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Role of Independent Directors in Corporate Governance

KEYWORDS

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ABSTRACT *As a system arrangement in corporate governance, implementation of the independent director will help improve structure of corporate governance, maintain interests of all stockholders, and protect rights and interests of small and-medium size of investors. There exist such many issues as insufficient information of independent directors, weak independence, low enthusiasm, and shortage of talents in the practice of the independent director system in India. Therefore, we should strengthen and optimize the independent director system with a Indian characteristic.*

WHO ARE INDEPENDENT DIRECTORS?

As per Clause 49 of the Listing Agreements an independent director shall mean non-executive director of the company who apart from receiving directors remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies; is not related to promoters or management at the board level or at one level below the board; has not been an executive of the company in the immediately preceding three financial years; is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity. is not a supplier, service provider or customer of the company. This should include lesser - lessee type relationships also; and is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

[Institutional directors on the boards of companies shall be considered as independent directors whether the institution is an investing institution or a lending institution.]

Global Developments

The concept of Independent Director entered the corporate world en route through US, though in latent form, as outside director supposed to fulfill the advisory role. The genesis of actual IDs began only in 1970s, as part of CG reforms to fulfill the monitoring role. During this transition period, concept of IDs get widespread currency, and so is, their rise on boards and various mechanisms to enhance the independence criteria. The position of IDs consolidated in the CG framework during hostile takeover period, with recognition of their role in enhancing shareholders prosperity. Subsequently, number of frauds in UK resulted in commissioning of Cadbury Committee on CG in 1992, which provided broadened definition of ID, their role and relation in the company. In 1997, Hampel committee (UK) and Blue Ribbon Committee (US), further defined and enhanced the role of IDs.

The paradigm shift however, occurred after number of corporate failures like WorldCom and Enron, with passing of Sarbanes- Oxley (SOX) legislation. The act not only it reinvented the role of ID but also made various corporate actions a necessity and increased the legal complexity. The SOX requires all the members of the audit committees to be independent with redefined roles and enforces strict penalties for any transgression. Higgs report (2003) on effectiveness of non- executive directors and Smith Report (2005) on audit committees, after the happenings in US, provided a big thrust to concrete the position of IDs in CG framework of UK.

The Higgs report particularly touched upon many aspects and proposed significant changes, redefined the independence and role non-executive directors, particularly IDs in the corporate board of the company. NYSE comprehensively revised its listing standards after SOX, requiring majority of directors to be independent, and strict independence criteria applied to all such directors, not just the audit committees. In wake of the recent financial meltdown, the role of IDS is under critical analysis in the developed world. A number reports in US and UK reports have looked upon the role of ID in the global financial crisis and pointed many flaws in the present system of IDs. They have stressed on need to strengthen the institution of IDs, so that they can play significant role in the avoiding failures of corporations.

Indian Scenario cum view of various committees

The term Independent Director" was first introduced in the Indian corporate arena through the **Kumar Manglam Birla Committee**, formulated by SEBI, to start up reforms in the area of CG. It soon found entry into corporate books, after Clause 49 was incorporated in Listing Agreement by SEBI. The Birla Report stipulates, Independent Directors are directors who apart from receiving directors remuneration do not have any other material pecuniary relationship or transactions with company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment. In the background of Enron debacle and sequel to SOX in US, Ministry of Company Affairs (MCA, then known as DCA) then constituted, the **Naresh Chandra Committee**, which give governance some more thought.

Committee recommendations were though much inclined towards audit and auditors; but it did brought some new thoughts to institution of IDs. It recommended IDs should not be less than fifty percent of the board. Nominee directors of lending institutions not be considered as independents. The recommendations encompassing the audit committees were identical to those of SOX, requiring

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all members of committee to be independent and having written charter for its function. It also provided impetus to ID remuneration, training and recommended to exempt them from criminal and civil liabilities. In 2003, SEBI constituted the **Narayana Murthy Committee** with terms overlapping with that of Chandra Committee, whose recommendations were incorporated in the Clause 49 by amending it in 2004.

The Murthy report adopted the same definition of IDs as formulated by the Chandra Committee, however, without the condition of nine-year term. It also pondered view on the qualification and remuneration of ID and stressed on the need evaluating performance of non-executive directors. The committee also enhanced the view of previous Chandra Report on audit committee, redefining its role and responsibilities, however, rejected the earlier of treating nominee directors of financial institutions at par with ID. Sequel to implementation of Murthy committee recommendation in Clause 49, MCA constituted another committee in December 2004 under the Chairmanship of Shri J. J. Irani, to give CG a legislative stamp by revamping the Companies Act, 1956.

The Irani Committee came up with several recommendations in relation to the IDs that were in conflict with the extant Clause 49 and/or the views of the Murthy Committee, e.g. (a) providing for several exemptions based on size and extent of public ownership in a mandatory CG framework so as to optimize compliance costs while maintaining a desired level of regulatory rigour; (b) the criteria for independence of IDs is proposed to be weakened significantly; (c) the mandatory requirement of IDs to constitute one-half of the Board be weakened to one-third of the total members of the Board (d) abolition of age limits for IDs. The present CG framework encompassing the ID is through Clause 49 based on the Murthy Report.

Connotation of establishing the independent director system

The reason for introduction of the independent director system in corporate governance, on one hand, was that the director should express his opinions when an independent director makes a decision, especially some significant decisions about enterprise merger, connected transaction, stock repurchase, and interest conflict between large and small stockholders.

Key role of an independent director in a company

- Board structure and objectivity of the Board
- Protection of minorities
- To build up shareholder's confidence in the company
- To improve relations with investors
- To make coordinated strategic decisions
- To resolve conflicts
- To enhance management transparency
- To increase company's value
- Role of other stakeholders in management
- System of reporting and accountability
- Audit and internal control
- Effective supervision and enforcement by regulators
- To encourage Sustainable Development of the Company and its stakeholders.

COMPANIES ACT AND INDEPENDENT DIRECTORS

The Companies Act looks at all directors alike:

- Throws some extra compliances in case of whole time directors
- Requires some disclosures by interested directors
- Defines officer in default giving a degree of immunity to directors other than the whole time directors

Does not exempt independent directors from any of the duties, liabilities, responsibilities of the Board. Independent directors as much as part of the corporate governance team as any other director. Independent directors have the same power that other directors have.

LEGAL PROVISIONS

Sec 5: officer in default:

- Independent directors are treated as such only where the company does not have a whole time director, or no specific director is charged with a particular compliance:
- Alas this provision is not applicable for compliances under any other law
- Sec 267-269 applicable only to whole time directors
- Sec 274: applicable to all directors
- Sec 284: procedure for removal of directors applicable to all directors
- Sec 291 general powers exercisable through board meetings
- Sec 292 certain powers may be delegated to whole time directors
- Sec 292A composition of the audit committee to include a majority of directors other than whole time directors
- Sec 297, 299, 300 applicable to all directors
- Sec. 309 (4):
- Separate limits and restrictions applicable on remuneration of independent directors
- Explanation IV to Schedule XIII: Managerial remuneration:
- Appointment and remuneration of managerial personnel to be decided upon by the remuneration committee. Committee to consist of at least 3 non-executive independent directors

INDEPENDENT DIRECTORS UNDER LISTING AGREEMENT IN INDIA Composition of the Board

- Not less than 50% of the board to be non-executive directors
- Independent Directors:
- If the chairman executive:
- At least half of the board should comprise of independent directors
- If Chairman non-executive:
- At least one- third of the board should comprise of independent directors
- Non-executive directors remuneration to be approved by shareholders
- Board meetings to meet at least 4 times, with gap not exceeding 3 months. Minimum information for board meetings laid down

Committees of Directors

- Audit Committee: requirements other than those u/s 292A shall have minimum 3 members all of them being non-executive and majority of them being independent
- Chairman of the committee shall be an independent director
- To meet at least thrice a year
- Company Secretary to act as secretary to the committee
- Remuneration Committee
- Shareholders/Investors Grievance Committee
- Limits on committee memberships and chairmanships

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LIABILITIES UNDER OTHER LAWS

The basic directorial liability apart, being a corporate director may invite liabilities under myriad Central, State and Local laws:

- Most often, notices, summons, etc are addressed to all directors Sometimes, IT searches are also unable to distinguish between working directors and independent directors.

RECENT EXAMPLES OF LIABILITIES OF INDEPENDENT DIRECTORS

- In case of Worldcom and Enron, directors settled liabilities:
- $ 18 million by 10 outside directors in Worldcom
- $ 13 million by 10 directors in Enron
- In Walt Disney case, the court did not impose liability on directors:
- Ruling based on Delaware law
- Duty of care, fiduciary duty and gross negligence discussed at length India:

The conclusion is inevitable that the liability arises on account of conduct, act or omission on the part of a person and not merely on account of holding an office or a position in a company. SC ruling in SMS Pharmaceuticals Ltd, Sept 2005

On one hand, independent directors can be arrested for minor offences that they are not even connected to, like bounced company cheques, late employee provident fund payments, even though they do not manage the company. On the other hand, there is no law Company, SEBI or otherwise, that defines the responsibility of independent directors and hence their accountability. Of course, fraud or collusion in fraud is punishable under the criminal code, but there is no booking negligence. Which means, independent directors with a silent conscience those who turn a blind eye to mismanagement, can escape without punishment.

i) Duties/ Responsibility/ Liabilities of the independent directors according to the Companies Bill 2009

The new clause 147 (1 to 6) of the Bill lays down duties of a director (including ID). According to provisions of 147 (3), an ID should exercise his duties with due and reasonable care, skill and diligence. The clause 158, which corresponds to some provisions of the 292A of present Act, requires ID should form the majority and chair the audit and remuneration committee. The Chairman of stakeholders committee should also be non-executive director. In the light of this, the responsibilities of the IDs have enormously increased; he is also liable for financial penalties in failing to do so. Under provisions of the Bill, if a person who has given his consent to become the ID cannot relinquish from his responsibilities.

Further, if we look at definition of officer in default provided in the clause 2 (zzi) of the Bill corresponding to the section 5 of the Companies Act, the IDs are included in same. By virtue provisions of same clause: (vi) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance. They are subject to liable for criminal and financial penalties according to clause 120 (7) of the Bill.

In Companies Act 1956, on careful analysis, it can be observed that IDs are included in the definition of Officer in default under section 5. On referring to section 292A on audit committees, the IDs are highly liable for both financial and criminal penalties, as being officer in default for any misdeed. However, the accused ID can be granted relief by court, if they can satisfactorily prove that they have performed their functions honestly and exercised it with due diligence, care and caution. In most of cases, however, the director has to face the trial and has to proof in front of court that he has performed his care and diligence and he is not involved in the given accusation. The relief to prosecution is not automatically granted to ID under the present framework. The listed cases torch light on the discussed issue:

1) Supreme Court: N.K. Wahi v. Sekhar Singh and others (2007) 2 LJ 10 (SC);

2) Rajasthan High Court: Alim Ahuja v. Registrar of Companies (2005) 62 SCL 110 (Raj);

3) Supreme Court: SMS Pharmaceuticals Limited v. Neeta Bhalla [2005] 6 CLJ 144 (SC);

The Satyam fiasco has raised questions over the responsibilities and liabilities of the IDs. Serious Fraud Investigation Office (SFIO) has filed seven cases against eleven ex-directors (including IDs) of Satyam. Followed by this, AP government move to arrest the ID of Nagarjuna Finance in alleged involvement of repayment of public deposits has worsened the situation. All this created a fear psychosis in the mind of ID. According a report, nearly 340 IDs have resigned from their post. Many people are now not advent to accept the post of ID and tarnish their reputation.

Conclusion :

I think, globally, we have same issue on independent directors. The mind set of the person getting appointed as director must be of one to act without fear or favor. If in your professional capacity, you feel the company is not acting in the interest of the stakeholders, you must question such actions and ensure that they are recorded in the minutes. We may not overcome the problem overnight but to slowly get over this issue, I have following quick

REFERENCE

1. Independent Directors must be appointed /nominated by a separate meeting of the minority shareholders, not representing the majority investors. A separate meeting of such minority shareholders must be conveyed prior to the AGM to nominate such independent directors and AGM should formally appoint such independent directors. The majority shareholders should not play any role in such appointments directly or indirectly. Any vacancy of the Board seat between two AGMs may be filled in by other independent directors continuing on the Board like Additional Director. 2. To ensure that the independent directors spend adequate time, they must be compensated well. Mere sitting fees of Rs.20,000 is obviously not enough. Such fees can be capped based on profits of the company or can be a fixed sum. 3. Independent Directors should not get any options. Having options, generally may affect their independent status. 4. Chairmen of the committees must be a rotating position. At least in three years, a new member must be appointed as chairman of Audit /Compensation committee. Such provision would help a board to get new and fresh views. 5. Liability of independent directors should be distinguished from the executive directors and non independent directors. No criminal liability should be attached to independent director for the acts of the company or other executive directors unless the independent director has personally committed a willful criminal act. This obviates the situation where independent directors can not be arrested unless personally and willfully involved in a criminal act.