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**LIABILITY OF DIRECTORS FOR DEBTS OF THE COMPANY IN INDIA AND THE CZECH REPUBLIC**

***(This article has been co-authored by the team of LexCounsel, Law Offices and Schaffer & Partner, Law Firm in Czech Republic)***

If you have questions or would like additional information on the material covered in this article, please contact the authors:

**LexCounsel, Law Offices:**

Seema Jhingan, Partner  
([sjhingan@lexcounsel.in](mailto:sjhingan@lexcounsel.in))

Neha Yadav, Principal Associate  
([nyadav@lexcounsel.in](mailto:nyadav@lexcounsel.in))

Saniya Kothari, Associate  
([skothari@lexcounsel.in](mailto:skothari@lexcounsel.in))

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**1. Introduction.**

1.1 Under common law rules and equitable principles, director's duties are largely derived from the law of agency and trusts. Under the law of agency, duties of skill, care and diligence are imposed on directors. On the other hand, law of trusts imposes fiduciary duties on directors. Accordingly, directors are the trustees of the company's money and property, and also act as agents in the transaction which they enter into on behalf of the company.

1.2 A director is expected to perform his duties as a reasonably diligent person having the knowledge, skill and experience both of a person carrying out that director's function and of that person himself. Directors as agents of the company (to the extent authorized by the company), enter into contractual obligations on behalf of the Company. These contractual arrangements may also entail payment obligations towards third parties, which raises the frequently asked question – can directors be held personally liable for debts of the company? A question of significance across jurisdictions, this article contains a brief analysis of the liability exposure of directors to debts of the company under both Indian and Czech laws.

**2. Liability of Director for Debts of the Company under Indian Laws.**

2.1 The Companies Act, 2013 ("CA 13") defines a director to mean 'a *director appointed to the Board of a company*'. CA 13 contains the concept of an 'officer who is in default' for the purposes of affixing liability on such person in respect of any contravention of the provisions of CA 13 by the company. The ambit of 'officer who is in default' is quite wide and includes, *inter alia*, every whole-time director. A company is a

**Schaffer & Partner, Czech Republic:**

Mgr. Aleš Eppinger, Partner  
([eppinger@schaffer-partner.cz](mailto:eppinger@schaffer-partner.cz))

Filip Choutka, Paralegal  
([choutka@schaffer-partner.cz](mailto:choutka@schaffer-partner.cz))

LexCounsel, Law Offices C-10,  
Gulmohar Park New Delhi 110 049,  
INDIA. Tel.:+91.11.4166.2861  
Fax:+91.11.4166.2862

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juristic person but since a company has to act through a living human being, decisions on behalf of the company, are taken by the board of directors (“**Board**”) of a company. An individual director has no power to act on behalf of a company of which he is a director, unless there is a specific resolution of the Board of the company giving specific power to him/her, or, where the articles of company confer such a power.

- 2.2 Ordinarily, a director is not, by way of holding the position of a director, liable for the debts of the company. The law in this regard is well settled and has been reiterated by courts in several judgments. For instance, the Delhi High Court in the matter of *Tristar Consultants vs. M/s. VCustomer Services India Pvt. Ltd. & Another*<sup>1</sup> made the following observations and upheld deletion of the name of the director from the suit filed, *inter alia*, for recovery of outstanding amount and damages:

*“20. Directors of companies have been described as agents, trustees or representatives of the company because of the fact vis-a-vis the company they act in a fiduciary capacity. They perform acts and duties for the benefit of the company. Thus, directors are agents of the company to the extent they have been authorized to perform certain acts on behalf of the company.*

*21. But directors of a company owe no fiduciary or contractual duties or any duty of care to third parties who deal with the company...*

*28. To interpret the law as is sought to be projected by the petitioner would mean negation of the concept of a company being limited by its liability as per the memorandum and articles of association of the company.”*

Thus, as a general rule, director(s) is/are not held personally liable on behalf of the company unless commission of fraud or gross negligence is proved against him/them in conducting business of the company at the relevant time.

- 2.3 That said, there may be exceptional circumstances, wherein the director may be called upon for settlement of the contractual third party debts of the company, such as:

- (i) Inducement of third party creditor through misrepresentation: Where a director, by making false representations about a company, induces a third party to advance a loan or money to the company, then on proof of fraudulent misrepresentation, such director may be held personally liable to the third party. Therefore, liabilities of directors of a company, under common law, are confined to cases of maleficence and misfeasance i.e. where they have been guilty of tort towards those to whom they owe a duty of care i.e. discharge of fiduciary obligations towards the company. Additionally, qua third parties, where directors have committed tort, to such third party, they may be personally liable.



Relevant in this context is the case of *Mukesh Hans & Anr. Vs. Smt. Uma Bhasin & Ors*<sup>2</sup>, where the Delhi High Court observed as under:

*“11. It is equally well settled that a Director of a Company though he owes a fiduciary duty to the Company, he owes no contractual duty qua third parties. There are, however, two exceptions to this rule. The first is where the Director or Directors make themselves personally liable, i.e., by execution of personal guarantees, indemnities, etc. The second is where a Director induces a third party to act to his detriment by advancing a loan or money to the Company. On the third party proving such fraudulent misrepresentation, a Director may be held personally liable to the said third party. It is, however, well settled that this liability would not flow from a contract, but would flow in an action at tort, the tort being of misrepresentation and of inducing the third party to act to his detriment and to part with money.”*

(ii) Giving of personal guarantee, indemnity or assurance: A director would be personally liable if the director has personally undertaken to clear any liability of the company or extended any indemnity or personally guaranteed the payment obligations of the company towards a third party creditor.

(iii) Deriving of personal benefit: A director may also be held liable in cases where if he/she has derived any personal benefit while purporting to act on behalf of the company.

2.4 Liabilities under Statutes: Certain Indian statutes also hold a director liable for certain liabilities of the company, such as liability for unpaid taxes. For instance, under the Income Tax Act, 1961 (“**IT Act**”), directors may be liable in certain circumstances, to pay the income tax of the company, if such taxes cannot be recovered by the tax authorities from the company. However, for the liability under IT Act to apply, the non-recovery of taxes should be attributable to gross negligence, misfeasance or breach of duty on the part of director(s) in relation to the affairs of the company, and in absence of such factors, the provisions of the IT Act will not be invoked against the director. On similar lines, the directors may also be liable for unpaid sales taxes (which cannot be recovered) in winding up proceedings under the provisions of the Central Sales Tax Act, 1956, unless they prove that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on their part in relation to the affairs of the company.

Similarly, under the Negotiable Instruments Act, 1881, if a company issues, and later dishonors a cheque which was presented for discharge of debt or other liability, every person who at the time of such dishonor was in charge of overall control of the day-to-day business of the company (including its directors), will be deemed to be guilty of the offence and will be liable to be proceeded against. If the offence is committed with the consent or connivance of, or is attributable to the neglect of a director, such director will be deemed to be guilty and liable to be proceeded against.

Reference may also be made to CA 13 where a director may be held personally liable for repayment of share application money which is not repaid within the prescribed period; for losses of the subscriber where the prospectus has been issued with the intent to defraud applicants or for other fraudulent purposes; for losses of the depositor where unpaid deposits have been accepted with the intent to defraud the depositors or any fraudulent purposes; for fraud in a company, where he has taken undue advantage or benefit; and for debts of the company, where in the course of winding up of a company it appears that any business of the company has been carried on with intent to defraud or for any fraudulent purpose.

### **3. Liability of Directors for Company's Debts under Czech laws.**

3.1 A business company, as a legal entity, acts through its "statutory bodies" (hereinafter referred to as "**director**"). Similar to Indian law, directors are generally not liable for the debts of the company. However, the law recognizes the fact that directors can fundamentally shape the economic health of a company and thus its ability to pay debts. Therefore, in some situations – generally characterized by directors' misconduct – the creditors can hold a director liable for their debts.

3.2 Directors' duties: According to the **Civil Code (Nr. 89/2012 Coll.)** and the **Business Corporations Act (Nr. 90/2012 Coll.)** the directors of a company are required to conduct their duties with the "due managerial care", that is, with the necessary loyalty, knowledge and care, exercised by a reasonably prudent person in a similar situation.

3.3 These concepts, which are also known as "duty of care" and "duty of loyalty" in some jurisdictions, are supported by the US doctrine of "Business Judgement Rule". The purpose of this rule is to ensure that directors are not held responsible for any business decisions which later turn out to be unsuccessful, provided that the decision was made with a reasonable amount of information and in good faith. If such requirements are met, the "correctness" of a business decision cannot be contested. This is based on the experience that all business decisions are based on a certain level of uncertainty and risk. The rule does not apply to decisions which are illegal, grossly negligent, or made under a conflict of interest.

3.4 General liability for a breach of duties: Should the company director break his duties, he is obliged to compensate the company for any damages caused. Failing to do so imposes a sanction upon the director – he becomes liable to any creditor of the company for its debt to the extent to which he failed to compensate the damage, if the creditor is unable to collect the debt from the company. The creditor must prove the inability to recover the debt from the company (i.e. its lack of assets).

An example of a decision based on this concept is a ruling of the Supreme Court<sup>3</sup>, which states that:

*"If, due to lack of property, an investment company becomes unable to compensate its investors for the damages arising due to a breach of duties owed by the members of the board of directors,*

*the board members are obliged to fulfil the claims of the investors for compensation of said damages.”*

3.5 This provision can be convenient in situations where the company fails to sue the respective director for damages.

3.6 Wrongful trading: Another form of liability, also regulated in the **Business Corporations Act**, occurs when a company is found insolvent (bankrupt). The court may decide that a director – or a former director – is liable for all debts of the company, if they have failed to take all necessary and reasonably foreseeable steps to prevent the insolvency.

3.7 However, in both of the situations described under points 3.4. and 3.5., the director’s liability is based on his misconduct, as confirmed in a verdict of the Supreme Court<sup>4</sup>:

*“The liability of a statutory body to the company for damages caused during the discharge of his function is considered by the statutory regulation regarding the liability of statutory bodies for the debts of a company to be a basic condition to render the statutory bodies liable.”*

As mentioned above, the director’s position is strengthened by the Business Judgement Rule. Even though the burden to prove the due conduct of business is shifted on the director, the creditors still bear an information deficit due to their position as outsiders towards the company. This means that creditors will often lack awareness that misconduct by a director has taken place; they may also be unable to present effective counter-evidence against the other party.

3.8 Delayed filing of insolvency motions: Furthermore, in case a company becomes insolvent, all directors must file a motion to commence the insolvency proceedings without undue delay. Defaulting on this duty, according to the **Insolvency Act (Nr. 182/2006 Coll.)** renders the directors personally liable to the creditors for any damages caused by such delay. However, only creditors who have submitted their claims in the insolvency proceedings are allowed to make use of this rule. This is especially expedient if the directors, acting on behalf of the company, accept a new obligation in spite of the company’s inability to honour it. According to a decision of the Czech Supreme Court<sup>5</sup>:

*“If the obligation came into existence during the period, when the statutory body or its member was in default with the fulfilment of said duty [i.e. to file the insolvency motion], the amount of damages equals to the whole difference between what the company, as a debtor, is obliged to pay to the creditor, and the amount, which the creditor has obtained during the course of the insolvency proceedings.”*

It is important to note that a director is absolved from this liability if he manages to prove that such a late filing did not influence the amount of funds to be redistributed among the creditors.

The law also regulates several minor statutory liabilities:

- (i) Liability of an expelled statutory body: A director, whose misconduct results in the bankruptcy of a company, can be expelled from holding the same or similar function by a court. Disrespecting such an expulsion automatically leads to the director's liability to third persons for all debts of the company, as stipulated by the **Business Corporations Act**.
- (ii) Transformation of a company: According to the **Business Corporation Transformation Act (Nr. 125/2008 Coll.)**, a director may be held liable for damages suffered by a company creditor as a result of the director's failure to comply with the procedures related to the transformation of business corporations.
- (iii) Entitlement to sign a promissory note: The provision of sec. 8 of the Act on Promissory Notes and Cheques (**Nr. 191/1950 Coll.**) stipulates that any person who signs a promissory note on behalf of another person without due authorization, is himself bound to pay the promissory sum. The High Court of the Czech Republic has extended its applicability to directors<sup>6</sup>:

*“If a vice president of a joint stock company, who had not been authorized to act individually on behalf of the board of directors, signed a promissory note on behalf of the company, he himself became the person bound by the promissory note.”*

#### **4. Concluding Remarks.**

- 4.1 The identity of a director is distinct from that of the company. That is the very genesis of a company having a separate and independent juristic personality. Accordingly, a director is not ordinarily held personally liable for debts of the company. This is common for both the Indian and Czech legal system.
- 4.2 However, as mentioned above, a director can become personally liable under Indian laws, in certain circumstances such as where the liability is stated to be unlimited in the company's organizational documents; or the director is found guilty of fraud or misrepresentation; or has personally assured, indemnified or guaranteed the payment obligations of the company; or where such liability is prescribed under applicable laws.
- 4.3 On similar lines, exceptions to the ordinary rule of limited liability of directors, have been carved out under Czech laws, primarily on the basis of special statutory provisions, which are “activated” by a breach of director's duties towards the company. This also reflects the importance of the director's performance on the solvency of the company.

4.4 The common thread that seems to be running through both legal systems, therefore, is that in certain exceptional cases (primarily where the debt arose due to the fraudulent actions/omissions of the director and/or gross breach of their duties), directors can be made personally liable for debts of the company.

#### Endnotes

<sup>1</sup>AIR 2007 Delhi 157.

<sup>2</sup>RFA 14/2010 and CM No. 495/2010, Decided On: 16.08.2010.

<sup>3</sup>File Nr. 29 Odo 1310/2005.

<sup>4</sup> File Nr. 23 Cdo 3484/2011.

<sup>5</sup> File Nr.: 29 Odo 1220/2005.

<sup>6</sup> File Nr. 12 Cmo 187/2004.

**Feedback**

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