THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE

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Independent directors have emerged as the cornerstones of the worldwide corporate governance movement. Their increased presence in the boardroom has been hailed as an effective deterrent to fraud and mismanagement, inefficient use of resources, inequality and unaccountability of decisions; and as a harbinger for striking the right balance between individual, economic and social interests. While presenting the Berkshire Hathaway 2002 report to shareholders, Warren Buffet criticized the performance of independent directors attributing their inability to participate to the extent of their potential to the lack of a conducive ‘boardroom atmosphere’ and the presence of ‘well-mannered people’ who were unlikely to raise a voice against the flow of the current. While Buffet reasoned that inadequacy of law was not the culprit, it cannot be denied that law is perhaps the only tool which can be used to tame this counter-productive boardroom environment. This paper shall study the concept of independent directors and their inter-relation within the corporate governance framework in India; their appointment, their envisaged role, their liability and the evolution of the concept in India and practical experiences. It shall attempt to outline the broad shortcomings of the current approach and make recommendations which include structural changes as well as a change in the attitude of corporate India.

I. INDEPENDENT DIRECTORS

“Impartial. Unable to perceive any promise of personal advantage from espousing either side of a controversy.”
- Ambrose G. Bierce, 19th century American writer

A. SPOTTING INDEPENDENT DIRECTORS IN THE WIDER WEB OF THINGS

With the Satyam fiasco still fresh in our memories, newspapers and journals have been abuzz with articles and reports proclaiming the need

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to strengthen our corporate governance systems day in and day out. Corporate governance is the new mantra; an old concept being pursued with a newfound vigour. The appointment and functioning of independent directors is part of a larger scheme to bring about more accountability into the workings of corporations.

It is undeniable that the corporate scenario has undergone a sea of change over the last few decades. There is an increase in the variety of stakes in the modern corporation and a diversification of the equity capital leading to a larger distance between capital owners and capital managers.¹ There is a strong undercurrent giving rise to the institutional investors which have in turn allowed the corporations to expand their presence, economically and physically, over trans-national boundaries.

Change must follow change. In this case, it is a matter of the system keeping pace with the realities. It is only expected of corporate governance to attempt to reconcile the functioning of the corporations with these emergent ground realities, which often vary from one country to another.

The fundamental purpose behind the appointment of independent directors is, so to speak, impartiality. Companies wish to identify directors who are capable of dispensing their duties without any conflict of interest in their judgment. To ensure this, there are certain guidelines which must be borne in mind while appointing independent directors. While a rigid definition would prove to be more detrimental than beneficial, the company must take a flexible stand in view of the prevailing circumstances to ensure that the following criteria are best met.

B. DEFINING AN “INDEPENDENT DIRECTOR”

According to the indicative definition by the International Finance Corporation (‘IFC’),² independent directors must fulfil certain prescribed minimum requirements. The standard which is sought to be established attempts to ensure the integrity of decision making; unhampered by circumstances extraneous to the interests of the company, i.e. they reduce the scope of interference by such circumstances.

1. The IFC Model

The IFC definition mandates that only those individuals may be considered for appointment as independent directors who have not been employed by the company or its related parties in the five years preceding the date of appointment. Moreover, they should not be affiliated with a company that is an advisor or consultant or significant customer or supplier to the company. They should not have personal service contracts with the company or its related parties or its senior management or be affiliated with a non-profit organization that receives significant funding from the company.

Ideally, independent directors 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.

Also, they should not have been affiliated with or employed by a present or former auditor of the company in the five years preceding the appointment or be a controlling person of the company (or member of a group of individuals and/or entities that collectively exercise effective control over the company) or such person’s brother, sister, parent, grandparent, child, cousin, aunt, uncle, nephew or niece or a spouse, widow, in-law, heir, legatee and successor of any of the foregoing (or any trust or similar arrangement of which any such persons or a combination thereof are the sole beneficiaries) or the executor, administrator or personal representative of any person described in this subparagraph who is deceased or legally incompetent.

2. The SEBI Model

The Securities and Exchange Board of India (‘SEBI’) has issued similar guidelines for the appointment of independent directors. These, however, are less stringent than those recommended by the IFC. As per SEBI, the expression ‘independent director’ refers to a non-executive director of a company who does not have any material pecuniary relationships or transaction with the company or its promoters or directors or senior management or holding company or subsidiaries and associates, apart from receiving the director’s remuneration, which may affect independence of the direction.

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3 *Id.*, for the purposes of these guidelines, “Related Party” means, with respect to the Company, any person or entity that controls, is controlled by or is under common control with the Company.

4 *Id.*, for the purposes of these guidelines, affiliated means: (1) a direct or indirect ownership interest, and (2) employment by such a party.

5 *See Cl. 49 A(iii) of the Listing Agreement.*
Independent directors must not be related to the promoters or persons occupying management positions at the board level or one level below the board or have been an executive of the company in the preceding three financial years. They must not have been a partner or an executive or involved with the statutory audit firm associated with the company or a legal or consulting firm with material association with the company at any time in the preceding three years. They must not be a material supplier or service provider or customer or a lessor or lessee or a substantial shareholder of the company.

C. READING IN BETWEEN THE LINES – A PURPOSEFUL DEFINITION

We see that comprehensive definitions have been propounded from which our understanding of independent directors emerges. We’ve looked at an international model and compared it with the Indian model. But what is the purpose behind instituting such expansive and rigid definitions? Since the definitions seem to heavily focus on an independent direction of thought – is there a deliberate attempt to weed out certain influences?

Randall Morck in the introduction to his paper on Independent Directors and Behavioral Finance in Corporate Governance begins with a quote by Woodrow Wilson – Loyalty means nothing unless it has at its heart the absolute principle of self sacrifice. He goes on to discuss how misplaced loyalty lies at the heart of numerous scandals in corporate governance – where directors overlooked their duties towards the shareholders and obedience to the law in the midst of their loyalty towards over-zealous executive officers. These directors could have very well prevented some of the biggest corporate scandals – Enron, Worldcom, Hollinger and even the recent Satyam disaster by asking the right questions and demanding the answers.

It is in this light that we must examine the definitions of independent directors. These definitions put unequivocal stress on the need for ethical integrity – the core principle which demands that their decisions be free from doubt as to any conflict of interest, real or perceived, in their minds. The following chapter examines the role played by these directors in corporate governance.

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6 Substantial Shareholder is defined as those shareholders who own 2 per cent or more of the voting shares.
II. INDEPENDENT DIRECTORS & CORPORATE GOVERNANCE

A. CORPORATE GOVERNANCE & INDEPENDENT DIRECTORS

Adam Smith, way back in the late 18th century, described an invisible hand of self-interest that motivated the proliferation of business. Arguably, the situation may have changed today, however what has also come to be of concern with regard to corporations is the self-interest in the working of directors within it.

Governance, it is said, is about ‘steering’ a company in the right direction. The former SEBI Chairman, Mr M. Damodaran, described corporate governance as a continuing process beyond the scope of mere legislation. What he implied was that governance mandates practices for which the legislative requirements should only be the starting point. Companies must pay heed to these practices not because of fear of sanction, but because in the absence of such governance the companies would fail to achieve true profitability. In his address, the former Chairman spoke of independent directors as functionaries who contribute to the Board with their divergent views. Another speaker referred to them as the “conscience keepers” who could guide the company towards its right interests when others may have been influenced by other interests.

Other thinkers have described corporate governance differently. While some have thought of it as a journey and not a destination, a few have compared it to “trusteeship”. But irrespective of these different approaches, the subject matter and purpose of corporate governance remains undisputed – even more so vis-à-vis the role played by independent directors.

Independent directors broadly fit into the overall structure of corporate governance. Their appointment ensures an effective and balanced composition of the boards. It is widely recognized that the board of directors is the most significant instrument of compliance with corporate governance. Ergo, the constitution of this board and its supervision is of utmost importance.

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8 Adam Smith in An Inquiry into the Nature and Causes of the Wealth of Nations (1776) put forth his view that every individual necessarily labours to render revenue to the society as great as he can without, in general, the intention of promoting any larger public interest and that individual simply intends his own gain. Smith goes on to state that by pursuing their own interests, individuals usually benefit the society at large more effectively than when the intention may be to promote public interest.

Putting this in perspective, the guidelines for the selection of independent directors are fortified by regulatory mechanisms which seek not only to provide for the qualification of these directors but also to secure a minimum fixed proportion of such independent directors on the board.

The independent directors contribute to the board by constructively challenging the development of policy decisions and company strategies. They also scrutinize the performance of the management and hold them accountable for their actions. Their independence, on account of lack of affiliation which is likely to prejudice their decisions, allows them to fulfil these tasks more efficiently. While they are answerable for the company’s actions, they are less likely to be affected by self-interest in these actions.

This puts them in a unique and advantageous position to question the company’s practices. It is because of this fact that, in practice, independent directors have conventionally been viewed as “adversaries” within the board. Their position has, however, gradually become more acceptable with the realization that independent directors bring something more to the table. Even when they stand in opposition to the other directors, the tension created within the board is nothing but positive tension. In the long run, independent directors bring with themselves a more balanced perspective.

The independent directors must meet at least once a year without the chairman or the executive directors and a statement in the annual report declares whether such a meeting was conducted or not. This is, again, to encourage the independent and uninfluenced judgment of the independent directors while keeping in mind the accountability owed to the shareholders of the company and to dissuade any self-interest to creep into the management of the affairs.

Apart from attending the annual general meetings and discussing the issues relating to their non-executive roles (which may vary depending on the company), they periodically review legal compliance reports prepared by the company and review the steps taken by the company to rectify any shortcomings.

What is interesting to note is the considerable effort, via institutional guidelines, to encourage the appointment of independent directors. For instance, the New York Stock Exchange regulations demand that a majority of the board of directors of a listed company comprise independent directors, for which it provides a stringent qualification. In addition, companies listed on the exchange must compulsorily have certain committees (such as Corporate Governance Committee, Audit Committee, etc.) which must consist only of

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10 Kothari, supra note 1.
independent directors. Ever since the practice of appointment of independent directors has been recognized as a legitimate means to bring about more transparency in corporate governance, increasingly more countries have adopted similar guidelines.

B. THE INDIAN CONTEXT

1. Conventionally Wrong: The Past Record

In the past, the Indian corporate sector has faced major criticism for its poor corporate governance compliance record, as the presence of large family-dominated businesses has posed serious threats to transparency and accountability. Traditionally, the major stakeholders in most of these enterprises have been family members who did not find it compelling to reveal sufficient information to the independent directors. Keeping a check on accountability and transparency became an arduous task for the independent directors especially because they attended very few meetings per year which were to a large extent ceremonial in nature. This did not make it possible for independent directors to fully comprehend the issues before the board and to be accountable in large business structures which were often conglomerates having diverse interests and investments. This may be contrasted with the more efficient western enterprises where independent directors are viewed as partners of management and as “outside guardians”,11 whose job is to make sure that the management stays focused on delivering shareholder value.

2. The New Clause 49: Independent Directors Get a Boost

In India, the SEBI monitors and regulates corporate governance of listed companies through Cl. 49 of the Listing Agreement. Influenced by the Sarbanes-Oxley Act of 2002 in the United States of America and the New York Stock Exchange regulations in 2003, SEBI launched a landmark initiative towards achieving higher corporate governance standards. SEBI issued Cl. 49 of the Listing Agreement which was to apply to companies in a phased manner. It applied first to all Group-A companies and then to other listed companies with a minimum paid-up capital of Rs. 10 crore / net worth of Rs. 25 crore and finally to companies with paid up capital of Rs. 3 crore / net worth of Rs. 25 crore. Later, SEBI amended the original clause and issued a new Cl. 49 with several changes.

The new Cl. 49 lays down a more stringent qualification for independent directors than the old clause and took away the discretionary power

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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 minimum number of audit committee meetings was also increased from 3 to 4.

As already discussed,\textsuperscript{12} Cl. 49 lays down an inclusive definition wherein independent directors are those directors who do not have a pecuniary relationship with the company, its promoters, management or its subsidiaries, which may affect the independence of their judgment. This is in contrast with the British definition based on the Higgs report, which is an exclusive definition specifying who cannot be appointed as an independent director. The latter appears to be more appropriate as it clearly provides who is not acceptable as an independent director while the Indian definition seems too restrictive.

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

The introduction of the new guidelines faced stiff resistance. The foremost argument against its implementation was that there was a paucity of qualified personnel.\textsuperscript{13} Most of the listed companies, out of 9000, were required to comply with Cl. 49 of the Listing Agreement by December 31, 2005, which mandates that independent directors should constitute 50 percent of their Boards; otherwise the defaulting companies will have to face severe penalties.\textsuperscript{14} An estimate puts the requirement of independent directors at over 30,000.\textsuperscript{15}

Moreover, it was argued that such directors who would attend very few board meetings (a minimum of four a year) and may tend to be obtrusive to the functioning of the board by professing their expertise without fully appreciating the conduct of the affairs. Besides, in the context of family-dominated Indian companies, where the promoters’ interests often over-shadow those of the share-holders, the independent directors may not be in a position to exert sufficient influence.

The first argument may be outright dismissed. It is unimaginable to think that in a country as populous as ours, finding qualified personnel could prove to be too onerous. Even if so, there is no reason to suggest that there is sufficient talent to appoint directors but not independent directors or that those

\textsuperscript{12} See discussion in Part II.B.


\textsuperscript{14} SEBI had issued a notification that failure to comply with the Clause would result in the companies being delisted. Even individual stock exchanges have been empowered to take such action against defaulting companies.


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with materially significant dealing with the company are likely to be any more qualified than those independent of such dealings. With the appropriate training, this paucity could very easily be overcome and pave the way for a more promising corporate governance regime. It has been pointed out that this, in fact, is a legitimate concern and it would perhaps take some time before the demand-supply gap could be effectively bridged, it is nonetheless a necessary move.\footnote{See Singh, Useem & Singh, supra note 11.}

As far as the second argument is concerned, the argument may be turned around on itself. India must continue to strengthen the institutional support towards independent directors to safeguard the interests of its industry. Independent directors must be allowed to be more involved with the board of directors and more vocal with their contributions to play an effective role. Our experience has shown that thus far, the only reason why independent directors have successfully averted potential fiascos and promoted accountability towards shareholders has been on account of their presence in considerably large numbers.\footnote{Supra note 11.} This support must continue. Therefore, while it may be open to debate as to what percentage of the board must be constituted by such independent directors, the importance of having a sufficiently large number is not.

4. The New Experience: Are there any benefits?

An analysis of the Sarbanes-Oxley effect in the New York Stock Exchange indicates that the regulations have substantially improved corporate governance standards but have increased the costs for companies to list with it by hiking their compliance costs. For instance, the compliance cost for a company with revenue of up to $50 million, the compliance cost may be as high as $3 million.\footnote{See Singh, Useem & Singh, supra note 11.} Therefore compliance may, in fact, land up serving as an obstacle for listing. This, however, is just one aspect of the consequences.

Research has confirmed that compliant companies do benefit with higher accountability and increased investor confidence. Some experts believe that over the next decade, it may be possible to achieve the highest levels of transparency and reliability.

Studies suggest a positive interaction between stronger shareholder rights and higher profits, higher sales growth, lower capital expenditure and lower corporate acquisitions. In fact, investors invest more in those shares which offer them strongest democratic rights and dispose off their investments in those with the weakest rights, and earn returns of over 8.5 percent through
this exercise. A US study has also found a link in between the increased sensitivity of CEOs towards performance and increased representation of independent directors.

5. The Committee Reports and Suggestions

The J.J. Irani Committee, 2004 (‘the Committee’) recommended that the provisions of Cl. 49 be extended to apply to all “large” companies. The Committee reaffirms the belief that the issue of corporate governance and independent directors are closely intertwined and presence of such directors in adequate numbers would improve governance.

With respect to widening the ambit of Cl. 49, the Committee suggests an approach which is sensitive to the specific kinds of companies and disagrees with a “one shoe fits all” philosophy. Wherever a company involves public interest, at least 1/3rd of the board must consist of independent directors. On the issue of nominal directors on the board who are representative of institutions, the Committee in clear terms recommends that such directors must not be equated with independent directors since they represent only sectional interests. It also elaborates on situations where independence may exist and may not exist.

The Report of the Kumar Mangalam Birla Committee (‘the Birla Committee’), 1999 on Corporate Governance had criticized the conventional practice of hand-picking of independent directors because such selection by itself takes away the independence of the directors. This loophole is yet to be fully addressed and still presents itself as a paradox - how independent can a director be if he is dependent on the promoters for his job?

Another shortcoming which has not been sufficiently set-off is the remuneration offered to independent directors. The Birla Committee was of the view that adequate compensation packages must be given to independent directors so that their positions become financially attractive to draw talent and ensure integrity in their working.

20 See Hermalin & Weisbach as quoted in Kothari supra note 1.
22 The Committee has left the task of defining “large” to the Government.
Even the Naresh Chandra Committee, 2002\textsuperscript{24} suggested expanding the companies covered under Cl. 49. Through the course of all three of the above mentioned reports, the definition of independent directors in the Indian context has become clearer and the scope of their application widened.

6. The Companies Act and Independent Directors

The Companies Act looks at all kinds of directors in the same light. While it provides for a few extra compliances for whole time directors and requires the disclosure by interested directors, it does not exempt independent directors from any of the duties, liabilities or responsibilities of the board. Therefore, independent directors are woven into the corporate governance team (after all that is the very purpose of their appointment) as any other director and are bestowed with the same power as the other directors.

\textsection{267} to \textsection{269}\textsuperscript{25} are applicable only to whole-time directors, while \textsection{274}, \textsection{284}, \textsection{291}, \textsection{297}, \textsection{299} and \textsection{300}\textsuperscript{31} are applicable to all directors. \textsection{309(4)} allows for separate limits and restriction to be made applicable on the remuneration of independent directors.

Apart from the liabilities that the director may invite as a corporate director, there may be other liabilities under other laws as well. Any communications addressed to the directors of the company are understood to address the independent directors as well.

For instance, in the Worldcom and Enron settlements, the liabilities extended to the independent directors to the tune of $18 million by 10 independent directors in Worldcom and $13 million by 10 independent directors in Enron. However, in the Indian context it may be argued that liability arises only on account of conduct or act or omission on part of the director to fulfil certain obligation, and not be the mere fact of holding an office.\textsuperscript{32}

7. In the Aftermath of Satyam: Lessons Learnt

The revelation of corporate governance irregularities which came to light with the investigations into the Satyam scam have given an impetus to

\textsuperscript{25} See Companies Act, 1956, \textsection{267}-\textsection{269}.
\textsuperscript{26} See Companies Act, 1956, \textsection{274}.
\textsuperscript{27} See Companies Act, 1956, \textsection{284}.
\textsuperscript{28} See Companies Act, 1956, \textsection{291}.
\textsuperscript{29} See Companies Act, 1956, \textsection{297}.
\textsuperscript{30} See Companies Act, 1956, \textsection{299}.
\textsuperscript{31} See Companies Act, 1956, \textsection{300}.
\textsuperscript{32} See S.M.S. Pharmaceuticals Ltd. v. Neeta Bhalla, (2005) 8 SCC 89.
contemporary debate on independent directors and the need to improve corporate governance structures in India. The role of the independent directors of Satyam came into question when the investors and regulators questioned a bid by the Satyam founder B. Ramalinga Raju to acquire a firm promoted by his kin.

In the immediate aftermath of the Satyam fiasco, nearly 350 independent directors resigned from their positions across India. The resignation of the independent directors signals to the investors that all is not well within the board. This is perhaps attributed to the fact that a considerable proportion of independent directors do not feel confident of facing the consequences of the conduct of their companies. This may be because they either have knowledge of illegal conduct and have failed to influence the board to counter-act effectively or because they are not in control of the happenings of the company – neither of the two reflect positively for the present state of corporate affairs in India.

It also brings to the fore another paradox – can independent directors be said to be independent if their jobs are in the hands of the promoters? If anything, this would make a case for a stronger voice (through numbers) for independent directors on the boards.

With the Satyam debacle behind us, there is optimism that corporate India shall heed to the reality that independent directors are so placed as guardians of the shareholders and that their accountability is of paramount concern to the investors and the company management alike.

### III. CONCLUSION

In conclusion, the objectives of corporate governance cannot, perhaps, be as effectively met without the inclusion of independent directors in the larger scheme of things. This becomes even more compelling in the context of a burgeoning Indian economy with unprecedented amounts of funds flowing into companies from within and outside the country. With this growth of business interest, there is a rise in expectations that Indian companies would abide by the highest standards of corporate governance in a manner clearly demonstrable to the investors. There have been long standing demands for greater transparency in the functioning of Indian companies which are now being met with through various proposals, amongst which a greater role for independent directors has been a welcome change.

Cl. 49 should also come as a reminder to directors that they are fiduciaries of shareholders, and not of the management and that there are continuous efforts being made to make them more accountable. To dispense with such fiduciary functions, it is not sufficient to show the mere absence of bad faith or fraud. Instead, this relationship implies the need for affirmative action.

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Inclusion of independent directors is a check on the management of companies as an oversight mechanism. Their ability to contribute to the board’s deliberations is an added bonus to voice the minority interests.

However, all is not merry. Certain things have not been clarified in the Listing Agreement. For instance, if it is revealed at a later date that the independent director on the Board is not in fact independent – what would happen to the decisions of the board?

Some experts have pointed out several deficiencies in the working of independent directors. These include complaints against their inability to find sufficient time and their lack of knowledge regarding the company affairs to fulfil the demands of their position. As noted in the paper earlier, there are concerns over the gap in between the demand and the actual number of qualified personnel.

These flaws are hardly unexpected. In a move which is likely to revolutionize the corporate governance structures in our companies, progress has to be steady even if slow. We need to contribute fruitfully to this process of transition. To address this paucity, institutions such as the Bombay Chartered Accountants Society have launched programs to professionally train individuals as independent directors.

In the coming few years, one would expect to see more active participation from independent directors. In addition to the aforementioned grey areas, solutions to other problematic areas- like the appointments which are handled by promoters, a comprehensive and clearer understanding of the responsibilities and greater empowerment of independent directors.

One possible model which has been suggested by critics of the present system focuses on handing over of the charge of training, recruiting, appointment and compensation of independent directors to a centralized authority under the SEBI.

Directors find themselves at the vanguard of the corporate governance revolution. They need to embrace the principles of good practices. At the same time, investors must also be pro-active in their demands and expectations of the highest level of governance by exercising their rights.

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33 Jay Lorsch, Professor at Harvard Business School, points out that the problems commonly faced with independent directors do not lie with people who serve on boards but instead the structure of the boards themselves. Thus, the underlying problem is that board members are part-timers who are time pressured and who often lack specific knowledge. See Jay Lorsch & Colin B. Carter, *Back to the Drawing Board: Designing Corporate Boards for a Complex World*, 2004, Harvard Business Press.

are in the right direction and recent events, particularly those discussed in the paper, further strengthen our resolve to pursue these objectives with utmost vigour.