

## Directors under Companies Act, 2013- is it old wine in new bottle?

### Introduction

The Companies Act, 2013 (“**Act**”) is enacted to gradually replace the old Act of 1956, with the objective to bring more accountability and good corporate governance. The Ministry of Corporate Affairs has notified ninety-eight sections of the Act which have come into effect from September 12, 2013 and repealed the corresponding sections of the 1956 Act. The Act appears to place a higher degree of responsibility on the Board members for good corporate compliance. A clear understanding of these obligations and responsibilities will be critical for current and prospective Board members. In the Act, the sections related to role, duties and removal of directors are yet to be implemented but it will happen soon and, therefore, merits attention. In the context of the Board of a company, the legislators have focused on the role of independent directors and have codified the duties of directors, which were missing in the old Act.

This newsletter describes selective changes introduced by the Act regarding different directors and their significance.

### 1. Board formation

The 1956 Act prescribes minimum 2 directors for private and 3 directors for a public company. This criterion is retained in the Act, but the maximum directors on the Board have been raised from 12 to 15 and the Act has also dispensed with the approval from Central Government for raising the number of directors above the prescribed limit. The Act requires the Board to devise mechanisms to ensure compliance with the applicable laws which should be effective and adequate. The Board may consist of several categories of directors including whole-time directors, managing directors, independent directors, nominee directors<sup>1</sup> and women directors.

Under the Act, there is a mandatory requirement that one-third of the Board should consist of independent directors for listed companies and public companies with a paid-up capital of INR 1,000 million (*approx \$16 million*<sup>2</sup>) or debt of INR 2,000 million (*approx \$32 million*).<sup>3</sup>

Independent directors are expected to be completely unrelated to the company or its shareholders. In order to implement this, the Act has prescribed certain disqualifications for appointment as an independent director which aim to ensure that a potential appointee or his

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<sup>1</sup> Explanation to Section 149 of the Act defines a *nominee* director as director nominated by any financial institution

<sup>2</sup> 1\$= INR 62 approximately

<sup>3</sup> See Section 149 of the Act

relative<sup>4</sup> is not an employee or involved in any relationship or transaction with the company. The most important disqualification is that the director has a pecuniary relationship or is a part of any organization with which the company does business at the time of his appointment. The Act mandates that not only him, but an independent director's relative should also not be an employee or be involved in any relationship or transaction with the company. These detailed criteria for eligibility of independent director were missing in the old Act and appear to have been introduced to bring objectivity to the functioning of the Board. Independent directors will not be able to hold shares and the Act even restricts their remuneration to payment of sitting fees and reimbursement for expenses, so as to ensure that they have no financial relationship with the company and can carry on their duties without any partiality. Independent directors may be selected from a data bank notified by the Central Government and after proper background check by the company to verify their independence.<sup>5</sup>

Every listed company and unlisted companies with paid-up capital of INR 1,000 million will now be required to appoint one woman director within one year and three years of notification of Section 149(1), respectively. This requirement is introduced to facilitate the presence of women in the Board room. India is already making progress in gender issues and this is a welcome step which should help to put diverse views on the boards of companies.

The section also stipulates that at least one director of the company should stay in India for 182 days or more in the previous calendar year. This will ensure that the Board shall continue to monitor directly the management of the company on a regular basis and shall be responsible for acts and deeds of the company. Their continued presence will not delay statutory action steps and will be a step forward towards meeting the timely corporate compliance requirements. This requirement was missing in the old Act and foreign companies starting business in India typically appoint foreign directors as the directors of the Indian subsidiary. With the implementation of this prerequisite, foreign companies doing business in India will now have to appoint at least one resident director or Indian national to act as director to comply with this qualification.

## 2. Role and duties of directors

### 2.1 *Independent directors*

The role of independent directors is chalked down in detail in the "Code for independent directors" appended to it,<sup>6</sup> which contains clear guidelines regarding professional conduct, roles and responsibilities of independent directors. Independent directors are bound by this Code to play a role in the appointments, determination of remuneration and removal of non-independent directors and other managerial employees. Though the 1956 Act and Clause 49 of the listing agreement have the provision of an independent director for every listed company, they have not elaborated on the roles and duties of these directors as the Act does. Such enumeration now require an independent director to ensure that he does not abuse his position and devotes his time and attention to assist the company in implementing best

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<sup>4</sup> The definition of "relative" is narrowed down and includes spouse, parents, grandparents, children, siblings, son's spouse and children but excludes daughter's spouse and children, spouses of son's children and siblings' spouses.

<sup>5</sup> Section 150 of the Act

<sup>6</sup> Schedule IV of the Act

corporate governance practices. The legislators have also set certain generic duties for the independent directors to bring a perspective on matters related to strategy, performance and risk management and balance the conflicting interest of the stakeholders. The duties under the Code are exhaustive and needs the director to maintain confidentiality and attend the general meetings of the company. The independent directors have to hold at least one meeting every year,<sup>7</sup> without the attendance of non-independent directors and with the members of management to review their respective performance, and determine whether the non-independent directors are meeting the specified targets and reporting compliance. They also have to ensure that the financials are reflected accurately, controls system and risk management are in place, seek clarifications in case of ambiguity and take and follow the advice of experts at the company's expense. Independent directors are also expected by the Code to act as a moderator to resolve disputes, act in the interest of the company and with no partiality towards management or shareholders. In audit committee, the role of independent directors is expanded under the Act and they have to now examine the financials and approve the related party transactions compared to only a review function in both cases under the old Act. The independent directors have also been given the duty to determine the appointment, removal and remuneration of executive directors, key managerial personnel and senior management. However, the exact process will be clear once the rules are finalized.

## 2.2 *Other directors*

The non-independent directors are under an obligation to make disclosure for buying, selling or disposing of any property, leasing of any property, appointment of an agent and appointment in place of profit in the company or in associate/subsidiary.<sup>8</sup> In view of the fiduciary position held by directors, explicit provisions prescribing directors duties have been added to the new Act. These include keeping away from situations in which they have conflicting interest with that of the company, duty to make good in monetary terms any undue gain/advantage on the part of the directors etc., similar to what was there in the old Act. There are also certain general duties, such as acting in good faith for the benefit of the company and to ensure that the company is filing its financials, annual return and payment of debentures in time. These amendments, though not substantial, have tried to shift the onus on the director for the loss/liability suffered by the company due to their lack of discipline by increasing the penalty and clearly codifying the role and duties.

The Act has focused on corporate compliance and a director will not be re-appointed if the company has failed to file its annual returns for three continuous years. Re-appointment in such cases, in that company or any other company, can happen only after five years from the date of the failure to file accounts. However, if the company chooses to re-appoint a director even after its failure to file the accounts shall be penalized. Additionally, the practice of directors absenting themselves from meetings and sending proxy has been placed under check. Any director who was absent from the board meetings for the previous twelve months, whether he sought leave or not, will have to vacate his office. If the director continues to function as a director even after he knows that he is disqualified to hold the office shall be imprisoned for up to one year or punishable with fine. The Act prohibits directors from buying, selling, leasing or disposing of any property, appointment of an agent and appointment in place

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<sup>7</sup> See Clause VII of the Code for independent directors in Schedule IV

<sup>8</sup> Section 184 of the Act

of profit in the company or associate/subsidiary and, in all such cases, they are mandated to make a disclosure for these transactions. In case of non-disclosure by a director, he will indemnify the company against any loss incurred by it. The Act has codified and set high standards for a director's duty and liability towards the company.<sup>9</sup> The general penalty prescribed for all the contravention above is fine of INR 100,000 (*approx \$1,615*) to INR 500,000 (*approx \$8,076*).

## Conclusion

While looking at all the details, the Act does not appear to have introduced too many significant changes in the provisions with respect to directors. The penalties for contravention under different sections have been increased from a minimum of INR 10,000 (*approx \$161*) to a minimum of INR 50,000 (*approx \$807*) to bring in more accountability. With the introduction of strict eligibility criteria for appointment of independent directors, their pecuniary interest is bypassed and this is to create a watchdog for public/listed companies. Penalty for any contravention by an independent director is also introduced, but they will be liable only for those fraudulent transactions for which they will give their consent or where it can be demonstrated that they have not acted diligently. This defense hardly provides any immunity as most Indian laws charge the directors for any offence. The Act also permits an Indian company to indemnify its directors and officers, unlike the 1956 Act. Women too are encouraged to join the board room, thus bringing in diverse viewpoints and talent. In essence, the Act has endowed responsibility and introduced high standards for directors so that they are accountable to the shareholders for their action and personally liable for any damage caused by them. But, the effectiveness of these provisions will depend on how strictly they are enforced.

## Author

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<sup>9</sup> Section 166 of the Act