

## EXPLORING THE LEGAL DYNAMICS: STRICT LIABILITY VS. DUE DILIGENCE DEFENSE FOR INDEPENDENT DIRECTORS UNDER THE COMPANIES ACT, 2013

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### ABSTRACT

This paper explores the interplay between strict liability and due diligence defense for independent directors under the Companies Act, 2013 in India. It examines the legal framework, compares it to international standards, and analyzes landmark cases to understand the challenges and opportunities this framework presents. The paper concludes by proposing solutions to enhance clarity, promote boardroom dynamics, and improve director training and regulatory guidance.

### INTRODUCTION

Indian corporate environment witnessed radical change by coming up with a stable Companies Act, 2013.<sup>805</sup> This panoptic law, which eventually replaced the Companies Act, 1956, and brought about the introduction of implementing a number of reforms, was an attempt to improve the practice of corporate governance. The principle of heightened transparency, accountability, and safety of the stakeholders has been a great functioning behind companies of India which has paved the way for a new era of responsible conduct and ethical management business activity.

The Companies Act, 2013 (the Act) ushered in a new era of corporate governance in India. A cornerstone of this reform was the enhanced role and responsibilities assigned to independent directors. These individuals, entrusted with acting as impartial stewards of a company's interests, shoulder significant legal burdens. This research paper delves into one of the most debated aspects of independent director liability: the interplay between the principle of strict liability and the due diligence defense enshrined in the Act<sup>806</sup>.

### SCOPE OF THE PAPER

The Companies Act, 2013, bestowed autonomy of independent directors in India converting them as entities playing a watchdog role in the interest of stakeholders. Nevertheless, a legal cycle is included that is also highly baffling. Through this research paper we'll explore the shifting paradigm between strict liability, a condition in which directors are held personally liable to a company's misfortunes, and the threat of due diligence defense which allows them to immunity against case when they prove they acted with due diligence. We go into war and peace with landmark cases such as the Sahara India versus SEBI. The Securities and Exchange Board of India Act, 1992 (sebi)<sup>807</sup> which enacted a strict liability clause and furnished the use of due diligence as defense. The latest sentence highlights factors like the impartiality of an information source and the expediency of detection for a level of national security. The Landscape is also enhanced by the proliferation of increasingly vigorous investor activism and its demand of full accountability and more stringent regulatory frameworks from both SEBI and other authorities. As the regulatory framework continues to evolve, the independent directors' ability to learn is critical, facilitating

<sup>805</sup> Companies Act, 2013 (India)

<sup>806</sup> <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/>

<sup>807</sup> <https://www.sebi.gov.in/sebiweb/landmark/landmark.htm>

strong communication within the boardroom, working with management in a team spirit, and asking for professional support where it is due. Through their comprehension of these considerations and implementation of preventive approaches, the independent directors can be pragmatic watchmen of corporate governance of India.

### ROLES AND RESPONSIBILITIES OF INDEPENDENT DIRECTORS WITHIN THE CORPORATE FRAMEWORK-

Assertion of independent directors is a fundamental justification of good governance, which is a necessary condition of Indian corporate framework. The Companies Act, 2013, sets out their various roles and responsibilities quite comprehensively, with the aim of ensuring the company management is supervised and that individual interests of caretaker's minor shareholders are well protected. Here's a breakdown of their key functions<sup>808</sup>:

1. Oversight and Guidance: The role of independent directors is to bring in independent governance which helps in giving directions to the company's board of directors to make constructive criticism of every decision concerning strategic goals, financial results, and risk management methods.
2. Safeguarding Minority Shareholder Interests: They provide essential for the prevention of disputes of interests not just the shareholder with greater control but also the minority ones. Transparency and fair treatment for all shareholders are important for the company, and they are a key factor for investors' confidence and trust.
3. Promoting Ethical Conduct: One of the key functions of corporate governance of the non-executive directors is to set the bias of ethical culture in the company. They are required to express worries about whatever they see as any

suspicious acts that may be committed or breaches of fiduciary obligations and support for ethical running of the organization.

4. Independent Scrutiny: The society members are authorized to interrogate the company from the board of director on any issue that may touch the company's business. This way they can check out the financial statements, audit reports and those details, which are of paramount importance to make sure the figures are correctly presented and no mistakes have been made.
5. Boardroom Balance: The independent directors approach the executive body of the company with unique competencies and points of view. So, they do not limit themselves to the consideration of the interests of the controlling stockholders alone. In fact, they take into account all the parties concerned.

### COMPARATIVE ANALYSIS WITH OTHER COUNTRIES

In India, act of the Companies Act, 2013, plays a role of a guardian and allocates the essential duties of independent directors to the shareholders. This consists in the attribution of such responsibility to them for omissions, among other duties, to avoid breach of contract under the strict liability principle. Nevertheless, a due diligence defense has been established to ease charges of, which might otherwise, be, unbearable. Let's decide well about India's directorial liability legislation given international standards as a model.

1. Strict Liability: The Commonness, with the Subtleness<sup>809</sup>.
  - Similarities: Several countries in the world particularly among them the active members who are the United Kingdom of Great Britain and Northern Ireland (UK) and the United States of America (US)

<sup>808</sup> Securities and Exchange Board of India. (2018). SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

<sup>809</sup> Chatterjee, S., & Rudra, S. (2020). A Comparative Analysis of Director's Liability under the Indian Companies Act, 2013 and the UK Companies Act, 2006. *Journal of Corporate Governance*, 10(2), 45-62

follow the strict liabilities of directors. It is a fact that this doctrine limits unrestricted interference and aspires the parties to only intervene responsibly.

- Differences: The Canadian common law that sets strict liability and its extent has been interpreted with more technology.
  - India: Liability content ranges between the legally grounded debts and the disciplinary deficits.
  - UK and US: Strict liability could be liable for particular crimes such as fraud or non-compliance of the counter party someone participated to.
- 2. Due Diligence Defense: <sup>810</sup>A Unique Shield, but not Without Variations in the Meanings
  - Similarities: Therefore, both India and other jurisdictions have a counsel defense which can be exercised. Provided that a director can be exempted from liability if he/she shows that reasonable care and competency was used while providing the suit to avert the wrongdoing / omission.
  - Differences: If due diligence is an issue, the weightstandard for proving it may vary.
    - India: Courts point out that one of their key responsibilities is to provide a platform for exercising the right to attend, question, and express concerns during board meetings, examining financial statements, and whistle-blowing in case of shifty practices, suspicions of dubious behavior, or any other related to wrongdoing.
    - UK and US: These tools may include:- setting up a sound risk management process- seeking

legal advise from a qualified solicitor.

### 3. Additional Considerations

- Directors' and Officers (D&O) Insurance: In Europe, much less common but quite similar to the US and UK is the so-called D&O insurance, which insures directors against the loss of their assets in case of lawsuits. In India, this is rarely the case; this is unlike doing so in the country where external factors receive less attention.
- Derivative Suits: The derivative suits typical in the American law system allow shareholders to act on behalf of the company whenever they consider that directors have breached their legal duties. However, this is relatively new to India and implementation is still not that common.

### 4. Convergence and Divergence: The Incongruous Capacity

- Convergence: While International standards, such as OECD's Principles of Corporate Governance, either put or lay emphasis on the responsibility and importance of independent directors and the need for strong oversight mechanisms. This falls in the line of responsibility of directors as is stated in the Indian corporate governance policy.
- Divergence: There is differentiation on the coverage of strict liability and the intricacies of due diligence standard involved in liability law. Moreover, dram shop law, the existence of D&O insurance and the voting option may lead to diversity of the legal setting the directors have to face.

### CASE LAWS-

The contradiction, in turn, between tort(/) strict liability and due diligence defensive independency of directors as it applied to

<sup>810</sup> US Securities and Exchange Commission. (n.d.). SEC Enforcement Manual - Due Diligence Defense. Retrieved from <https://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

around the world gives the complication scope for legal structure. Here's a comparative analysis using case studies from India and other jurisdictions:

## 1. India-

I. The Sahara Financial Survey<sup>811</sup> Ltd. is among the Giant sponsors of the IPL. Sebi & Ors (2012): This case is a pre-2013 provision of the Act, which has created the principle of strict accountability of the directors in India. Indeed, it usually agreed on this matter, but it sometimes admitted the use of due diligence as a defense. Singaporean case law switched from the question whether directors had conducted themselves with appropriate care and skill.

- Lessons Learned: However, directors can defend themselves from the strict liability provisions by presenting proper reasons for inadequate due diligence exigencies.

II. Satyam Computer Services Ltd. Scandal (2009): The conflicting independent directors have not fulfilled their professional duty and it was a great company fraud of accounting. Naturally, this prohibition by SEBI has made some directors ineligible to hold such posts, thus drawing the line in the sand for the directors who failed in the discharge of their duties.

- Lessons Learned: If the oversight responsibility is neglected against all odds because of passive or active negligence, that can lead to the liability and reputation loss.

## 2. United States:

I. In re Caremark International Inc. Derivative Litigation (1996)<sup>812</sup>: This Delaware case, being as crucial as it was, highlighted the directors' duties as something they were under an

obligation to take care and apply. However, it is examining directors' personal liability toward the liquidation of the company, which is not strict liability. Liability risks necessitates a situation where Directors show that they had the good faith to make informed decisions and exercised due diligence in overseeing the company.

- Lessons Learned: It is in the purview of directors to have knowledge and to employ effective control mechanisms, even if they are not the ultimate responsible persons for the outcome.

## 3. United Kingdom:

- Re Kingston upon Hull City Council [1997]: The lawsuit under the UK Company Act was conducted addressing the "wrongful trading" clause. The Directors can be held as individuals to account for insolvent trading when they do not take reasonable steps to ensure that their companies do not continue trading while insolvent. Conversely, they square off with liability by demonstrating the diligence of the steps they put in place toward the goal of minimizing the loss incurred.

- Challenges: The task of implementing Strict Liability and Due Diligence is absolutely a difficult issue on the minds of Independent Directors.

- And independent directors stipulated by the Companies Act 2013, is meant to be the framework of corporate governance promotion. However, this framework presents several challenges that can hinder its effectiveness: However, this framework presents several challenges that can hinder its effectiveness.

<sup>811</sup> Sahara India vs. SEBI & Ors. AIR 2012 SC 2732.

<sup>812</sup> Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

## OPPORTUNITIES

### 1. Enhanced Corporate Governance: A Gentleman in the Governance

- In a situation where a company intentionally benefits by implementing a robust due diligence defense that can be truly effective, it could act as a stimulant for excellent corporate governance behavior in companies. Here's how:
- Increased Scrutiny<sup>813</sup>: Realizing home, they could be released from liability due to due diligence the directors feel more comfortable exerting control over the strategic planning process. This may result, therefore, in a more stringent read and an assessment of the financial statements, the management plans as well as the risks which may accompany it.
- Improved Boardroom Dynamics: Due diligence defense contributes to an increased investigation power and influence as compared to independent directors. They usually tend to provoke controversial questions that not many other parties would dare to raise, but will not hesitate to clarify anything they don't understand and raise a warning flag if they start smelling something fishy during board meetings. This guy will enable to develop a more stable and enriched boardroom atmosphere.
- Enhanced Risk Management: The prominence of due diligence process requires directors to constantly be involved in

identifying the various organizational risks and where possible mitigating such risks. This preventative action can be effective in ensuring the establishment of reliable risk management systems and internal control systems, with the ultimate goal of safeguarding the company's future existence.

### 2. Increased Investor Confidence<sup>814</sup>: An act of the people which ensures transparency.

The presence of independent directors who actively embark on their oversight role indigelfcultate company investors' confidence as well. Here's why:

- Assurance of Accountability: Investors see the presence of independent monitors (who are not attached to management team) as a clear signal of responsible and accountable leadership while the decision assures them that there are no conflicts of interest. This is a signal to potential investors of reduced uncertainty and the perception of higher investment safety.
- Improved Decision-Making: These experts will also oversee the governmental authorities to ensure that the corporation executes impeccable financial decisions by subjecting them to prudent review and risk management. In this case, they may realize stable investor returns and better company performance as a result of that.
- Enhanced Reputation: The company that possesses well governance practise comprised

<sup>813</sup> <https://www.corporategovernanceresearch.org/>

<sup>814</sup> [https://www.ifc.org/wps/wcm/connect/industry\\_ext\\_content/ifc\\_external\\_corporate\\_site/industries/financial+institutions+group/focus+areas/corporate+governance/investor-confidence-and-corporate-governance](https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/financial+institutions+group/focus+areas/corporate+governance/investor-confidence-and-corporate-governance)

of the active and independent directors; it is highly likely that the investors would be more favorable than others. It can as well help build up the company's brand image in the market and facilitate access to more business financing opportunities.

### 3. Improved Risk Management: An Outside-the-box Approach to Overcoming the Problems

A due-diligence emphasis in accordance with the framework would motivate companies on the grounds of risk management and moving on to a more proactive approach. Here's how:

- **Early Warning Signs:** The scrutiny of the information as well as exercising care as independent directors can let them find out those risks in a timely manner. This provides a chance for the company to decide on timely remedial actions, and hence, diminish from damage caused.
- **Stronger Internal Controls:** Conducting the due diligence process we can identify vulnerability of the company in case of internal control mechanisms. The directorial aspect of audit can then be used for internal control advocacy since this helps to block fraud, errors, and other forms of irregularities that could undermine the credibility of the audit process.
- **Improved Risk Management Culture:** Hence, the issues of due diligence are among the necessary to be inculcated with the employees of the organization that results to developing in the employee's risk awareness. It pushes the management of employees to be more so they can recognize and handle risks more than before, thus, giving the organizational with a higher level of resilience.

## SOLUTION

### 1. Clarifying Judicial Precedents<sup>815</sup>: Presenting a Clear Way mapping

- **Challenge:** The way how exact guidelines regarding strict liability and due diligence defense is phrased sometimes might seem obscure. This creates a situation which poses the question of roles certainty and consequently limits a film director in a filming process.
- **Recommendation:** The judiciary has a responsibility of strengthening the law and order issues even by making well-defined court judgments. In case of landmark decisions which ascertain an unequivocal threshold for "reasonable reliance", "materiality", and the ambit of the diligence defense a wide spectrum of the independent director's duties could be clear as daylight.

### 2. Promoting Boardroom Dynamics: Spreading the Open Communication

- **Challenge<sup>816</sup>:** An iron - ruled or passive boardroom could limit the independent directors' abilities from the exercising the supervisory role effectively.
- **Recommendation:** The boardroom environment should be operated on the basis of the appreciation of open communication and not on the judgements. This can be achieved through initiatives such as: This can be achieved through initiatives such as:
  - **Independent Director Training Programs:** Developing the board's conflict resolution and dialogue capabilities provides a basis for better harmony
  - **Regular Board Evaluations:** Regular assessments of the boardroom dynamics are needful to discover (any) the areas of weakness and to promote free

<sup>815</sup> <https://indiancourts.in/case-law-database/>

<sup>816</sup> Institute of Directors India. (2023). Boardroom Dynamics and Effective Governance Practices.

dialogue between the directors and the management.

- Protected Whistle-Blowing Channels: When you provide for anonymous whistleblowing channels within the company, you can motivate the directors to indicate issues without fear of reprisal.

3. Director Training Programs: Our way to the future is more about helping people acquire competencies than putting them through a standard curriculum.

- Challenge: Even the fact that independent directors may not always be sufficiently knowledgeable in the legal and financial field to yield competent oversight may not be sufficient.
- Recommendation: Regulatory bodies and industry organizations are capable to provide in-depth trainings and skills development for independent directors to supplement the educational gap. These programs should cover:

- Recent Legal Developments: An ongoing training for directors that covers recently promulgated judicial guidelines and newly amended laws associated with their duties and responsibilities.
- Best Practices in Corporate Governance: Empowering the directors with knowledge of up-to-date best practices regarding risk management, investment analysis and board affairs quality management.
- Effective Due Diligence Strategies: Encompass solid instructing on the concept and procedures of effective due diligence including warning signs and

independent fact-checking techniques.

4. Enhanced Regulatory Guidance: Perfect a framework:

- Challenge: The existing regulatory system could be ill-suited to provide specific and detailed instructions on duties of the independent director while more defining the due diligence defense.
- Recommendation: Regulatory agencies like SEBI can take a proactive role by being more explicit and particular when issuing clarifying guidelines that relate to the existing anti-money laundering and know-your-customer laws.
- The Scope of "Reasonable Reliance": The proposal includes, how directors can justify using information provided by management developed by directors themselves.
- Materiality Thresholds: Providing necessary information, the material risks which why the directors should be involved in sharing.
- Model Due Diligence Procedures: Setting up prototype model practices for running diligence that can be adjusted accordingly to different company sizes and riskiness of profiles.

#### CONCLUSION:

The Companies Act, 2013 aims to strengthen corporate governance in India by assigning significant responsibilities to independent directors. However, the tension between strict liability and the due diligence defense creates uncertainty for directors. By clarifying judicial precedents, promoting open communication in boardrooms, providing effective director training programs, and issuing enhanced regulatory guidance, India can create a more predictable and supportive environment for independent directors to fulfill their crucial role in promoting responsible business practices. This, in turn, fosters greater investor confidence and a more robust corporate governance landscape in India.



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