

# CLIENT UPDATE

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## Company Management, Governance & Administration under the Companies Act, 2013

### **In Brief**

The Companies Act, 2013 (the “**2013 Act**”) received Presidential assent on August 29, 2013 and replaces the Companies Act, 1956 (the “**Old Act**”).

In the 2013 Act, many new provisions have been made which may have a significant impact on the way business is conducted in India.

In this update, we discuss about the company management, governance and administration under 2013 Act.

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## BACKGROUND

The Companies Act, 2013 received Presidential assent on August 29, 2013 and replaces the Companies Act, 1956.

Following are some details and an analysis of the provisions related to company management, governance and administration which have been modified by the 2013 Act:

1. **Resident Director:** Every company shall have at least one director who has stayed in India for a total period of not less than one hundred eighty days in the previous calendar year. Existing companies to comply with this provision within one year from the date of commencement of the 2013 Act.
2. **Independent Directors:** Every listed public company shall have at least one third of the total number of directors as independent directors and the Central Government may prescribe the minimum number of independent directors in case of any public class and classes of companies. The companies will be given one year to comply with this requirement.
  - 2.1 **Qualifications:** An independent director is not a Managing Director (“MD”) or a Whole-time director (“WTD”) or a nominee director. Following are the qualifications of an independent director:
    - i. A person of integrity and possessing relevant expertise and experience.
    - ii. He is not a promoter of the company or its holding, subsidiary or associate companies.
    - iii. He is not related to the promoters or directors of the company, its holding, subsidiary or associate companies.
    - iv. He has no pecuniary relationship with the company, its holding, subsidiary or associate companies, or their promoters or directors, during the two immediately preceding financial years or during the current financial year.
    - v. His relatives have no pecuniary relationship or transaction, amounting to two percent or more of the company’s gross turnover or total income or INR 50,00,000 or such prescribed higher amount, whichever is lower, with the company, its holding, subsidiary or associate companies or their promoters or directors, during the two immediately preceding financial years or during the current financial year.
    - vi. He or his relative does not hold the position of KMP (defined hereinafter) and is not in the employment of the company, its holding, subsidiary or associate companies in any of the three immediately preceding financial years.
    - vii. He or his relative has not been in employment of the firm of auditors, company secretary or cost auditors or legal consultants of the s.
    - viii. He does not hold together with his relatives two percent or more of the total voting power of the company.
    - ix. He or his relative has not been a chief executive or director of any non- profit organization that receive twenty five percent of its receipt from the company, any of its promoters or directors or its holding, subsidiary or associate companies or that holds two percent or more of the total voting power of the company.

Every Independent Director must declare that he or she meets the criteria of independence.

2.2 *No ESOP to independent directors:* The 2013 Act prohibits issue of stock options to independent directors, but allows remuneration by way of fee and profit related commission, as may be appointed by members. Notably, Clause 49 of the Listing Agreement allowed stock options to independent directors.

2.3 *Tenure of independent director:* An independent director may hold office for two terms, each of five consecutive years. Further appointment is possible after a cooling off period of three years provided he has not been appointed in or associated with the company in any other capacity, either directly or indirectly during the three year cooling off period.

3. **Woman director:** The 2013 Act requires at least one woman director on the Board of certain companies.

4. **Key Managerial Personnel (“KMP”):**

4.1 In relation to a company, KMP means:

i. Chief Executive Officer or MD or Manager;

ii. Company Secretary;

iii. WTD;

iv. Chief Financial Officer (“CFO”); and

v. such other officer as may be prescribed.

4.2 Prescribed classes of companies to have whole-time KMP.

4.3 A whole-time KMP shall not hold office in more than 1 company at the same time.

4.4 CFO has been made responsible and liable for penalty and /or prosecution for compliance with various provisions such as maintenance of books of accounts, preparation and filing of annual accounts, disclosure of financial information in offer document, risk management, internal controls, etc.

4.5 In case of companies with no profits or inadequate profits, managerial remuneration can be paid as per the Schedule of remuneration (Schedule V – similar to Schedule XIII to the Old Act). If the conditions of such Schedule are not complied with, payment of managerial remuneration will require approval of Central Government.

4.6 Insurance premium paid by company for indemnifying specified KMPs against the liabilities for negligence, breach of duty etc. of such specified KMPs shall not be treated as part of the remuneration of such KMPs.

MD or WTD of the company who is in receipt of any commission from the company shall not be disqualified from receiving any remuneration / commission from its holding company or subsidiary company subject to necessary disclosures in the Board of Directors report.

5. **Certain matters now require special resolution; approval in board meeting for certain additional matters:** Certain matters, which under the Old Act required approval of shareholders by ordinary resolution will now require vote by special resolution. These matters include (a) disposal of the whole or substantially the whole of the

undertaking of the company; (b) investing funds received by way of amalgamation and merger; and (c) borrowings exceeding the paid-up share capital and free reserves. The 2013 Act defines the terms 'undertaking' and 'substantially the whole of the undertaking'. An 'undertaking' means an undertaking in which the investment of the company exceeds twenty percent of its net worth as per the audited balance sheet of the preceding year or an undertaking generating twenty percent of the total income of the company during the previous financial year.

6. **Promoter:** The 2013 Act has introduced the definition of 'promoter'. Promoter means a person named in the prospectus or annual return or who has control over the affairs of the company or in accordance with whose advice, directions or instructions the board of directors is accustomed to act. This does not apply to a person acting in a professional capacity. The duties and obligations associated with the office of a "Promoter" are set forth in Schedule I hereof.
7. **Ceiling on number of directors:** The maximum number of directors in a company has been increased from twelve to fifteen. Also, the maximum number of directorships a person can hold is increased from fifteen to twenty with not more than ten directorships in public companies.
8. **Disqualification of director:** Additional grounds for disqualifications of directors include committing offences concerning related party transactions, non-payment of call in respect of any shares of the company held by him.
9. **Board meeting:** The 2013 Act requires every company to hold at least four board meetings in each year. There is no requirement of holding a meeting in each quarter as required under the Old Act. The only requirement is that not more than one hundred twenty days should elapse between two consecutive board meetings.
10. **Related party transactions:** A clear definition of "related party" has been provided in the 2013 Act. The requirement of obtaining central government approval (in cases when the paid-up capital exceeds a certain limit) has been dispensed with. Now approval of the Board and in certain cases<sup>1</sup> the members' approval is required for related party transactions. Related party transactions entered in the ordinary course other than transactions which are not on an arm's length basis are exempted from seeking the Board's and members' approval.
11. **New Committees:** The 2013 Act provides for constituting 'nomination and remuneration committee' and 'stakeholders relationship committee'. The nomination and remuneration committee has to be established by every listed company or classes of companies as may be prescribed. This committee will recommend remuneration for directors, KMPs and other employees, will identify persons qualified to become directors and evaluate directors' performance.

The committee will consist of three or more non-executive directors, at least half of which have to be independent directors. The 'stakeholders relationship committee' has to be established by a company having more than one thousand shareholders, debenture-holders, deposit-holders and any other security-holders. It will consider and resolve the grievances of the security-holders of the company.

The chairperson of a listed company (whether executive or non-executive) may be appointed as a member of the nomination and remuneration committee but is not allowed to chair such Committee.

12. **Allowing the same person to be the Chairperson and MD or CEO in certain cases:** The 2013 Act provides separation of office of chairperson of the company and MD or CEO. It does not permit an individual to be appointed or reappointed as the chairperson as well as the MD or CEO at the same time unless the articles of association permit or in cases where the company does not carry on multiple businesses. Further, the restriction on appointing the same

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<sup>1</sup> Where the paid-up share capital is not less than such amount or transactions not exceeding such sums as may be prescribed

person as the chairperson and the MD or CEO does not apply in the case of such a company engaged in multiple businesses and which has appointed one or more CEOs for each such business. The above applies to such class of companies as may be notified by the Central Government.

13. **Entrenchment provision in the articles:** The 2013 Act provides that the articles of association (“**AoA**”) of a company may contain provisions for the entrenchment to the effect that specified provisions of the AoA may be altered only if conditions or procedures that are more restrictive than those applicable in the case of a special resolution are complied with. The provisions for entrenchment may be made either on formation of a company, or by an amendment in the AoA. Any amendment in the AoA for the entrenchment will be effective if is approved by all the members of the company in the case of a private company and by a special resolution in the case of a public company.
14. **Control:** A new definition and concept of ‘control’ has been introduced. Control has been defined to include the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. This definition is the same as the definition of control in Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.
15. **Resignation of Directors:** A director may resign from his office by giving a notice in writing to the company and the Board shall take note of the same. The company shall intimate the registrar of companies and shall also place the fact of resignation in the reports of directors laid in the immediately following general meeting by the company.

A director shall also forward a copy of his resignation to the registrar of companies along with the detailed reasons within thirty days of resignation.

16. **Duties of Directors:** The Old Act did not contain any specific provision that governed the duties of directors. The duties were instead governed by common law, which were applied on a case by case basis. Under common law, there are two broad sets of directors’ duties: (i) duty to act with skill, care and diligence, and (ii) fiduciary duties (to act in the interests of the company, to avoid conflicts of interest and to act for proper purposes). However, past track record in India indicates that cases where common law director duties have been applied are few and far between. For this reason, duties of directors are incapable of being defined as clearly as one can in other jurisdictions, particularly in developed markets.

In order to induce a greater level of clarity in directors’ duties, the 2013 Act has a specific provision that deals with the subject matter. The UK too adopted the strategy of codifying directors’ duties in the Companies Act, 2006 (sections 171-177). The following are some of the primary duties specified by the 2013 Act:

- i. to act in accordance with the AoA;
- ii. to act in good faith and in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment;
- iii. to exercise due and reasonable care, skill and diligence, and exercise independent judgment;
- iv. not to involve in a situation that presents a conflict of interest;
- v. not to achieve any undue gain or advantage (and to return any equivalent amount to the company if such gain or advantage is indeed made); and
- vi. not to assign office.

In case of any breach of duties, it would also amount to a **criminal offence** with punishment of INR 100,000 to INR 500,000. This is different from the common law position where there is only civil liability for breach. The criminal liability may incur in the following cases:

- i. Dishonoured Cheques;
- ii. Offences under the Income Tax Act; and
- iii. Offences under Labour Laws.

At the outset, it is necessary to note that this is only a partial codification of directors' duties. It is not possible to prescribe rules for every situation in which directors' actions can be judged. That necessarily has to be left a principles-based determination, usually by judges in specific cases, and hence the role of courts in implementing these duties cannot be taken away. While the statutory provisions do give some guidance, much would depend on the manner in which courts interpret these duties, on which previous jurisprudence is scant. Moreover, with issues surrounding delays and costs in the court system, it is not clear if a body of judge-made law (in terms of principles) is likely to emerge to guide the actions of directors. Hence, it is not clear if the codification of the duties will necessarily result in a tangible enhancement when it comes to enforcing the duties.

The 2013 Act requires directors to act in the interests of '*employees, the shareholders, the community and for the protection of the environment*'. This encapsulates the stakeholder model of corporate governance wherein directors are required to take into account non-shareholder constituencies as well. This is consistent with the renewed emphasis on corporate social responsibility, which has been introduced by the 2013 Act. While it seems unlikely that any duties owed by directors in connection with non-shareholder constituencies can be justified or enforced in a court of law, this at least prevents shareholders from initiating actions against directors for not solely (or even primarily) considering shareholder interests.

17. **Loan to Directors:** No company shall directly or indirectly advance any loan (including loan represented by a book debt) or give guarantee or provide security in connection with such loan to any director / related persons. An exception to the above rule is made for MD or a WTD if such loan is in accordance with the terms of services extended to all employees or is approved by shareholders by special resolution. Provisions for loan to directors are applicable to private companies as well.
18. Electronic voting for Board and shareholders meetings has been introduced by the 2013 Act.

## Schedule I

### The Duties and Obligations Associated with the Office of a Promoter

#### Duties of promoters

The 2013 Act contains no provision which states the duties of the promoters, but cultural notions and legal trends have enumerated certain duties:

#### Initiator

The promoter originates the scheme for the formation of a company, he gets memoranda and articles prepared, executed and registered and he deals with merchant bankers, brokers and legal advisors.

#### Fiduciary agent

Promoters stand as a fiduciary agent of a company. As a fiduciary agent, the following duties are done in his name:

- i. He should make all disclosures regarding accounts and formation so as to maintain transparency at the time of transfer of management to the director.
- ii. He should not make any secret profit out of the promotion of the company.
- iii. He should make all disclosures regarding transactions entered by him on behalf of the company as promoter.

#### Liabilities of promoters

1. **Section 25 and Schedule II of the Act**- These sections require that the promoter state all the contents of a prospectus, such as general information; capital structure of the company; terms and conditions of the present issue; company management and its projects; and financial information such as reports of editors, accountants, and the underwriting commission brokerage. The liability of the promoter arises only with respect to original allotments of shares and would not extend to any further allottees.
2. **Civil Liabilities (Section 42)** - Civil liability arises when any person applies for the shares and debentures on the faith of the prospectus, believing it to be true, and later finds untrue statements and records regarding the public issue of the company. The company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or INR 2,00,00,000, whichever is higher, and the company shall also refund all monies to subscribers within a period of thirty days of the order imposing the penalty
3. **Criminal liabilities** - Criminal liability arises like civil liability-Every promoter authorizing the issue is punishable by imprisonment for a term up to three years, a fine up to INR 50,000 or both.
4. If any promoter is found to be involved in an activity which amounts to an offence regarding the promotion, management or formation of a company, the court can bar such a promoter from taking part in administration of the company for five years.

5. The court can order a promoter liable to public examination when he is found to have been involved in fraudulent activity at the time of promotion of the company.
6. **Section 35-** If, in the course of the winding up of a company, it appears that any business of the company has been carried on with the intent to defraud creditors, the court may declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally liable.
7. **Pre-incorporation contracts-** If any promoter enters into any contract on behalf of the company before it was actually incorporated, then the promoter shall be personally liable for non-fulfillment of the contract unless it was rectified by the company after incorporation.