

Independent Directors under Companies Act, 2013 – Boon or Bane?

Introduction

The Companies Act, 2013 (“**Act**”), sets to overhaul the provisions relating to independent directors entirely by conferring greater power and responsibility in the governance of a company. There are no explicit provisions for independent directors under Companies Act 1956 (“**1956 Act**”) and only clause 49 of the Listing Agreement¹ prescribed for the induction of independent directors and made it mandatory for listed companies. Thereafter, the Ministry of Corporate Affairs carried out corresponding changes to the provisions of 1956 Act, in an attempt to include the requirement of having an independent director on the board of listed companies to oversee corporate governance. However, such attempts proved to be futile as the changes failed to explain the roles, duties or liabilities of independent directors lucidly. Board’s independence from external influences is critical and directly proportional for effective corporate governance. Thus, the need for comprehensive and strong legislation relating to independent directors became vital and eventually led to the enactment of the Act. The present e-newsline discusses the specific changes relating to independent directors proposed by the Act and analyzes their pros and cons.

1. Appointment

The Act imposes a specific obligation on listed companies to have at least one third of the total number of directors as independent directors and, also empowers Central Government to include other class/classes of companies within the scope of this requirement.² Accordingly, the above condition will be applicable to public companies with a paid-up capital of INR 1 billion (*approximately US\$ 16 million*³) or turnover of INR 3 billion (*approximately US\$ 48 million*) or aggregate loans/debentures/borrowings of more than INR 2 billion (*approximately US\$ 3,225,065*)⁴. To ease the process of selection, the Central Government and organizations authorized by the Central Government will maintain a data bank of persons willing and eligible to be appointed as independent directors, from which the companies can choose suitable persons for the position. But, the critical issue will be if there are enough number of qualified individuals to fulfill the demand. Chances are companies may find it difficult to satisfy the requirement of the Act. Though the Act provides one year period for companies to implement the provision, it would still be difficult task until sufficient persons with requisite skill sets are developed in India. Accordingly, it will become necessary to conduct and organize appropriate training sessions by recognized organizations/associations for suitable persons to develop the required skill sets for performing their entrusted responsibilities.

¹ Clause 49 of listing agreement mandates that if the Chairman of the board is a non-executive director, at least one third of the board should comprise of independent directors and if he is an executive director then at least half of the board should comprise of independent directors.

² Section 149 of the Act.

³ 1 US\$= 62 approximately.

⁴ Rule no.11.2 of Draft rules under Companies Act, 2013, Chapter XI, Appointment and qualification of Directors.

2. Prescribed statutory criteria

2.1 Requirements: An independent director is someone who does not have any material or pecuniary relationship with the company/directors. Section 149(6) of the Act⁵ prescribes the criteria for independent directors which are as follows: (i) such individuals must possess integrity and relevant industrial expertise; (ii) such individuals must not have any material or pecuniary relationship with the company or its subsidiaries; (iii) they or their relatives should not have had any pecuniary relationship with the company or its subsidiaries, amounting to 2% or more of its gross turnover or total income or INR 5 million (*approximately US\$ 80,645*), whichever is less, during the two immediately preceding financial years or in the current financial year; (iv) such appointees or their relatives should not have any key managerial position in the company or its subsidiary companies during any of the three preceding financial years; (v) such persons or their relatives should not have been an employee of the company or its subsidiary companies during any of the three preceding financial years; (vi) they or their relatives must not be a director of a nonprofit organization, which receives 25% or more of its receipts from the company or its subsidiary companies or its promoters/directors or from anyone who holds 2% of voting rights in such companies; (vii) such individuals must not be a promoter of the company or its subsidiaries; (viii) they must not hold more than 2% voting rights in the company either by themselves or together with their relatives.

2.2 Responsibility: The above criteria were introduced mainly to ensure transparency in corporate governance and safeguard the autonomy of independent directors. The Act also requires the individuals to submit a self-declaration confirming that they have satisfied the criteria prescribed for the position.⁶ The Act also casts great responsibility on the independent directors. For instance, it specifies that any decisions taken by the board in the absence of independent directors must be circulated to all directors and can be final only upon receiving the ratification from at least one independent director.⁷ Further, independent directors can be removed if they fail to attend any board meeting for 12 months period with or without permission from the board.⁸ Even a proposed alternate is appointee for an independent director must comply with the prescribed criteria for the position.⁹ The tenure of the independent and such alternate directors must not exceed two consecutive periods of 5 years each, and can be extended for a second term only after the board passes a special resolution.¹⁰ Further, section 149(11) mandates that reappointment after the expiry of second term can be done only after a cooling period of three years. Hopefully, this will ensure impartiality and varied person(s) can come on the board. The demand for effective vigil mechanism has been increased tremendously after the emergence of various corporate scandals in India. Hence, the Act has set high standards and increased their participation in the boards' decision-making to enhance monitoring the management and promoters for protecting the interests of the shareholders.

⁵ Section 2(47) of the Act states that criteria for independent directors is described under section 149(5), but in fact the correct reference is under 149(6).

⁶ See Section 149(7) of the Act.

⁷ Refer Section 173(3) of the Act.

⁸ See Section 167 of the Act.

⁹ See Section 161 of the Act.

¹⁰ See Section 149(10) of the Act.

2.3 Liability: With a view to safeguard independent directors from the negative ramifications arising out of the non-independent directors' activities, the Act explicitly provides under section 149(12) that they can be implicated only for offences committed with their knowledge, connivance or negligence. This should limit their liability and, hopefully, instill confidence in the minds of such individuals for taking honest and unfettered decisions, which eventually will ensure proper monitoring of company's management.

2.4 Remuneration: The Act expressly disallows independent directors from obtaining stock options and remuneration other than sitting fees and reimbursement of travel expenses for attending the board and other meetings. Profit related commission may be paid to them, but subject to the approval of the shareholders.¹¹ The reason for restricting the remuneration was to prevent personal financial nexus with the company and to safeguard their independence. However, the flip side is if the remuneration is not attractive then it would be difficult for companies to attract suitable and experienced persons for the position.

2.5 Rendezvous: The Act mandates that all independent directors must meet at least once annually without the presence of non-independent directors and members of the management. Such meetings are termed as separate meetings, where they are required to evaluate the performance of the company's chairperson, non-independent directors and the board as whole. The requirement for such meetings is a welcome change, as it would help these directors to express freely in an open environment as well as allows them to take suitable and impartial decisions based on the performance of the board.¹² Similarly, the Act also mandates the board to convene a meeting for evaluating the performance of independent directors without their presence and where the board should determine to continue their term. These provisions act as a check and ensure that their powers are being utilized in a proper and rational manner.¹³

3. Committees

The Act has mandated presence of independent directors on certain committees, which are described below:

3.1 Corporate Social Responsibility ("CSR") Committee - The Act proposes that every company with a net worth of INR 5 billion (*approximately US\$ 80 million*) or more, or turnover of INR 100 billion (*approximately US\$ 161 million*) or more, or net profit of INR 50 million (*approximately US\$ 806,451*) during any financial year must constitute a CSR committee with 3 or more directors out of which at least one director must be an independent director.¹⁴ CSR is a mandatory commitment for the company to contribute for the social, economic or environment development activities, which includes promotion of education, promotion of gender equality and empowerment of women, eradication of hunger or poverty, contribution to Prime Minister's national relief fund. The designated committee has to formulate the CSR policy and recommend proposed activities in each financial year. It is mandatory for qualifying

¹¹ See Section 197(7) of the Act.

¹² See Schedule IV code VII of the Act.

¹³ See Schedule IV code VIII of the Act.

¹⁴ See Section 135 of the Act.

companies (as outlined above) to spend at least 2% of their average net profits on CSR activities.¹⁵

The legislation mandates the presence of independent directors to oversee that the CSR activities are implemented in an effective manner. The legislation does not have any coercive provisions against defaulting companies except a report to be submitted by them explaining the reason for failure to perform the CSR activities.

3.2 Nomination and Remuneration committee (“NRC”) - The Act mandates every listed company to constitute a NRC with three or more non-executive directors out of which one-half must be independent. The chairman of the company cannot chair the NRC but can become a member. The main functions of NRC are: (i) identify suitable persons with requisite qualifications to hold the office of directors; (ii) recommend appointment/removal of directors; (iii) evaluate director’s performance; (iv) formulate suitable remuneration policy and establish criteria for determining qualifications, positive attributes and independence of directors.¹⁶

The presence of independent directors in NRC will ensure identification and appointment of skilled individuals as directors/key managerial personnel of the company which, in turn, will imbibe high proficiency at board/managerial levels.

3.3 Audit Committees

The Act specifically stipulates that every listed company must constitute an audit committee of at least three directors with a majority of independent directors. Audit committees are entrusted with various vital fiscal functions including assisting the board in the appointment of the auditors, issuing approval for related party transactions, examining financial statements/auditor’s report, reviewing auditor’s independence, providing valuation for the undertakings or assets of the company, evaluating the internal financial control, monitoring the utilization of funds raised through public offers and if necessary can conduct investigation into any issues relating to these functions for preventing fraud by the companies.¹⁷

4. Code of conduct, functions and duties

The Act prescribes a Code of conduct and other functions and duties which raise the bar of standards and performances of independent directors.¹⁸ The duties include constructive attendance in all board/general meetings, reporting unethical practices, fraud and violation of law, retaining any confidential information pertaining to company as confidential, ensuring the concerns relating to management are placed before the board and be recorded in the minutes of board meeting. In short, there is a significant onus on them to assist in safeguarding the legitimate interest of the company and its stakeholders.

¹⁵ See Section 135 of the Act.

¹⁶ Refer Section 178(1) of the Act.

¹⁷ See Section 177 of the Act.

¹⁸ Schedule IV of the Act contains an exhaustive code of conduct.

While the power of the independent director is fortified on one hand but the level of responsibility has been increased and, thus, the director must possess necessary skills and experience to perform the functions diligently.

Conclusion

The Act empowers independent directors with proper checks and balances, so that such extensive powers are not exercised in an unbridled manner, but in a rational and accountable way. The changes are a step in the right direction. They should enhance corporate governance and ensure the management and affairs of the companies are conducted in the interest of stakeholders. It is expected that these changes will thwart corporate scandals in future and insulate shareholders interest. However, since the provisions are not yet in force, the actual effectiveness and practical defects can be determined only in the time to come.

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