

# De Jure

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Independent Directors – "to be or not to be"



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## Introduction

In any company, the directors on the board comprise (i) the executive directors, (ii) the non-executive directors, and (iii) the nominee directors (who are usually appointed by the banks, financial institutions, and government agencies).

The expression 'independent director' would mean an individual who is appointed and designated as the non-executive director of the company.

The role of independent director is considered to be of great significance in the corporate governance framework but surprisingly the Companies Act, 1956 (the "Old Companies Act") that has ruled the area of company law for all these years never included any provisions for the same, although it did cover several sections with regard to directors.

In India, the importance of the term 'independent director' was recognised with the introduction of "Corporate Governance". The major development

that came in this regard was the inclusion of an exhaustive Clause 49 in the Equity Listing Agreement (the "Listing Agreement"). With the advent of Clause 49, the Listing Agreement covered the provisions with regard to the executive director, the non-executive directors, and the nominee directors qua the listed companies.

Now with the new Companies Act, 2013 (the "New Companies Act") coming into effect, there is a full-fledged provision to deal with the concept of independent directors. The New Companies Act deals with the concept of independent directors in a detailed manner and contains provisions on the requirements, eligibility criteria and applicability thereof – in certain instances even beyond the listed companies.

In this Article, we have attempted to briefly deal with the concept of independent directors and the implications of the new provisions on the individuals to be appointed as the independent directors under the New Companies Act.

## Need for Independent Directors

The need for independent director arises from the need to have a strong framework of corporate governance in the functioning of the company. These independent directors are the trustees of good corporate governance. An active and involved board consisting of professional and truly independent directors plays an important role in creating trust between a company and its investors, and is the best guarantor of good corporate governance. The role they play in a company broadly includes improving corporate credibility, governance standards, and the risk management of the company. The independent director also functions as a watchdog of the affairs of the company in general.

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## New Companies Act

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An independent director means an independent director as referred under section 149(5) of the New Companies Act (*Section 2(47) of the New Companies Act*). In fact, reference should have been made to section 149(6), as this is the relevant section which deals with the attributes of independent directors

In terms of the provisions of the New Companies Act, every public listed company shall be required to appoint at least one-third of the total strength of the Board of directors as independent directors (*Section 149(4) of the New Companies Act*). The draft rules under the New Companies Act also requires the (unlisted) public companies to appoint independent directors in case such companies have (i) a minimum paid-up share capital, (ii) a turnover, and (iii) in aggregate outstanding loans/ borrowings/ debentures/ deposits in excess of such amount as may be prescribed under the rules to be notified.

The New Companies Act contains a laundry list of qualifications and requirements to be taken into consideration before appointment of any independent director (*Section 149(6) of the New Companies Act*). In terms of these provisions, one such requirement is that an independent director must be a person of integrity and should possess relevant expertise and experience or any such other qualifications as may be prescribed (*Section 149(6)(a) of the New Companies Act*). The terms "integrity", "expertise" and "experience" are not the defined terms and it is not clear the manner in which such characteristics of an individual has to be determined while selecting an independent

director. Due to the lack of clarity, the appointment of independent directors based on these conditions becomes very ambiguous and subjective. In our view, this test should have been made more objective may be by specifying the parameters for fulfilling the conditions, similar to the manner in which the Securities Exchange Board of India has done by covering the provisions for the 'fit and proper' person under its various regulations.

The New Companies Act requires that an independent director should not be related to promoters or directors in the company, its holding subsidiary or associate company (*Section 149(6)(b)(ii) of the New Companies Act*). It further provides the independent director must not be either directly or any of the relatives of independent director holds or has held the position of key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three (3) financial years (*Section 149(6)(e) of the New Companies Act*). In our view, the conditions set out in the preceding second sentence is a far-fetching exercise and a person can be disqualified to be appointed as an independent even if his relative holds (or held) the position of key managerial personnel of the holding, subsidiary or associate company.

The independent director is also required to give a declaration (*Section 149(7) of the New Companies Act*) stating that he meets the criteria of independence as provided in section 149(6) of the New Companies Act.

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In terms of the New Companies Act, an independent director is not entitled to any stock option and may receive sitting fees, reimbursement of expenses incurred for attending board or other committee meetings and commission linked to profits (*Section 149(9) of the New Companies Act*). The reason for denying monthly/yearly remuneration is to preserve his independency.

The New Companies Act provides that an independent director shall be held liable in respect of such acts of omission or commission by a company which had occurred with his knowledge or connivance or for failure to exercise due diligence in such acts (*Section 149(12) of the New Companies Act*). Again, the extent of due diligence required to be exercised by the director

is subjective in nature and the same may prove to be a tedious and time consuming task entailing the independent directors to also have sufficient resources at his disposal to undertake such exercise.

As regards the term of holding office, subject to the provisions of the New Companies Act, the term of the independent director has been kept for five (5) consecutive years (*Section 149(10) of the New Companies Act*) and such term can be extended by another five (5) years (*Section 149(11) of the New Companies Act*). Considering the role of independent directors in the company, and the importance of maintaining their independency during their time of association with the company, it is only reasonable to have such condition in place.

## A FINAL WORD

As it can be noted, the New Companies Act imposes numerous conditions and restrictions for a person to get qualified as an independent director. Even after the appointment, the independent director is burdened with additional responsibilities such as conducting diligence exercise to avoid any personal liability. Considering the nature of requirements, it may be a major deterrent factor for the appointment of independent director, and there shall be a sense of reluctance for the good qualified individuals to take up a post of this crucial role in the company as an independent director.

While some of the conditions are reasonable and necessary to maintain their independency (such as conditions with regard to term, remuneration), other conditions look too ambiguous and may be seen in the nature of over policing, which may, in turn, shun away prominent individuals from taking up the role of independent director in the companies.

In addition, the draft Rules may impose additional responsibility on the company for the appointment of the independent directors and the on-going obligations on independent directors during their tenure once the draft Rules come into effect.

To conclude, although the introduction of the new concept of independent directors under the New Companies Act is a welcome step for corporate governance in India, the nature of compliances which are prescribed for their appointment and the continuous obligations to be adhered during their tenure may prove a critical aspect for their appointment and working as an independent director.

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