



DEMYSTIFYING THE MYTH OF INDEPENDENT DIRECTOR

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ABSTRACT:

In this research paper titled "Demystifying the myth of Independent director", the primary aim of the author is to come at parlance with the reality of "independent" director. The concept derives its origin from the days of financial hardships and breakdowns in USA when the fivestars' faith was defeated due to repeated breach of the legalities. In the light of such situations, India also chose to strengthen its budding corporate governance regime and chose to adapt to the international standards after improvising them as per it requirement. An independent director, till date, has been regarded as integral tool in the monitoring mechanism of the company. This is mainly because of the presence of the trait of "independence" as compared to other directors. But the food for thought is how far an "independent" director is actually independent? Is he/she actually serving the purpose it was intended to, at the time of improvising this tool? The paper intends to dissect and examine the myth and evaluate how true it stands in today's scenario.

INTRODUCTION:

Independent directors today are the keystone of the corporate governance world. The entire foundation of corporate governance revolves and emerges from it. Increase in number of independent directors on the board has been said to bring a deterrent

effect when it comes to fraudulent activities. They have been affiliated to preventing mismanagement, inequality, erosion of legal foundation and footage of the company. They have also been titled as forerunner for striking the balance and maintain checks in the company. But is that all that can be attributed with the role of an independent director? Since every coin has two sides, does the coin of independent director not possess another side? The other side refers to how it has failed to satisfy the purpose of the system and proved to be burden on the company.

The definition of ID is defined under section 149(6), Companies Act, 2013. An independent director is generally regarded as the person who has severed all his ties with such aspects that are likely to impact the decision of the director. However, mere the fact that there are no ties involved cannot be said to render the quality of "independence" over the director. It is imperative for a person to possess the traits of loyalty, unbiased and other managerial elements so as to be regarded as an independent director, (referred as ID hereafter).

To delve and develop upon the research proposition, the researcher shall primarily rely on secondary data for the purpose of research. The intent is to look into the survey conducted, legal opinions and rely on the national and international journals and books by the experts in the field to conduct a detailed study to come to the conclusion inclusive of both online and offline materials. This paper aims at demystifying the myth of "independent director". It shall also try to identify the other side of the coin on having an ID in the company. The paper seeks



understand if at all, having an ID can be a hurdle in the growth of the company. The paper shall unfold tracing the history of origin of independent director in India particularly, ponder upon what is the concept of independent director, identify roles and functions of an ID followed by the problems that the presence of an independent director may bring to the company and conclusion. While all this is dealt with in detail, the author shall simultaneously dissect and examine the reality behind the myth of "independent" director while defining what an ID, in reality is.

LITERATURE REVIEWS:**• LITERATURE REVIEW 1:**

The author **Roberta S. Karmel** in the article "**Is the Independent Director Model Broken**" begins with tracing the legislative growth and requirement of having an Independent director in the Sarbanes-Oxley Act, 2002 and the status of an independent director around the world. The model of independent director is put forth before the readers followed by the problems faced, substantiated with the help of several studies. As per a study conducted in 2009, it was concluded that the companies which had more number of independent directors experienced worst stock crisis. Indeed the author has very beautifully laid the tussle between independent and non independent director and makes one conscious of the need to striking the balance. The paper then throws light on an altogether different model which is a combination of shareholder primacy and independent director. The author, who was a director herself once, through this article makes a suggestion that the expertise of the director is more

important that the independence of the director.

• LITERATURE REVIEW 2:

The article "**The Independent Director: Has It Been Indianised Enough**" written by **Madhuryya Arindam** is set in the Indian regime. The paper begins with tracking the reasons for development and growth of independent director. It has very well attempted to define and portray an evolution in the meaning of "independent director" in context of its functions. In order to give a holistic idea about the independent director, the author has also delved with the nomination, election and removal of the independent director. An additional study that the paper supplies to its audience is over whether the psychological factors have any effect on the performance of such directors is an intriguing element of the paper. The author then drops the curtains over the paper with her last remarks in form of suggestions and alternatives in which working of the institution can be made more effective in presence of independent directors.

• LITERATURE REVIEW 3:

In the research paper, "**The Role of Independent Directors in Controlled Firms In India: Preliminary Interview Evidence**" the authors, **Vikramaditya S. Khanna And Shaun J. Mathew** have conducted empirical study to understand the role of the independent directors on the board. This involved conducting interviews in both controlled and dispersedly companies. As a result, it was found that most of the people didn't perceive the independent directors to play the role of a watchdog and neither did the companies



seem to welcome their ideas. Rather it was found that imposing monitoring duty seriously proved to be detrimental in the interest of the company. In terms of liability, their compensation was found to be grossly inadequate. Since the paper is set in the post Satyam regime, the research attempts to conclude it by briefly exploring reforms undertaken to improve the current scenario.

EVOLUTION:

It was in the year of 2000 when SEBI issued a mandate for all the large public listed companies in India to abide by the requirement of having minimum number independent directors in their companies. The root cause of emergence of this requirement takes us to the corporate governance situations prevailing in U.S. and U.K. during the 1990s.¹ Unlike U.S. and U.K., India is said to have an insider model. Holding organizations, banks, other nonfinancial partnerships, and familial control are predominant highlights of insider framework.² In other words, insider corporate structure means that the management and the board is a composition of the people not independent of the company. They may be called to be the parties having interest in the working of the company. Such insider structure based management has technically all the control over the structure of the board and management and has upper hand over the working of the company and its affairs. Such

a model of company is also called as the "family/state" model.³ These companies run with the tradition of passing on the control of the company into its own lineage. Some of the famous examples of such companies in India are The TATA Trust, Aditya Birla Group, and Reliance Industries Limited etc. Perhaps this resulted in the conflict of interest between the shareholder's of the company and the management, where both want to reap the benefits of the companies working all by themselves. This kind of situation very quickly became the talk of the town for the analysis in the field of economics and was named "agency problem". The corporate literature defined agency problem to be a pack of three types.⁴ India is said to succumb to the conflict between the majority shareholders and minority shareholders.

As an antidote to this problem "monitoring board" theory was devised. Monitoring board theory lays down the foundation of a new model of the structure and check mechanism of the company which involved the executive officers, the board dominated by the outsiders' helping in ensuring keeping a check on the performance of the management.⁵ Professor Melvin Eisenberg was an ardent advocate of this model. He

¹ Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 Berkeley Bus. L.J. 315, 320-322 (2005).

² MAHER, M. & ANDERSSON, T. *CORPORATE GOVERNANCE: EFFECTS ON FIRM PERFORMANCE AND ECONOMIC GROWTH.* 105-107 (2018).

³ La Porta, et al. *Law and Finance*, The Journal of Political Economy, 1113, 1115 (1998) (describing insider systems as "characterized by the significance of the state, families, non-financial corporations, employees, and banks as a source of funding and/or control").

⁴ R. K. *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press. 22, 26. (1984)

⁵ Dent. G. *The Revolution in Corporate Governance, The Monitoring Board, and The Director's Duty of Care*. 61 B.U. L. REV. 623, 645 (1981).



emphasised on finding the useful functions that a board can perform rather than making any unrealistic demands and the most important function of the board was found of that of monitoring.⁶

The seed for the growth of this theory is found to be sown from the era of Berle and Means' study. However this theory was more of "manager-shareholder conflict centred". It rightly enunciated that there is difference between ownership and control which leads to the interest of the shareholders become secondary as against the managers. Since the shareholders' of the company are generally widely spread out, the managers get an upper hand when it comes to decision making. This thus gives unbridled power to the manager leading to the abuse of his position and powers. Two economists, Alchian and Demsetz explored this issue with an opinion that the party which gets the residual income would be deemed to be the best monitoring authority. This is based on the premise that such a party shall reap the maximum amount if the monitoring is done at its best, thus giving incentives to monitoring authority to supervise the firm's conduct properly.⁷ They suggested that the appropriate authority for this is the shareholders since they are the ones who are the recipients of the residual income of the company. Since the shareholders' are going to be the claimants of the residue of the company, it is argued that they are the most appropriate monitors

for the company.⁸ In any case, while the law provides investors with the right to cast vote and power to ensure enforcement of a policy decision, these are to be retained for situations of urgency.⁹ In general, investors have nothing like the legal right, ability or the longing to exercise the type of control required for proper monitoring of the agents i.e. directors of the company.¹⁰ This problem ultimately led to the entrustment of this monitoring responsibility on the independent directors. But with the board of director comprised of the insiders, it was nearly impossible to expect the independent director to do his task religiously. For the independent director to serve the motive of its establishment, it was necessary that he/she must be independent of the management. Thus, the composition of the board now began to gained importance.

The corporate governance mechanism to tackle this menace was long developed in the era of 1970s in U.K. and U.S.A. It came in form of various legislations such as Sarbanes-Oxley Act in U.S. and Cadbury Committee Report and Greenbury Code in U.K. India, after suitable modifications as per its conditions, decided to transplant the same into the Indian scenario. India saw a radical shift in its economic conditions and policies after liberalization in 1991 which called for change in the corporate governance policies of the nation. The year of 1992 bought SEBI as a threshold to the change. SEBI developed its own rules and regulations to prevent insider malpractices

⁶ *Id.* at 650.

⁷ Armen, A. and Harold, D, *Production, Information Costs, and Economic Organization*, The American Economic Review, 62, 777 (1972).

⁸ Bainbridge, S. *Participatory Management Within a Theory of the Firm*, 21 J. Corp Law Review, 657, 672 (1996).

⁹ *Id.* at 680.

¹⁰ *Id.* at 682.



and encourage the shareholder interest in the companies. In 1998, the initiators of the change called for making of the Confederation of Indian Industry (CII) and recommended a Code for Desirable Corporate Governance which was accepted by several companies willingly.¹¹ Thereafter in 1999, SEBI under the chairmanship of Shri Kumar Mangalam set up a committee called as Kumar Mangalam Birla Committee to raise the standards of good corporate governance in case of listed companies. Its main objective was to review the current standards of corporate governance from the shareholders' and investors' perspective and prepare a suitable code to suit the changing environment.¹²

SEBI in a meeting held on 25th January, 2000 considered the recommendations of the committee and decided to make the necessary amendments to the listing agreement namely, introduction of clause 49.¹³ Post the Enron, WorldCom and other major break downs of the companies due to lacuna in the corporate governance code of USA and subsequent enactment of

Sarbanes- Oxley Act, SEBI again decided to bring forth the reforms to strengthen the governance regime. This was done with the help of the Murthy committee established under the chairmanship of Narayan Murthy.¹⁴ The committee was required to revisit Clause 49 and provide recommendations for changes as per the prevalent scenario. The revised version was issued on October 29, 2004. However it was brought into force only on January 1, 2006.¹⁵

DEFINING INDEPENDENT DIRECTOR:

There is no particular definition of independent director. However an attempt to do so is evident in section 149, Companies Act, 2013 whereby the legislatures expound the nature of the independent director. For the purpose of this paper, the author shall not delve into the scope of the section but throw some light on the concept of Independent director across the world of corporate governance. For the layman's understanding the definition of the term "independent director" is evident meaning thereby that such a director who has no pecuniary or any kind of relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors which may have any impact over the decision of the director is known as an independent director.¹⁶ An independent director is expected to make decisions'

¹¹ Asian corporate Governance Organisation. *Confederation of Indian Industry, Desirable Corporate Governance: A Code.* (1998).

¹² GK Today. (2015). *Key Recommendations of Kumar Mangalam Birla committee Report.* [online].

Available at:
<https://academy.gktoday.in/article/key-recommendations-of-kumar-mangalam-birla-committee-report/> [Accessed 22 Feb. 2018]

¹³ SECURITIES AND EXCHANGE BOARD OF INDIA (2000). *Recommendations of Kumar Mangalam Birla Committee.*

Available at:
https://www.sebi.gov.in/legal/circulars/feb-2000/corporate-governance_17930.html. [Accessed 22 Feb. 2018].

¹⁴ SECURITIES AND EXCHANGE BOARD OF INDIA (2000). *Recommendations of Narayan Murthy Committee.* Available at: <http://www.sebi.gov.in/circulars/2005/dil0I05.html> [Accessed 22 Feb. 2018]

¹⁵ Ibid.

¹⁶ *Companies Act, 2013.* § 149.



based on the merit of the matter placed before the board rather than on superfluous determinants.¹⁷

Such a director is usually non-executive and an outsider in the management of the company. He can also be called as an outsider since he is a non employee and non management director of the company.¹⁸ As far as his liability is concerned, he shall be liable only for those acts of omission or commission on behalf of the company which had occurred with his knowledge derived (a) during board process (b) with his consent or connivance in the commission of offence; or (c) where he has not acted diligently or prudently.¹⁹ It is mandatory for every listed company to have at least one-third of the total number of directors as independent director.²⁰ Such a director can hold the office for the tenure of five years only. After the lapse of these five years, he is bound to vacate the office.²¹ In no event can a director be elected for the period for more than two terms consecutively.²² So far, it is difficult to specify the defining trait of an independent director. Some of the scholars argue that autonomy is the defining trait of the independent director. There are also certain scholars who beg to differ and distinguish autonomy from independence. Daniele Marchesanit, in the article "The Concept of Autonomy and the Independent Director of Public Corporations" has very

diligently argued the difference between the two. Citing Dworkin²³, Frankfurt²⁴ and Robert Young²⁵ the article defines "autonomous" as a person who not only formulates his life plan in accordance with his own values and desires, but also carries through with it.²⁶ In the present context it would mean that a director is said to be autonomous when he has the power to decide the goals of the company and define the pathway and plan to achieve the goals and objectives so put forth by him. He must be free from all the constraints and possess the positive qualities to achieve them.²⁷ While the word independence is defined as free from influence of others. It is also argued that the trait of independence alone is not enough for the director to be termed as an independent director. This is because the absence of the trait of autonomy shall deprive such a director from any powers for carrying out and fulfilling its responsibilities. The author has argued that the current definition of the independent director is misleading and portrays the independent director to be a person who will be an effective and therefore trustworthy director, but the requirements of the definition are inadequate for this purpose.²⁸ The learned author of the paper suggests an alternate definition as stated below²⁹

¹⁷ *Unitrin, Inc. v. Am. Gen. Corp.* [1995]A.2d 651 (Del), p.1361.

¹⁸ Supra 1.

¹⁹ Mittal, P. (2014). *Independent Directors*. [ebook] Delhi: FCS PKMG Law Chambers. Available at: <http://Annexure-E.pdf> [Accessed 22 Feb. 2018].

²⁰ *Companies Act, 2013*. § 149(3).

²¹ *Companies Act, 2013*. § 149(10).

²² *Companies Act, 2013*. § 149(11).

²³ Dworkin, G. (1998). *The Theory And Practice Of Autonomy*. Cambridge [u.a.]: Univ. Press.

²⁴ Frankfurt. (1998). *The Theory And Practice Of Autonomy*. Cambridge [u.a.]: Univ. Press.

²⁵ Young, R. (1986). *Personal Autonomy: Beyond Negative and Positive Liberty*. Routledge.

²⁶ Supra note 15.

²⁷ Ibid.

²⁸ Supra note 15.

²⁹ Ibid.



"The definition should require that a director be free from compromising ties and have the motivation, skills, and other characteristics necessary for him to be effective. It should also account for structural and procedural elements that may affect the director's ability to act. Only a person who satisfies all of the conditions for autonomy will be reliable as a director who will set his own objectives and effectively pursue them to satisfy his obligations under the law."

However, the researcher totally agrees to the opinion of the learned author. The researcher strongly feels that if the independent directors' role and definition was not made to be as stated above, it would override the concept itself. As soon as the director finds the element of motivation to work effectively and efficiently in the company the purpose of choosing a person "who has no interest in the company" is defeated. Applying the Maslow's hierarchy of needs and motivation where he opines no work, no motivation formula and states that an unsatisfied need will always motivate person to work to achieve it, none of the independent directors can be called to be independent in real sense. As soon as the word "purpose", "motivation" or "remuneration" is attached with this concept, it inherently defeats the idea of an "independent director". In event where director's remuneration becomes genuinely lucrative, some directors might become too dependent on their positions and lose the independence that is felt to be critical to good corporate governance, since outside directors play a central role in overseeing

management.³⁰ Another major contradiction comes through the wordings of the legislation whereby the legislators mandate both that the "independent director" should have no pecuniary relation with the company but be provided with the remuneration for their work. The Ministry's Guidelines recommend that independent directors be paid "adequate sitting fees" based both on the company's net worth and turnover.³¹ For no man would work in a company and devote all his time and efforts, unless he is derives benefit out of it none of the independent directors are independent of the company in real sense.

ROLES AND FUNCTIONS OF INDEPENDENT DIRECTOR:

The literature and code in corporate governance has defined various roles of an independent director. It includes addressing the governance related problems, being "watch dog" or monitoring the activities of the company on behalf of public shareholders, serving as a strategic advisor to

³⁰ Radonjić, D. (2012). INDEPENDENT DIRECTORS AND NEW CORPORATE GOVERNANCE PARADIGM (PROS & CONS OF INDEPENDENT DIRECTORS). *Annals FLB – Belgrade Law Review*, Year LX, [online] 3. Available at: <http://anali.ius.bg.ac.rs/Annals%202012/Annals%202012%20p%20096-112.pdf> [Accessed 25 Feb. 2018].

³¹ KHANNA, V. and MATHEW, S. (2010). THE ROLE OF INDEPENDENT DIRECTORS IN CONTROLLED FIRMS IN INDIA: PRELIMINARY INTERVIEW EVIDENCE. *National School Of India Rev*, [online] 22(35). Available at: <HTTP://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx> [accessed 15 jan. 2018].



the controlling shareholder etc³² however there is no one role carved for the independent director to play. There are several assumptions with regards to the role of the independent director and one of them is monitoring the related party transactions although not barred by law, may nonetheless erode shareholder value if conducted without following proper valuation practices.³³ An independent director is expected to act as a guard of the minorities and build up the confidence of the shareholders' on the company.³⁴ They are also expected to bring onboard their specialist knowledge and business connections and thus make the board more efficient.³⁵ Presence of an independent director on board helps in bringing diversity, effectiveness and balance to the blood of the company. They are called to be the "conscience keepers" who could guide the company towards the right path.³⁶ Due to the presence of the trait of "independence", an independent director is sought to as an effective middleman to resolve the conflicts in the company.³⁷

Independent director is generally presumed to maintain a check on the development policy and strategies of the company. They do so by critically examining the performance and acts of the management and ensure that the actions fall within the purview of their power regime. They are a part of the system of reporting and accountability and provide for proper internal control and audit requirements.³⁸ Since they are independent of the management, their decisions are less susceptible to mala fide and prejudice. They question the working of the business and challenge it in the event of any discrepancies. In nutshell, they are the advocates of sustainable development of the company and believe that the growth of the company and the stakeholders go hand in hand.³⁹

The new act categorically emphasize on appointment of an independent director as a member or as a chairperson in various committees.⁴⁰ Unlike earlier, an independent director is supposed to keep himself updated with the workings of the company. He/she must be regular at annual general meetings and discuss the problems faced by the non-executive team of management. The code described in schedule IV of the Act, 2013 clarifies the role, function and duties of the director in detail.

³² Supra Note 28.

³³ *OECD Principles of Corporate Governance*. Principle IV.D.6, "One of the functions of the board of directors is to monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions."

³⁴ Batth, C., Nayak, D. and Sarangi, D. (2016). Role of Independent Directors in the Changing Business Scenario in India. *International Journal of Scientific Research and management*, 4(2).

³⁵ Arindam, M. (2013). The Independent Director: Has It Been Indianised Enough. *NUJS Law Review*, 6(231).

³⁶ Mittal, P. (2011). Role of Independent Directors In Corporate Governance. *NUJS Law. Rev.*, 4.

³⁷ Supra note 31.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ Ibid.



PROBLEMS FACED DUE TO PRESENCE OF INDEPENDENT DIRECTORS:

Having an Independent director on board, has become a mandate in today's corporate governance regime. After a massive breakdown of companies like WorldCom, Enron etc the legislatures were said to be practically living their worst nightmares. Public had lost its faith in investing in the corporations. The legislatures had no option but to work on this issue with immediate effect. The role, structure and function of the Board in a company were required to be revamped. This led to the emergence of the "monitoring board" which further lead to the introduction of the independent director. The growth of an independent director in the corporate regime has already been discussed above.⁴¹ The concept of independent director was introduced with the hope of securing the coming future and rights of the public in the corporate world. It was expected that independent director would prove to be a whistle blower in a company. This paradigm shift came with multiple disclosures and financial controls over the company and the corporations had to adopt it or elucidate the reason for not doing so.⁴² Most of the companies across U.S., U.K. and India quickly adopted this change. But the real question that arises whether this reform actually serves its purpose? Whether the introduction of the independent director actually helps in improving the corporate governance performance of the company or is it a mere burden on the stakeholders and the company? For the purpose of this paper, I shall only limit myself to the cons of having

an independent director in the organisation since the potential pros are already widely known.

Even U.S., the birthplace of this reform does not give a clear picture as to how much have this reform contributed in the improvement of the corporate governance.⁴³ For this purpose the author prefers to resort to an interview conducted by Vikramaditya S. Khanna and Shaun J. Mathew⁴⁴ in 2010 wherein the directors themselves threw some light on their role and real time experiences. Time and again, numerous directors, have expressed strong sentiments regarding their "expected" role as a watchdog in the company. They have admitted that they're reluctant in doing so where there's a scope for reputational damage and incurring liability. There have been instances where they have been served with arrest warrants for the reason that they were acting as a whistle blower in the company, which ideally was expected to be their role. Speaking of the role of the director, they have also revealed that they are not playing a very significant role in the board when it comes to being an advisor. The "ritual" of independent director giving advice to the board is adhered to, but it's always the promoter's choice that prevailed. There have been some instances as well where heated boardroom conflicts have lead to abandonment of the independent director. In the event where the independent director is not able to exercise its tools and powers to deter promoter's inappropriate activities, they prefer resigning from the company expecting that this may send a "watchdog's" signal to the general public.

⁴¹ Refer heading in the paper "Evolution".

⁴² Supra Note 27.

⁴³ Ibid.

⁴⁴ Supra Note 28.



The interview also revealed the extent of “independence” of the independent director. Each director who was interviewed, at least once has been approached by the promoters’ directly without following a selection process. The reason for the same was that the board cannot simply have strangers put together to arrive at a conclusion in welfare of the company. In order to do that efficiently the board needs to be collegial in nature. Some directors have also expressed their grief in terms of insufficient updates on timely performance and development of the company. While the rest of the directors who got access to such resources submitted that they were poor in quality and insufficient.

Apart from this interview, there are more studies which throw light on the cons of having an independent director on board and suggest that independent director are not a sure shot solution to the problem and prove to be a burden on the company. Scholars have argued that lack of experience amongst independent director causes them to adopt a conservative approach when it comes to decision making. It is also submitted that since they have “artificial interest” in the company they are not willing to take risks. It is not so easy to take a strong stand in favour or against the presence of independent director. Bearing in mind that we are considering only the element of “independence” of these directors, it would be too early to jump to any conclusion. Nevertheless, if improvised and empowered independent director can be a powerful tool against frauds and law evaders.

CONCLUSION:

With the end of this paper, the author has discovered that the concept of “independent director” does not exist per se. No director is independent of the firm in literal sense. Some or the other tie will always exist between the company and the director. The author believes that the concept like this can never exist in reality. It is difficult to have a director become independent of the company while having a pecuniary relation in form of remuneration, and prestige connected with the company. As long as there is a relation between the two, the director can never be said to be independent. Noting this, there will never be a situation where person may work selflessly for a company without anything in return. Thus, the author finds no hesitation in negating the concept of the “independent” director completely.

Also it is extremely difficult to find someone fulfilling the requisites of an ID i.e. presence of integrity, probity and high ethical standards. It is a rare and difficult chance to find an appropriate candidature with these qualities coupled with suitable qualifications and interest in being an independent director. Thus it is that same few selected group of people who perform the task of independent director in the companies.

With regards to the limitations of having an ID, so far, the author has found no reason as to why should one deter from keeping an “independent” director in his/her company. Considering this, when a pseudo-independent director can be so great help to the companies, there is no doubt as to what wonders an ID is capable of doing. Therefore it is strongly believed that there’s an ardent need there and vast scope of improvement in this concept so as to make it a full proof



device against the menace. So far it is a boon with minimal effect but it definitely has potential to widen its effects.

