ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE

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I. Abstract

Independent directors have played an emerging role in the world wide corporate governance movement. This increased presence in the boardroom has effectively worked as harbinger for striking a fair balance between individual, social and economic interest. Moreover, their presence has been hailed as a deterrent to fraud, mismanagement, inefficient use of resources, inequality and unaccountability. However there is a lot of criticism pertaining to the performance of independent directors attributing to their inability to indulge with full potential to the lack of a conducive 'boardroom atmosphere' and the presence of some people who are unlikely to raise their voices against the flow of the current. This paper shall bring into the light the concept of independent directors and it's inter- relation within the framework of corporate governance in Indian business culture; their appointment, their duties, liabilities and the evolution of this concept and practical experiences. It shall attempt to outline the loopholes in the current approach and provide for recommendations which not only include structural changes but also a change in the attitude of corporate India.

II. Issues

1. What is the relationship between Independent Directors (IDs) and Corporate Governance?
2. How has the concept of relation between IDs and Corporate Governance developed in India?

III. Analysis

A. *Who are Independent Directors?*

According to the International Finance Corporation (IFC),[1] an independent director must fulfill certain prescribed minimum requirements. It mandates that only such people must be considered for appointments who have not been employed by the company or its related parties in the five preceding the date of appointment. Moreover, they should not have affiliation with a company that is a consultant or advisor or significant customer or supplier to the company. They should not have any personal service contracts with the company or its related parties or senior management or affiliated with a NGO that receives a significant funding from the company. Ideally, IDs should not be employed as executives of another company where any of the company's executives serve on the Board of Directors or are members of the immediate family of an individual who is, or has been during the past five years, employed by the company as an executive officer. On the same line in India the Securities and Exchange Board (SEBI) has issued similar guidelines for the appointment of IDs. However the standards incorporated by SEBI are less stringent than what is considered by IFC. As per SEBI,[2] 'independent directors' refers to a non-executive director who does not have any

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[1] IFC, Indicative Independent Director Definition International Finance Corporation, available at http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/ Independent+Director+Definition.doc/$FILE/Independent+Director+Definition.doc (Last visited on January 19, 2020)

[2] Securities and Exchange Board, Equity Listing Agreement, 2000. cl.49 (A) (iii)

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material pecuniary relationships or transaction with the company or its promoter or director or senior managements or any other alliances, apart from receiving the director's remuneration, which may affect independence of the direction. They must not be related to the promoters or persons holding management positions at board level or one level below the board or an executive of the company in the preceding three financial years. Furthermore, they should not have been a partner or an executive or involved with audit firm associated with the company at any time in preceding three years. They should not be the supplier of material or the provider of any servicer or customer or lessor or lessee or a substantial shareholder in the company.

B. *Independent Directors & Corporate Governance*

Governance, as it is said is about steering a company in the right director. Mr. M. Damodaran, former SEBI chief, described corporate governance as a continuing process beyond the scope of mere legislation.[3] By this he implied that governance requires practices for which the legislative mandate should only be a starting point. Companies must follow these practices not because of fear of sanction, but because the absence of such governance will lead to decline in its potential to achieve true profitability. Other thinkers have described corporate governance differently; some believe that is a journey and not a destination, while some compared it to 'trusteeship'. But irrespective of different approaches, the subject matter and purpose of corporate governance remains undisputed- even more so vis-a – vis the role played by independent directors. The IDs broadly fits into the overall structure of corporate governance. They are appointed to ensure an effective and balance board. There is no denying to the fact that the board of directors (BoDs) is the most significant instrument of compliance with corporate governance and its supervision is of utmost importance. The IDs contribute to the board by constructively challenging the development of policy decisions and strategies. Moreover they ensure accountability by scrutinizing the performance of the management. Their independence, on account of lack of affiliation which is likely to prejudice their decisions, allows them to fulfill these tasks more efficiently. While, they are answerable for the actions of the company, they are less likely to be affected by self- interest in these actions. The above- mentioned characteristics put them in a unique position to question the company's practices as they have been conventionally been viewed as "adversaries" within the board. However, their position has been gradually become more acceptable with the realization that independent directors bring something more to the table which implies that in a long run independent directors bring with themselves a more balanced perspective.[4]

It is an interesting point to note that considerable effort has been made via institutional guidelines, to encourage the appointment of independent directors. For e.g. the New York Stock Exchange

[3]Prime Directors, CII Summit Stresses on Importance of Independent Directors in Corporate Governance, September 14, 2005, available at http://www.primedirectors.com/ Press Reports/CII2.pdf (Last visited on January 18, 2020).

[4]Vinod Kothari, Role and Responsibilities of Independent Directors, available at http://www.vinodkothari.com/role%20and%20responsibilities%20of%20independent% 20directors.ppt (Last visited on January 18, 2020)

regulations provides that majority of board of directors of a listed company should comprise independent directors, for which there is a stringent qualification.[5] Additionally, companies listed on exchange must compulsorily have committees such as Corporate governance committee, audit committee etc, which must only consist of independent directors. Ever since the practice of appointment of IDs has been recognized as a legitimate means to bring about more transparency in corporate governance, increasingly more countries have adopted the similar guidelines. Let us discuss it in the context of Indian Corporate business.

C. *The Indian Context*

a. *Conventionally Wrong: The Past Record*

Indian Corporate sector has faced a major criticism for its poor record in complying with norms of corporate governance as the presence of large- family dominate business has posed serious threats to accountability and transparency. Traditionally, in most of these enterprises, majority stakeholders have been the family members who did not find it compelling to disclose sufficient information to the IDs and hence it became an arduous task for them especially considering the fact that they used to attend very few meetings per year which were ceremonial to a large extent. This made it impossible for independent directors to comprehend fully the issues before the boards and to be accountable in large business structures. This was in total contrast with the more efficient western enterprises where IDs are viewed as partners of management and 'outside guardians'[6] whose job is to ensure that the management stays focused on delivering shareholder value.

b. *Clause 49: Independent Directors get a Boost*

In India, the SEBI monitors and regulates the corporate governance of listed companies through clause 49 of the Listing Agreement. SEBI in 2003 launched this landmark initiative towards achieving higher corporate governance after being influenced by the Sarbanes- Oxley Act of 2002 in USA and the New York Exchange regulations in 2003. After introduction cl. 49 was to apply to companies in a phased manner, firstly it applied to all Group- A companied and then to other listed companies with a minimum paid up capital of Rs. 10 cr./ net worth of Rs. 25 cr. Later it was amended and issued with several new changes.'

The new clause lays down more stringent qualification for independent directors than the previous one and most prominent is that it took away discretionary powers conferred upon the board to decide whether the independent director's material relationship with the company had affected his independence apart from increasing the number of mandatory board meetings from 3 to 4. The clause lays down an inclusive definition wherein independent directors are not supposed to have any kind of pecuniary relationship with the company, its promoters,

[5]Martin Wheatley, Corporate Governance - Time to Take Stock, October 2006, available at: http://sc.sfc.hk/gb/www.sfc.hk/sfc/doc/EN/speeches/speeches/06/mw_061014.pdf (last visited on January 22, 2020)

[6] Jitendra Singh, Mike Useem & Harbir Singh, Corporate Governance in India: Is an Independent Director a Guardian or a Burden, February, 2007, available at http://knowledge. Wharton.upenn.edu/India/ article.cfm?articleid=4157 (Last visited on January 19, 2020).

management or its subsidiaries, which may affect the independence of their judgment.

D. Resistance to the Change: Do we really need Independent Directors?

The new guidelines by SEBI faced stiff resistance. The foremost argument that was presented against its implementation was the paucity of the qualified personnel.[7] The clause mandates that independent directors should constitute 50% of a company's board, the omission of which can lead to imposition of severe penalties. Furthermore, it was argued that such directors who would attend only a few board meetings and may tend to be obstructive to the functioning of the board as they will profess their expertise without fully knowing the conduct of the affairs. Besides, in the context of family dominated business, the independent directors may not be in a position to exert requisite influence.

The first argument may be outright dismissed as it is unimaginable to think the in a country like India, finding a qualified person could prove to be too onerous. Arguendo, if it is so, there is still no reason to suggest that there is sufficient talent to appoint directors but not independent directors. With the appropriate training, this paucity could easily be overcome and pave the way for better governance in the corporate regime. As for the second argument, it may be turned around on itself. India must continue to strengthen the institutional support the independent directors, they must be allowed to participate more with the board of directors and be more vocal with their contributions to play an effective role.[8] It has been shown that the only reason why independent directors have successfully averted the potential fiascos and promoted accountability towards shareholders has been on the account of their considerable involvement within the company. Such kind of support must continue. Therefore, while it can be a matter of debate as to what percentage of board must be constituted by such IDs, the importance of having a considerable number is definitely not.

E. The New Experience: Any Benefits?

An analysis of the Sarbanes- Oxley effect in NYSE suggested that the compliance towards the corporate governance standard have increased substantially due to these regulations, but at the same time the cost for companied to list with it by hiking their compliance cost has also increased. For e.g. if the compliance cost for a company with its total revenue is $ 50 million, then the compliance cost alone is $ 3 million. Therefore the compliance may, in fact land up serving as a hurdle for listing.[9]

Some studies also suggested a positive interaction between stronger share holder rights and higher profits and sales growth & lower capital expenditure and corporate acquisitions.[10] In fact, the investor are more inclined to invest in those share which offer them the strongest democratic rights and

[7] N. Venkiteswaran, Independent Directors: Key to Corporate Governance, Business Line, July 21, 2005, available at http://www.thehindubusinessline.com/2005/07/21/stories/2005072100831000.htm (Last visited on January 19, 2020).

[8] *Id.*¶ 12.

[9] supra note 5.

[10] Rashmin Sanghvi, Independent Directors, August, 2005, available at http://www.domainb.com/management/general/20050825_independent_directors.html (Last visited on January 18, 2020)

dispose off their investments in those with the weakest rights. A US study also suggested a link between the increased sensitivity of CEOs towards the performance of the company and the increased representation of IDs on the board.[11]

F. The Committee Reports and Suggestion

In 2004, the *J.J. Irani Committee*[12] recommended that the provisions of cl.40 of the Listing Agreement should be extended to all 'large' companies. The committee reaffirmed the belief that the concept of corporate governance and the principle of independent directors are closely intertwined and presence of such directors in considerable amount would improve governance.

With respect to widening the scope of cl. 49, the committee suggested a sensitive approach to the specific kinds of companies and disagrees with the philosophy of 'one shoe fits all'. Wherever a company involves the interest of the public, at least one-third of the board must consist of IDs. On the issue of nominal directors on the board who are representative of institutions, Committee recommends to not equate them with IDs since they represent only the interest of one section.

The Report of *Kumar Mangalam Birla Committee*[13] in 1999 on Corporate governance criticized the traditional practice of hand- picking of the IDs as such selection itself takes away the independence of the directors. This loophole still remains as a paradox; how independent can a director be if he is dependent on the promoters for his job? Another loophole which has been sufficiently looked into is the remuneration offered to the IDs. The Birla Committee was of the view that adequate compensation packages must be provided to the independent directors to make their positions more financially attractive to draw talent and ensure integrity in their working.

In 2002, *Naresh Chandra Committee*[14] reiterated the need for the expansion of companies under Clause 49 of the Listing Agreement. Through the course of all three of the herein mentioned reports, the scope of independent directors in the context of Indian business has become more cleared and widened.

G. The Companies Act, 1956 and Independent Directors

The Act looks at all kinds of directors in the same light. While the provisions of extra compliances are provided for the full time directors, it does not exempt IDs from any of the duties, responsibilities or liabilities of the board. As a result of this the IDs are included into the corporate governance team as any other director and are bestowed with the same powers.

Sections 274[15], 284,[16] 291,[17] 297,[18] 299[19] & 300[20] of the original Act was applicable to all

[11] Hermalin & Weisbach as quoted in Kothari, supra note 4.

[12] Report of the Expert Committee on Company Law, available at http://icai.org/resource_ file/ 10320announ121.pdf (Last visited on January 20, 2020).

[13] The Report of the Kumar Mangalam Birla Committee on Corporate Governance, available at http://www.sebi.gov.in/commreport/corpgov.html (Last visited on January, 22, 2020)

[14] The Report of the Naresh Chandra Committee on Corporate Audit and Governance, available at http://finmin.nic.in/downloads/reports/chandra.pdf (Last visited on January 22, 2020).

[15] The Companies Act, 1956. § 274.

[16] The Companies Act, 1956. § 284.

[17] The Companies Act, 1956. § 291.

[18] The Companies Act, 1956. § 297.

[19] The Companies Act, 1956. § 299.

[20] The Companies Act, 1956. § 300.

directors, while § 309(4[21]) allowed for separate limits and restriction to be made applicable on the remuneration of IDs only. Apart from this, other liabilities under other laws as well can also be applied. Any communications addressed to the directors of the company are deemed to be addressed to the independent directors as well. The classic example is the Worldcom and Enron settlement, in this case the liabilities extended to the IDs to the tune of $18mn by 10 IDs of Worldcom and $13mn by the IDs of Enron. However in the context of India it can be argued that liability arises only on the account of omission to do certain act or misconduct on the part of director and not by the mere fact of holding an office.[22]

H. The Satyam Fiasco

The blowing up of the irregularities in corporate governance, which came to light with the investigation into the Satyam fraud has given an impetus to contemporary debate on the role of IDs and the urgent need to improve corporate governance structures in India.[23] The question arose when the investors and regulators doubted and questioned a bid by the founder of Satyam B. Ramalinga Raju to acquire a firm promoted by his kin. In the aftermath of the Satyam fiasco, nearly 350 IDs resigned from their posts across India which was a clear indication to the investors that all is not well within the boards.[24] This might perhaps attributed to the fact that an adequate proportion of IDs do not feel confident of facing the consequences of the conduct of their companies. This may be because they either already have the knowledge of illegal conduct but have failed to influence the board to act upon it effectively or they are not in control of the happenings of the company.

I. The Way Forward- Companies Act, 2013

The Companies Act, 2013 came up with stringent provisions than that of the listing agreement. The Act in itself came up with a dedicated chapter on Corporate Governance.[25] Under this law, various provisions were made under at least 11 heads viz. Composition of the Board, Woman Director, Independent Directors, Directors Training and Evaluation, Audit Committee, Nomination and Remuneration Committee, Subsidiary Companies, Internal Audit, Serious Fraud Investigation Office (SFIO), Risk Management Committee and Compliance to provide a rock solid framework around corporate governance.

a. The Rationale behind Independent Directors

There are two types of directors in any company viz. Executive Directors (EDs) and Non- executive Directors (NEDs). The NEDs are further divided into 2 categories viz. Independent Directors (IDs) and others. The IDs are primarily meant to oversee the functioning of the board and ensure that their decision do not hurt the interest of the minority shareholders. The current norms demand that the two third members of the

[21] The Companies Act, 1956. § 309, cl. (4).

[22] S.M.S Pharmaceuticals Ltd. v. Neeta Bhalla, (2005) 8 SCC 89.

[23] Naveen Srivastav, Shigufta Hena Uzma, Satyam Fiasco: Corporate Governance Failure and Lessons Therefrom, January2010,https://www.researchgate.net/publication/228118526_Satyam_Fiasco_Corporate_Governance_Failure_and_Lessons_Therefrom (last visited on January 22, 2020).

[24] Manoj Shivanna, The Satyam Fiasco- A Corporate Governance Disaster, May 2010. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616097 (last visited on January 22, 2020).

[25] The Companies Act, 2013. Schdule IV.

Audit Committee and the Chairman should also be Independent. An independent director can serve in the same capacity in maximum seven companies. Further, if a person is whole-time director, he cannot be an independent director in more than three listed firms. An Independent *Director who has already served on a company's board for 5 years can serve only one more term of 5 years. Companies are now required to disseminate Independent Director's resignation letter to Stock Exchanges & on company website.*

IV. *Conclusion*

The objectives of corporate governance cannot be perhaps met without the involvement of independent directors in the larger schemes of things. This becomes even more compelling in the context of burgeoning state of Indian economy with unprecedented amount of funds flowing into the companies from within and outside the country. With the growth in business, there is a rise in the expectations that Indian companies would follow the higher standards of corporate governance in a manner clearly demonstrable to the shareholders. It has been a long standing demand for greater transparency in the procedures and functioning of the Indian market and companies with are now being met through various new proposals, amongst which a wider role for IDs has been a welcome move.

Cl. 49 of the Listing Agreement should come as a reminder to the directors that they are accountable to the shareholders of the company and not the management. They are in a fiduciary relationship with their investors and to dispense with such fiduciary obligations, it is not sufficient to show the mere absence of fraud or bad faith. Instead, such relationship implies the need for an affirmative action. Furthermore, there are many things which do not find its clarifications in the listing agreement, for e.g. - if it is revealed at a later date that the ID on the board is not in fact independent; what would happened to the decision of the boars in such circumstances.

However, in coming few years, one would expect to see more active co-operation from IDs. At the same time, investors must also play an active role in their demands and expectations of the highest level of governance by exercising their rights.

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