent or connivance of the independent director, or due to the independent director's failure to act diligently.

While these provisions appear narrow and protective, judicial and regulatory interpretation across these grounds have been inconsistent, leading to uncertainty about the liability of an independent director. Below is an analysis of these inconsistencies through case laws, structured around each of the four grounds.

### i. “With Their Knowledge” – Inconsistencies in Establishing Awareness

The first threshold of liability of independent directors requires that a director had actual or constructive knowledge of the misconduct. Courts, particularly the Supreme Court and the Securities Appellate Tribunal (“SAT”), have taken a relatively strict approach, requiring specific evidence of such awareness. However, the Securities and Exchange Board of India (“SEBI”) has often relied on presumed knowledge, based on the director's position or committee membership.

- In *Pooja Ravinder Devidasani v. State of Maharashtra*<sup>1</sup>, the Supreme Court quashed criminal proceedings for dishonoured cheques under Sections 138 and 141 under the Negotiable Instruments Act, 1881 holding that mere status as a director is insufficient without specific allegations linking the individual to the offence.
- Similarly, in *Venkadasamy Venkataramanujan v. SEBI*<sup>2</sup>, SAT found no material proof showing the independent director's knowledge, noting that he did not attend meetings and had no operational role. SAT in *Rahul H. Shah and Ors. vs. SEBI*<sup>3</sup> stated that “the standard of proof in a criminal case is a higher standard to the extent that the person cannot be convicted unless he is proved to be guilty beyond reasonable doubt”.
- In contrast, the SEBI order in the matter of *LEEL Electricals Limited*<sup>4</sup>, treated failing to exercise independent judgment and scrutiny, and not raising appropriate red flags regarding the transactions in question as the independent directors' failure to object to financial irregularities. This was treated as indicative of knowledge of the independent director by SEBI, without specific proof of such awareness. These irregularities included fictitious sales and purchases, booking of non-existent inventory, diversion of business sale proceeds and wrongful claims of tax credits. This shifts the burden to the independent director, contradicting the presumption of innocence affirmed in other judicial rulings.

### ii. “Knowledge Attributable Through Board Processes” – Divergent Standards on Committee Responsibility

The second limb of liability of independent director limits liability to cases where the knowledge of company's misconduct is “attributable through board processes.” The inconsistency lies in how SEBI and SAT evaluate the significance of mere presence of an independent director versus their active participation.

- In *SVAM Software Ltd. v. SEBI*<sup>5</sup>, SAT held that independent directors could not be held liable unless it was shown that they actively participated in the board meetings during which the default occurred. SAT made it clear that mere association with the board is not enough—there must be a demonstrable link between the director's presence and the specific decision under scrutiny.
- The ruling of SAT in *Adesh Jain v. SEBI*<sup>6</sup> reinforces this view. Although Mr. Jain, an independent director, had signed a board resolution approving a global depository receipt's issuance, SAT found that the resolution itself contained no reference to the fraudulent downstream arrangements later uncovered. Since there was no evidence that the board was informed of or had discussed the misuse, Mr. Jain's signature was held insufficient to attribute liability through board processes. SAT concluded that passive or procedural participation does not meet the threshold of this provision.
- In contrast, the SEBI order in the matter of *Bombay Dyeing and Manufacturing Company Limited*<sup>7</sup>, imposed penalties on independent directors who approved financial statements that included inflated revenues. While the directors did not personally execute the fraudulent transactions, SEBI held that their approval in board meetings sufficed to attribute liability through the board process.

This divergence in enforcement standards creates ambiguity around what constitutes “board process” for the purposes of liability. While SAT insists on actual engagement, such as discussion, questioning or informed approval of the disputed decision, SEBI has increasingly treated attendance, silence or procedural endorsement as enough to meet the requirement of liability of an independent director.

### iii. “With Their Consent or Connivance” – From Passive Endorsement to Active Culpability

The third threshold attributes liability where there is intentional approval or even connivance by the independent directors. SAT requires clear proof of consent or involvement in the misconduct, while SEBI has, in several cases, penalised independent directors based merely on the director's signature on documents or resolutions in question or where independent directors did not raise objections, flag concerns, or scrutinize questionable decisions, interpreting this silence as approval or connivance.

- The SEBI order in the matter of *MPS Infotecnics Limited*<sup>8</sup>, held a non-executive director liable for signing an account charge agreement, despite his claim of ignorance. SEBI inferred consent from the act of signing, even

though there was no evidence of understanding or active support by the non-executive director.

- However, the above order was challenged in *Adesh Jain v. SEBI*<sup>9</sup>, where SAT quashed SEBI's order that penalised the non-executive director merely for signing a board resolution. The SAT found no evidence of his consent or participation in the fraudulent downstream arrangement, and stressed that intent could not be presumed from procedural compliance alone.

This inconsistency reflects a broader issue: procedural signatures, often executed under managerial advice, should not automatically be considered as consent or connivance by independent directors in any fraudulent activities undertaken by a company. SAT's judgments suggest this is not the case, whereas SEBI tends to assume that passive compliance equals conscious consent.

#### iv. "Where They Had Not Acted Diligently" – Ambiguity in the Application of Oversight Obligations

The diligence test under Section 149(12) and Regulation 25(5) is both the broadest and the most inconsistently applied. SEBI frequently uses it to justify enforcement of liability on independent directors in the absence of concrete knowledge or consent, whereas SAT has insisted on a context-sensitive evaluation of the independent director's role, access to information and tenure before attributing liability.

- The SEBI order in the matter of *Manpasand Beverages Limited and Others*<sup>10</sup>, stated that the independent directors failed to prevent financial misstatements and did not exercise adequate scrutiny over disclosures and audit irregularities. Although no evidence was presented to show their involvement in the fraud, they were penalised for not asking questions or seeking additional information, reflecting an interpretation that equates passive acceptance with a breach of diligence.
- In *SVAM Software Ltd. v. SEBI*<sup>11</sup>, however, SAT ruled that mere absence of inquiry does not prove lack of diligence by independent directors unless there is clear evidence of awareness, the independent director's appointment subsisting during misconduct, or red flags visible at the time of the misconduct.

Thus, while SEBI often equates inaction with a lack of diligence, SAT maintains that diligence must be evaluated in light of an independent director's actual role, capacity and information access, and not in abstract or with the benefit of hindsight.

## VI. Our Analysis

Although statutorily there is consistency on the four grounds under which independent directors can be held liable and prosecuted, there is inconsistency in how various judicial and quasi-judicial bodies have interpreted and determined independent director's liability, leading to an unsettled position in law.

The MCA Circular 2020 provides important guidance by limiting the scope of prosecution to instances where there is knowledge, consent, connivance, or failure to act diligently. However, in the absence of binding enforceability, this clarity is often undermined by inconsistent regulatory application. Greater coordination between MCA, SEBI, and SAT is necessary to establish stable judicial principles around independent director liability in listed companies. SAT has, on several occasions, read down SEBI's orders on attributing liabilities to an independent director due to insufficient evidence directly linking an independent director to the alleged misconduct. This inconsistency could be remedied if SEBI were to adopt the MCA Circular 2020 as a formal directive, thereby clarifying evidentiary standards and shielding independent directors from liability for routine corporate actions in which they had no role or knowledge. Doing so would ensure a fairer, more consistent enforcement regime, which is essential to preserve the integrity and attractiveness of independent directorships in India's listed entities.

The prevailing uncertainty also has a wider impact on the corporate ecosystem. Businesses are finding it increasingly difficult to attract high-quality professionals to serve as independent directors due to the fear of unwarranted liability. This risk aversion not only affects board composition but also undermines effective governance, as cautious directors may refrain from offering candid advice or challenging management decisions. For companies, this leads to diminished board oversight, weakened investor confidence, and an erosion of accountability mechanisms that are vital for long-term stability and growth. Clarity and consistency in regulatory enforcement will thus not only protect individual directors but also enhance the overall resilience and governance standards of Indian corporates.

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### References

- <sup>1</sup> (2014) 16 SCC 1
  - <sup>2</sup> 2020 SCC OnLine SAT 20
  - <sup>3</sup> 2004 SCC OnLine SAT 77
  - <sup>4</sup> SEBI Order No. WTM/AB/CFID/CFID/30277/2024-25 dated April 18, 2024
  - <sup>5</sup> MANU/SB/4263/2022
  - <sup>6</sup> 2020 SCC OnLine SAT 553
  - <sup>7</sup> SEBI Order No. WTM/AB/CFID/CFID\_1/20686/2022-23, dated 21 October 2022
  - <sup>8</sup> 2020 SCC OnLine SEBI-OCM 31
  - <sup>9</sup> 2020 SCC OnLine SAT 553
  - <sup>10</sup> 2024 SCC OnLine SEBI-OCM 19
  - <sup>11</sup> MANU/SB/4263/2022
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