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New directions for independent directors

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New directions

The responsibilities, rewards and liabilities of independent directors will be transformed by the new Companies Act

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The board of directors is the most important decision-making body of a company. Its independence is indispensable in ensuring high standards of corporate governance. In the wake of recent corporate scams that India has witnessed and the subsequent increase in the number of resignations by independent directors from the boards of companies, the revamp of the existing corporate regime's concept of independent director is a welcome change. For the first time, the Companies Act, 2013 (new act), includes guidance about the role and standards that independent directors must aim to achieve and maintain.

This article analyses the concept of independent directors in listed companies as envisaged under clause 49 of the Listing Agreement and the Companies Act, 1956 (1956 act), and examines the changes brought about by the new act. The article focuses on the issues, potential areas of conflict with the Listing Agreement, and the challenges involved in implementing the new act's provisions relating to independent directors.

The existing regime

The origin of the concept of independent director under the existing corporate law regime can be traced to the recommendations of the Kumar Mangalam Birla committee (1999), the Naresh Chandra committee (2002) and the Narayana Murthy committee (2003). Further to these proposals, the term "independent director" was introduced for the first time in India when the Securities and Exchange Board of India incorporated clause 49 in the Listing Agreement.

Clause 49 gives an inclusive definition of independent director, covering under its ambit non-executive directors who do not have a material pecuniary relationship with the company, its promoters, management or subsidiaries, which may affect the independence of their judgment. Independent directors, as envisaged under the Listing Agreement, cannot be substantial shareholders of the company (i.e. owning 2% or more of the voting shares),

but are entitled to receive remuneration in accordance with the decision of the board, with the prior approval of the shareholders.

The 1956 act does not define the term "independent director". India's listing standards require the boards of listed companies to include independent directors but neither the Listing Agreement nor the 1956 act precisely define their roles and liabilities. The 1956 act places independent directors on the same footing as any other director for purposes of decision making and does not specify any privilege, duty or function which they ought to perform or the liabilities they could incur for the actions of the board. This has led to uncertainty with respect to the roles to be performed by independent directors.

The new act brings clarity to the role of independent directors by laying down a non-exhaustive list of duties to be performed by them. This has brought the Indian law in line with the legal position in jurisdictions such as UK, where the codified duties and roles of an independent director exist alongside their common law duties.

Board composition

The Listing Agreement mandates that the board of a listed company will have an optimum combination of executive and non-executive directors with not less than 50% of the board comprising non-executive directors. Where the chairman of the board is a non-executive director, at least one-third of the board should be independent directors. Where the chairman is an executive director, at least half of the board should be independent directors.

In contrast, the new act requires that at least one-third of the total number of directors of every public listed company must be independent directors. In all other classes of public companies, the central government will have the power to prescribe the minimum number of independent directors.

Qualification criteria

In addition to the qualifications prescribed under the Listing Agreement, the new act prescribes detailed qualification criteria for independent directors. Under the new act, "independent director" means a person other than a managing director, a whole-time director or a nominee director:

1. Who, in the opinion of the board, is a person of integrity and possesses relevant expertise and experience;
2. Who is or was not a promoter of the company or its holding, subsidiary or associate company;
3. Who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
4. 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 the current financial year; and
5. None of whose relatives have or had pecuniary relationships or transactions with the company, its holding, subsidiary or associate company, or their promoters or directors, amounting to 2% or more of the company's gross turnover or total income or ₹5 million (US$80,000) or higher amount which may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year.

While the Listing Agreement restricted the appointment of a person related to the promoters or persons occupying management positions at the board level or one level below, the new act has restricted the appointee from having a relationship with the promoter or directors of the company, its holding, subsidiary or associate company. From this, it can be inferred that unlike the Listing Agreement, the new act does not require the appointee to be unrelated to a person occupying management positions at the board level or one level below the board. Considering that the new act does not supersede or replace the Listing Agreement, companies will have to comply with the requirements under both, until the rules framed in this regard provide greater clarity. Further, while the Listing Agreement does not contain any stringent provisions with respect to the relatives of the proposed appointee, the new act provides that neither the independent director nor any of his/her relatives:

1. Holds or has held a key managerial position or is or had been an employee of the company or its holding, subsidiary or associate company in any of the three financial years preceding the financial year in which he/she is proposed to be appointed;
2. Is or has been an employee or proprietor or partner, in any of the three financial years immediately preceding the financial year when he/she is proposed to be appointed, of: (a) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or (b) any legal or consulting firm which has or had any transaction with the company, its holding, subsidiary or associate company amounting to 10% or more of the gross turnover of such firm;
3. Holds together with his/her relatives 2% or more of the total voting power of the company;
4. Is a chief executive or a director, by whatever name called, of any non-profit organization which receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company.

In addition to the above qualifications, the new act empowers the central government to prescribe additional qualifications for independent directors.

It is evident from the new act's provisions that much emphasis has been placed on ensuring greater independence of independent directors. However, while the new act requires an independent director to be a person of integrity, relevant expertise and experience, it fails to elaborate on the requisite standards for determining whether a person meets such criteria. This would eventually mean that listed companies (acting through their respective nomination and remuneration committees) would exercise their own judgment in the appointment of independent directors. It is pertinent to note that unlike the new act, the Listing Agreement's description of the persons eligible to be appointed as independent directors does not include the term "a person with integrity and possessing relevant expertise and experience".

While enumerating the independence criteria, the new act also mandates that neither an independent director nor his/her relative can be a chief executive or director of any non-profit organization which receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company, or which holds 2% or more of the total voting power of the company. The Listing Agreement contains no such provision.

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, nor is provided with incentives by it in any manner, which may compromise his/her independence. In view of the additional criteria prescribed in the new act, many listed companies may need to revisit the criteria used in appointing their independent directors.

Pecuniary relationships

The Listing Agreement also stipulates that an independent director should not have any material pecuniary relationship or transactions with the company, its promoters, its directors, or its holding company, its subsidiaries and associates, at the time of appointment as an independent director, which is likely to affect his/her independence. The new act further states that this relationship should not have existed either in the current financial year or in the immediately preceding two financial years, making the provision significantly more restrictive than the Listing Agreement.

While the Listing Agreement states that an independent director must not have "any material pecuniary relationship" or transaction with the company, the new act states that an independent director must not "have had any pecuniary relationship". The disqualification arising from any pecuniary relationship in the previous two financial years under the new act may be unreasonably restrictive, as there may be situations where a pecuniary transaction of the proposed independent director may safely be considered to be of a nature which does not affect the director's independence, for instance, a person proposed to be appointed as an independent director may be the promoter or director of a supplier (or a counterparty to an arm's length transaction) which has in the past (either during or for a period prior to the two immediately preceding financial years) been selected by the company through an independent tender process.

Nominee directors

The new act brings about a clear demarcation between a nominee director and an independent director. While the Listing Agreement states that the nominee directors appointed by an institution that has invested in or lent to the company are deemed to be independent directors, the new act clearly states that an independent director will be a director other than the nominee director of a lender or an investor.

Under the new act, companies may appoint independent directors from the candidates who have enrolled in the data bank maintained by any institute, body or association. However, the new act is silent on whether companies may only appoint candidates listed in the data bank or may appoint candidates who fulfil the criteria mentioned, even though they have not enlisted in the data bank.

Under the Listing Agreement, the board of a company could appoint as an independent director any individual it deemed fit, so long as he/she fulfilled the qualifications set forth in the agreement.

Independence, an ongoing requirement

The Listing Agreement requires independent directors to disclose their shareholding in a listed company prior to their appointment to that company's board. Under the new act, independent directors must give a declaration of independence at the first meeting of the board in which they participate and thereafter at the first meeting of the board in every financial year or whenever there is a change in circumstances which affects their status as an independent director. As the new act does not override the provisions of the Listing Agreement, the conflicts highlighted above require a clarification or an amendment to the Listing Agreement to bring it in conformity with the new act.

Several other restrictions have also been built into the new act to ensure that there is no financial nexus between an independent director and the company. For instance, the new act prohibits independent directors from receiving stock options of the company. The Listing Agreement does not prohibit the issue of stock options. Rather it provides that the maximum limit on stock options to be granted to independent directors can be decided by a shareholders' resolution.

The new act limits the remuneration of independent directors to sitting fees, reimbursement of expenses for participation in the board and other meetings, and such

Arm's length relationships: Independent directors should not have any pecuniary involvement with the company or its promoters or directors.

profit-related commission as may be approved by the shareholders. This is yet another area of inconsistency with the Listing Agreement that will have to be clarified by the regulators.

Role elaborated

Neither the Listing Agreement nor the 1956 act prescribes the scope of duties of independent directors vis-à-vis the executive directors, the promoters or the shareholders, minority or otherwise.

Independent directors may be viewed as repositories of vigilance intended to ensure that the promoters and executive directors carry on the activities of the company in conformity with the interests of the shareholders as a whole. Alternatively, independent directors could be viewed as strategic advisers to the board, critical to maximizing revenue and overall value of the company. Research has shown that independent directors tend to perform an advisory (rather than a supervisory) role, principally in view of low remuneration and a high degree of liability.

The new act includes a guide to professional conduct for independent directors, which crystallizes the role of independent directors by prescribing facilitative roles, including offering independent judgment on issues of strategy, performance and key appointments, and taking an objective view on performance evaluation of the board. Independent directors are additionally required to satisfy themselves on the integrity of financial information, to balance the conflicting interests of all stakeholders and, in particular, to protect the rights of the minority shareholders.

What about common law?

The concept of independent directors and the list of duties of directors set out in the new act seem to have been inspired by the UK's Companies Act 2006, the Combined Code on Corporate Governance and various practices adopted in UK. The combined code, which is structured on a "comply or explain" basis, governs the behaviour of companies which seek to maintain listing on the London Stock Exchange, and forms the standard for corporate governance in the UK and across the world. The code was amended to incorporate the recommendations of the Higgs Report, which envisaged a two-fold role for independent directors – contribution towards business strategy and scrutinizing management's performance.

India's new act adds an additional dimension to the role of the independent directors – balancing the conflicting interests of the stakeholders while protecting the rights of the minority shareholders. The combined code provides non-executive directors the opportunity to attend shareholder meetings to develop a balanced understanding of issues faced by shareholders.

The Companies Act 2006 includes a list of duties that independent directors are required to perform. However it also clarifies that these duties have to be interpreted and applied in accordance with the principles of common law and equitable principles. While India's new act does not have a similar clarification, we believe that it has to be interpreted in a similar fashion. While a list of specific duties has been introduced, it can by no means be considered to be exhaustive. Independent directors would not be exempt from liability merely because they have fulfilled the duties specified in the new act, but will need to carry out all duties required for effective functioning of the company.

The Companies Act 2006 has also imposed on independent directors the duty to promote the success of the company. India's new act provides that a company director shall act in good faith to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community, and for protection of the environment. If a duty to "promote the success of the company" is read into the provisions of the new act, it remains to be seen whether a company's inability to continue profitably will be deemed to be failure of the company and hence, a breach of the director's duties.

Conclusion

The Satyam affair and other scandals in India exposed the growing need to ascertain precisely the standard for determining the liability of independent directors for prevention and detection of fraud, in view of the limited roles performed by them in the company. Under the 1956 act, independent directors are not considered as "officers in default" and consequently are not liable for the actions of the board. The new act provides for the liability of independent directors to be limited to acts of omission or commission by a company which occurred with their knowledge, attributable through board processes, and with their consent and connivance or where they have not acted diligently.

The new act makes a considerable effort to bring the role of independent director in line with changing needs. The primary objective behind the new act's provisions on independent directors is to ensure transparency and independence and at the same time to bring value to the company by providing input on strategy, business, marketing, legal, compliance and other matters, including performance of monitoring functions.

While on the one hand the new act imposes a higher level of responsibility by clearly defining independent directors' role and liability in cases of failure, on the other hand it imposes limits on their remuneration. These may prove to be disincentives for individuals to accept appointments as independent directors. Imposing a high degree of liability on independent directors may prove to be counter-productive, as independent directors cannot be held liable for transgressions of the board.

While the new act intends to bestow broader roles, greater independence and defined liabilities on independent directors, it also limits their effective functioning on account of their being a minority (i.e. one-third) of the board. Further, certain provisions pertaining to independent directors in the new act conflict with the Listing Agreement, requiring changes in the Listing Agreement to ensure that it continues to apply along with the new act. Following the notification of the new act, the government should prioritize the bringing in of the rules, which will bring greater clarity, remove inconsistencies and aid in achieving the objectives of the new act as envisaged by the regulators. ■

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