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Much ado about independent directors

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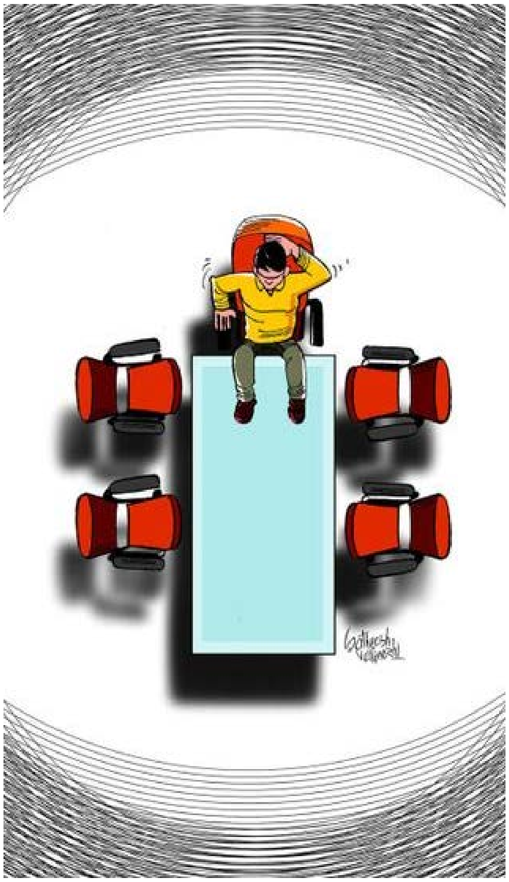

Independent company directors cannot really affect the board's functioning. The new law fails to grasp this.

The Companies Act, 1956 ("1956 Act") and Clause 49 of the Listing Agreement ("Listing Agreement") deal with the concept of 'independent directors' with respect to listed companies.

While the listing standards mandated the listed companies' board to include independent directors, neither the Listing Agreement nor the 1956 Act precisely defined the duties, roles and liabilities of an independent director.

The Companies Act, 2013 ("2013 Act"), on the other hand, attempts to crystallise the role of independent directors, aimed at ensuring higher standards of independence.

Detailed provisions

The Listing Agreement required at least one-third of the board where the chairman of the board is a non-executive director or half of the board to comprise independent directors, if the chairman is an executive director.

But the 2013 Act relaxes this requirement by mandating only one-third of the board (of public listed companies) to comprise independent directors.

In addition to the qualifications prescribed under the Listing Agreement the 2013 Act also prescribes detailed qualifications for the appointment of an independent director. Some of these qualifications include:

(i) he/she should be a person of integrity, relevant expertise and experience;

(ii) who is or was not a promoter of the company or its holding, subsidiary or associate company;

(iii) who is not related to the promoters or directors in the company, its holding, subsidiary or associate company;

(iv) who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors during the two immediately preceding financial years or during the current financial year;

(v) none of whose relatives have or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors amounting to 2 per cent or more of its gross turnover or total income or Rs 50 lakh or higher amount which may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year.

Built-in checks

The overall intent behind these provisions is to ensure that an independent director has neither any pecuniary relationship with, nor any monetary interest in the company.

In addition, the 2013 Act, unlike the Listing Agreement, sets forth stringent provisions with respect to the relatives of the proposed appointee.

Several other restrictions, including prohibition on the issuance of stock options to independent directors, have been built into the 2013 Act to ensure that there is no financial nexus between the independent director and the company.

Apart from the restriction on stock options, the remuneration of independent directors has also been limited to sitting fees, reimbursement of expenses for participation in the board and other meetings and profit related commission as may be approved by the shareholders. Every independent director should give a declaration of independence at the first meeting of the board and thereafter at the first meeting of the board in every financial year or whenever there is a change in the circumstances which affect his/her status as an independent director.

The 2013 Act also sets forth a clear demarcation between a nominee director and an independent director, by stipulating that an independent director will be a director other than a lender or an investor's nominee director.

It seems listed companies would have to comply with the requirements stipulated under both, which would eventually require many listed companies to revamp the existing processes.

Areas of conflict

Some of the potential areas of conflict between the Listing Agreement and the 2013 Act are that while the Listing Agreement states that an independent director must not "have any material pecuniary relationship" or transaction with the company, the 2013 Act states that an independent director "must not have had any pecuniary relationship."

The proposed disqualification arising from any pecuniary relationship in the previous two financial years under the 2013 Act may be unreasonably restrictive. There may be situations where a pecuniary transaction of the proposed independent director does not affect the director's independence.

The 2013 Act will also bring in a new provision regarding limitation of liability of independent directors.

Liability under the 1956 Act was attributable only to "officers in default", wherein independent directors were not covered within its ambit and hence did not impose any liability on them for the actions of the board.

The 2013 Act, on the other hand, expands the scope of "officers in default" and provides for liability of independent directors. However, such liability is limited to acts of omission or commission by a company which had occurred with his knowledge.

The 2013 Act is a positive step towards setting higher standards of integrity and independence for independent directors.

However when examined critically, it seems that while expanding their roles and defining their liabilities, the 2013 Act fails to recognise that independent directors have a very limited ability to affect the functioning of a board.

Their most effective tool is to record a dissent or indeed resign from the board which may force a company to follow best practices in corporate governance.

In addition, a closer scrutiny of the specific norms pertaining to independent directors in the 2013 Act indicates that certain provisions exhibit a conflict with the Listing Agreement as discussed earlier, necessitating the requirement of suitable changes to be effected in the Listing Agreement, to ensure that it continues to apply along with the 2013 Act.

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