## Introduction

With the introduction of the Companies Act 2013, the intention of the legislature to provide for better self-governance by companies has been reaffirmed. The act places greater emphasis on achieving the independence of boards of directors. The legislature has tried its level best to bring the act into conformity with other regulatory legislation in India and the act's forward-looking approach takes corporate governance, specifically the independence of boards of directors, to new heights. The act offers elaborate provisions and codes for independent directors and tries to make the board of directors more independent and balanced.

The relevant provisions that deal with independent directors are Sections 149 and 150 and Schedule IV of the act. Although some other sections of the act have already been notified, these provisions are still awaiting notification.

## Legal framework

Section 149 of the act requires that the boards of directors of listed companies comprise at least one-third independent directors. Further, independent directors must be appointed in public companies with:

- a share capital of Rs1 billion or more; or
- aggregate outstanding loans, borrowings, debentures or deposits exceeding Rs 2 billion.

The number of independent directors required on the board of directors under the act is not fully in sync with the requirement under the listing agreement. Under the listing agreement, where the chairman of the board of directors is a non-executive director, at least one-third of the board should comprise independent directors, but where he or she is an executive director, at least half of the board should comprise independent directors. Thus, in case of a listed company where the chairman is an executive director, the requirement of higher number of independent directors must be complied with.

Section 149 of the act comprehensively defines an 'independent director' as any director that excludes, among other things, a managing director, full-time director, nominee director or promoter. Further, the act provides that an independent director will be a director who, in the opinion of the board, is a person of integrity and possesses the relevant expertise and experience. In order to check the subjectivity of this requirement and to ensure that companies analyse the expertise of independent directors at the time of their appointment, the draft rules further clarify that independent directors must possess the appropriate balance of skills, experience and knowledge in one or more of the following fields: finance, law, management, sales, marketing, administration, research, corporate governance, technical operations or other disciplines related to the company's business.

Thus, to some extent, by issuing rules the legislature has tried to limit the subjectivity of Section 149 of the act. The rules are clarificatory in nature and attempt to limit the field of

expertise that will be considered by the board when deciding whether a person is fit to be an independent director in a company. However, it remains to be seen how much the specified standards will assist the board in reaching a well-reasoned appointment. It is hoped that such subjective criteria will not result in substantial differences in the judgment of companies.

Furthermore, when defining an independent director, the act prohibits such director from having any kind of pecuniary relationship with the company, its holding, subsidiary or associate company, or its promoters or directors, during the two financial years immediately preceding his or her appointment or during the present financial year. Thus, the act prohibits any kind of pecuniary relationship between a company and the independent director, whether material or immaterial.

The prohibition on pecuniary relationships is not restricted to independent directors, but is also extended to their relatives. Therefore, the independence of the director will be seen to be compromised even if his or her relatives have a pecuniary relationship with the company, its holding, subsidiary or associate company, or its promoters or directors –where such relationship amounts to either 2% or more of its gross turnover or total income or to Rs 5 million (or such higher amount which may be prescribed), whichever is lower – during the two immediately preceding financial years or during the present financial year.

The act also prohibits relationships with any person whose relatives have been an employee, owner or partner of:

- a firm of auditors, company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company in any of the three immediately preceding financial years; or
- a legal or consulting firm that has or previously had any transaction with the company, its holding, subsidiary or associate company amounting to 10% or more of the gross turnover of such firm in any of the three immediately preceding financial years.

Although some leeway has been carved out for a legal or consulting firm by providing a minimum threshold for applicability of the restriction, no such exception has been provided for auditors, company secretaries in practice or cost accountants. This may present an issue for company secretaries in practice or auditors, by which even an issuance of a compliance certificate or valuation report will bar them from becoming an independent director.

## Selection of directors

The requirement to have an independent director will apply equally to unlisted public companies meeting specified criteria and to listed companies. Public companies will have one year from the date of notification of the relevant section in which to comply with the requirement relating to independent directors. In order to assist public companies with complying with the requirement, the act provides that the independent director may be selected from a database that contains the name, address and qualification of persons eligible and willing to act as an independent director. The database will be

maintained by the central government and will be hosted on the Ministry of Corporate Affairs website, and any other authority as may be notified by the government.

However, the appointing company will be solely responsible for carrying out due diligence on the person chosen from the database to be appointed as an independent director. The central government or any other authority hosting the database will not be held responsible for contravention of any law by such independent director. Further, the company appointing such independent director cannot argue in its defence that it had merely selected the appointed independent director from the database.

## Tenure and remuneration

Independent directors will be appointed for a five-year tenure. A director can be reappointed for a further term of five years, although this is dependent on a evaluation report being prepared by the board of directors. However, an independent director cannot be re-appointed for more than two consecutive tenures. After two consecutive tenures of five years, the independent director can be appointed again only after a cooling-off period of three years. The independent director must in no way be associated with the company during this cooling-off period.

The act provides that an independent director will be entitled to remuneration only by way of a fee for attending the meeting of the board or the committee and commission out of the profits. Independent directors will not be entitled to any equity stock.

## Code of conduct

Schedule IV of the act also provides a detailed code of conduct for independent directors, by which they must abide. In addition to the manner of appointment and reappointment, the code lays down comprehensive guidelines for the role, function and duties to be performed by independent directors. Among other things, independent directors must uphold ethical standards of integrity and probity, and devote sufficient time and attention to their professional obligation for informed and balanced decision making. Further, the code entrusts independent directors with performing certain roles and functions, such as:

- scrutinising the performance of management;
- satisfying themselves of the integrity of financial information and robustness of financial controls and risk management; and
- reporting concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy.

It can be seen from the duties, guidelines, roles and responsibilities enunciated in the code that the act intends to make the board of the company a self-governed mechanism. Increased responsibilities and duties under the code place an added obligation on independent directors to discharge their function with the utmost integrity and professionalism. The code also places an onus on independent directors to ensure that the company is compliant with all laws and that the

interest of shareholders and the company is well secured.

Independent directors must have at least one meeting a year without non-independent directors and members of management in which to review the performance of non-independent directors, chairpersons of the company and the board as a whole. Independent directors must also assess the quality, timeliness and quantity of flow of information between company management and the board. In turn, the performance evaluation of independent directors will be done by the entire board of directors, excluding the director being evaluated. The evaluation as done by the board of directors will form the basis of extending or continuing the term of the independent director.

## Liability

In order to encourage well-reputed professionals and individuals to become independent directors in a company, the act provides reasonable comfort to such individuals. By way of protection, Section 149 of the act provides that an independent director should be responsible only in respect of such acts of omission or commission by a company that occurred with his or her knowledge, consent or connivance, or if such act is attributable to the board process.

## Comment

The inclusion of provisions relating to independent directors in the act demonstrates the legislature's clear intention to make a company's board of directors a self-governing transparent body with due checks and balances. The legislature has increased the compliance for unlisted public companies and brought them into parity with public listed companies, which were already required to comply with the requirement for independent directors under the listing agreement. If everything falls in place, independent directors will prove to be a strong force in the fight for better corporate governance.

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