A director's liability in cases of fraud

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Over the next few weeks, we will see increased scrutiny by banks, and, in turn, by authorities such as the CBI. Photo: Ramesh Pathania/Mint

In the past few weeks, the Central Bureau of Investigation (CBI) has registered cases against multiple companies and their officials for bank frauds, such as Gitanjali Gems and Simbhaoli Sugars. Coupled with such revelations is the response of the government, which has brought the investigative authorities out of their usual stupor. The government has now asked public sector banks to evaluate potential frauds in all bad loans above Rs50 crore. Thus, over the next few weeks, we will see increased scrutiny by banks, and, in turn, by authorities such as the CBI, Enforcement Directorate (ED) and Serious Fraud Investigation Office (SFIO).

Through the Finance Bill, 2018, the government amended the Prevention of Money Laundering Act, 2002 (PMLA). The handling of proceeds from corporate frauds will now be a money- laundering offence. As the PMLA gives ED the power to attach and confiscate property determined to be proceeds of crime, the amendment will help authorities to prevent the dissipation of proceeds from corporate frauds. However, the unintended repercussion of the amendment will be innocent parties being questioned about their dealings with a company where fraud is discovered and potentially having their assets seized or directors arrested.

Therefore, it is critical for directors and officials of companies to now maintain high vigil. Relationships with banks are typically promoter-driven and foreign investors or joint venture partners do not play a role in this. However, this does not imply that they would be insulated from liability. The question that arises is, when can directors and other officials of the company be held vicariously liable for the actions of the company?

In *Sunil Bharti Mittal v. CBI*, the Supreme Court held that an individual can be held liable for an offence by the company (i) if there is sufficient evidence of the individual's active role coupled with criminal intent; or (ii) where the statute itself stipulates the liability of directors and other officials, such as under the PMLA. Under the Companies Act, an exception has been specifically carved out for independent and non-executive directors, ensuring that they are liable only in cases where their knowledge and involvement can be established or where they, despite having knowledge, failed to act diligently. However, such exceptions are generally not prevalent in other statutes like the PMLA. Given that investor directors are usually non-executive in nature, they should normally not be liable for actions which are largely promoter-driven. However, such non-executive directors often find themselves explaining to the authorities that they were not involved or that they had acted diligently. Once a fraud is discovered, authorities generally look at everyone with suspicion, and merely being a non-executive director does not shield the individual from liability or criminal prosecution.

Thus, ensuring that appropriate measures are in place to shield against any criminal investigation, prosecution and its effects is critical. Having such measures in place also enables individuals to be viewed as cooperative in the investigative exercise. What, then, are the measures and actions that could be taken?

The master directions on fraud (July 2017) issued by the Reserve Bank of India identify certain early warning signals for identification of fraud. Early warning signals could be foreign bills that remain outstanding with the bank for a long time, the tendency for bills to remain overdue, and a substantial increase in unbilled revenue year after year. Upon identification of one or more early warning signals, the account is red-flagged, and triggers further reporting and investigation. If a fraud is identified, the banks are required to report it to the state police/CBI/SFIO, depending upon the size of the fraud and type of bank. The foreign joint venture partners, directors and officials of a company should be cautious of such early warning signals so that they are not caught unaware. Further, as the business plans and accounts of the company are usually placed before the board of directors, it is necessary that appropriate questions are asked about the business plan and that confirmations from the audit committee, internal auditors, and external auditors are obtained. Heightened pre-investment financial and forensic diligence, particularly in the case of companies with large outstanding debts, is also imperative. Director and officer liability insurance or indemnity agreements are also extremely useful.

Further, tendering a resignation is traditionally viewed as a good way of safeguarding against liability, and is usually advisable. However, it does not provide a complete cover. Stepping down may also have unwanted consequences, such as disabling an investor from exercising its contractual rights like reserve matter rights.

Lastly, different authorities investigate different types of offences. The powers of these authorities (CBI, ED and SFIO) also differ, and so does the nature of investigation. Thus, while dealing with different authorities, different approaches may be required.

A man is known by the company he keeps. Failure to act may result in investors and foreign partners finding themselves being identified with fraudsters. Not only does it bring the risk of imprisonment, it has reputational consequences. It is thus imperative that the directors take necessary steps to avoid liability.

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