

Independent Directors: An Indian Perspective

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INTRODUCTION

The subject of Corporate Governance has drawn a considerable amount of attention in the recent times both in India as well as all over the globe. The concept primarily rests on basic principles of corporate governance, i.e. fairness, integrity, transparency and accountability of the management, with a sharp focus on investor protection and maximizing of shareholders' wealth.

The acid test of good governance lies in managing a company in a transparent manner - ensuring investor protection and maximizing long-term worth of the investments. A key element of good governance lies in maintaining transparency, which incorporates a system of checks and balances between key players like Boards, Management, Auditors, Investors and other stakeholders. In this context, the role of Independent Directors has come to be viewed as significant, since they are expected to bring an element of objectivity and independence in the boardroom practices and management decisions. The subject of Independent Directors shot into the centre stage ever since the courts in India ruled [8] in the Satyam saga that the Independent Directors are equally to share the burden of negligence of duties, same as for the executive directors. The issue is now up for a closer scrutiny, and a critical evaluation by the business fraternity, encompassing both the academicians as well as practitioners, is required.

BOARD OF DIRECTORS

The Board of Directors is a team of professionals at the highest level of hierarchy in a company, working full-time or part-time and are entrusted to make business decisions. The Board of Directors play a key role in corporate governance. It is their responsibility to endorse the organization's strategy, develop directional policy, supervise and remunerate senior executives and ensure the accountability of the organization to its owners and authorities. The board's primary responsibility is to steward the company to achieve its full potential [15].

Directors comprise the Board as its members. They are trustee managers of a company who are entrusted to keep the business going, with a view to ensure that the outfit survives to stay in business and grows to prosper and diversify to succeed in the long run to accomplish the goals set by the promoters. Section 2(13) of the Companies Act, 1956, defines a Director as, "*any person, occupying the position of a Director, by whatever name called. They are professional men, hired by the company to direct its affairs. But, they are not the servants of the company. They are rather the officers of the company.*"

Based on their working relationship with the company, the Directors are primarily of two types :

- a. *Executive Directors* are also called *Functional / Full time Directors*.
- b. *Non-Executive Directors* are also called *Non-functional / Part time Directors*. In the corporate circles, such individuals are legally termed as "*Independent Directors*" if they are not nominated by FIIs and do not have any other relationship with the company or any member of its management.

RESPONSIBILITIES OF THE BOARD [9]:

- 1) Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- 2) Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- 3) The board should apply high ethical standards. It should take into account the interests of stakeholders.
- 4) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans;

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setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

- 5) Monitoring the effectiveness of the company's governance practices and making changes as needed.
- 6) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- 7) Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
- 8) Ensuring a formal and transparent board nomination and election process.
- 9) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- 10) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
- 11) Overseeing the process of disclosure and communications.
- 12) When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
- 13) Board members should be able to commit themselves effectively to their responsibilities.

INDEPENDENT DIRECTORS

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The term '*Independent Directors*' became a part of the Indian corporate glossary subsequent to release of the Kumar Mangalam Birla Committee Report [13] in 2000. Three years later, the Naresh Chandra committee gave governance more thought. Finally, in 2004, the Narayana Murthy committee recommendations lead to the inclusion of Clause 49 in the SEBI listing agreement. As at present, the existing company law does not mention of independent directors.

IDs are appointed with an objective to bring a fresh and independent orientation, coupled with transparency to the decision-making by the board with a view to taking the business forward. The guidelines [2] on the subject prescribe that a company headed by an executive chairman shall have not less than 50% independent directors. A company with a non-executive Chairman should have 1/3 rd of its Board constituted of independent directors. The Independent Directors are looked upon as agents of change in the field of corporate governance and are considered to be the cornerstones of good governance [6].

The institution of an Independent Director seeks to bring credibility to the Board of directors. The attributes of IDs are independence of mind, integrity and the courage to question the decisions in the broader interest of stakeholders and the company itself [19].

PURPOSE

A common feature of the Joint-Stock Companies is that they have well designed systems in place, which allow sufficient freedom to the boards and management to take decisions towards the progress of the companies and innovation, while remaining within a framework of effective accountability. It is important that insiders do not take undue advantage of their position and draw unfair advantage. In order to prevent such a situation, the demand for Independent Directors has risen during the recent years in India. It is widely believed that the Independent Directors can counterbalance managerial infirmities in the company. They would also ensure that the legal and ethical behavior of the company remains on the expected track. In short, it is believed that the Independent Directors play a crucial role in upholding the principles of corporate governance.

ELIGIBILITY

SEBI has issued only non-mandatory guidelines [2] advising the companies to ensure that the IDs should have the requisite qualifications and experience. According to SEBI's Clause 49 of the listing agreement, the IDs :

- 1) Should not be related to promoters or the management at the board level or at one level below the board.
- 2) Should not have been a partner or an executive of the statutory audit firm or an internal audit firm or legal and consultancy firm, during the last three years.
- 3) Should not have been suppliers, service providers or customers of the company.
- 4) Should hold below two per cent of the shares of the company.
- 5) Should not have been an executive of the company in the immediately preceding three financial years.
- 6) Appointment of non-executive director beyond a continuous period of nine years is not permissible.
- 7) Nominee directors of banks or FIs will not be considered as independent directors.

APPOINTMENT

- 1) The promoters identify and put up the name of the person to the company's nomination committee, which is deliberated and normally approved.
- 2) The nomination is subsequently taken up for shareholders' approval at the AGM i.e. Annual General Meeting of the company shareholders, where again it is taken up for ratification.
- 3) In case of PSUs, the appointments are made by the administrative ministries concerned and orders are issued by the Department of Public Enterprises, Ministry of Heavy Industries, Government of India [11].

TENURE

IDs are appointed for a specific term and then are subject to re-election at intervals of not more than three years. At present, no maximum term has been defined, but evidence supports that after a few years, the so-called '*independence*' may wane, as familiarity breeds in with the passage of time. An ID should normally be expected to serve two three-year terms, unless exceptional circumstances make a longer term appropriate. Any extension beyond six years must be justified. Further, any ID serving nine years or more must be re-elected annually. Once an ID is appointed, he/she must inform the Chairman and the Board before any new appointment is accepted by him/her.

RESPONSIBILITIES OF IDs [16]

- 1) The primary role of the IDs is the protection of shareholders' money and interests by stonewalling proposals that are detrimental to their interests.
- 2) Ensure compliance to legal and ethical norms by the company, simultaneously promoting accounting controls by participating in the Audit Committee.
- 3) Counter balance management weaknesses in a company.
- 4) Augmenting the reach of a company through contacts, expertise and access to Debt and Equity Capital.
- 5) Contribute to well conceived and considered decisions through regular Board meetings.
- 6) Help the company move on, grow and prosper through improved succession planning, leveraging their role in the nomination committee.
- 7) As a watchdog, reduce conflicts between specific interests of the management and wider interests of the shareholders.
- 8) Ensuring financial transparency with specific interests of the minority shareholders and the employees.
- 9) As business advisors, IDs are Independent to evaluate investment plans.
- 10) Contribute one's expertise with a view to resolve technical, financial and managerial problems.
- 11) To maintain good communication between the management and the shareholders.

12) A final point on ID's responsibilities is a broad requirement to act in the larger and bona fide interests of the company.

POWERS

- 1) To demand any information relevant to the company business.
- 2) To exercise their votes.
- 3) To ensure transparency in company business.
- 4) To govern, so that it is easier for them to perform their duties.
- 5) To protect the interest of the shareholders and other stakeholders.

CATEGORIES

In his article, *'the Naked Truth About Independent Directors'*, Prithvi Haldea [4] has categorized Independent Directors in India on the basis of their background. These are :

- 1) **Home Directors** : These are personal acquaintances of the promoters. Interestingly enough, several loopholes exist in the guidelines, which allow personal favours. For instance, according to the Companies Act, all those related to one's wife or mother is not covered under the present definition of relatives. Haldea's study finds that this variety constitutes about 75% of the total Independent Directors.
- 2) **Value Directors** : These nominees bring a value-addition in terms of knowledge and expertise like professionals from Finance, Law, Technology or Management, etc. Bureaucrats provide networking for the company with the government, politicians and institutions. Such persons are hired to give a sense of comfort to both the institutional as well as the retail investors and constitute 15% of the lot.
- 3) **Celebrity Directors** : These people add an aura of respectability and news value. It also helps influence both the institutional as well as the retail investors. They include film stars, lyricists, sportsmen, senior defence personnel, fiction writers, etc. like Narayan Murthy, Ratan Tata, Sachin Tendulkar, Amitabh Bachhan, Aishwarya Rai and Javed Akhtar, etc. and form about 5% of the total.
- 4) **PSU Directors** : These are appointees on the boards of the listed PSUs. Their names are recommended by the concerned ministry. A number of them are either politicians or bureaucrats who protect the interests of the dominant shareholder-the government. In a way, these can be termed as home directors and constitute 5% of the total.

REMUNERATION

As per the provisions of the Indian Companies Act, the Non-Executive Directors can be compensated for their services in the following ways:

- 1) In the form of Sitting fees (under Section 310) for Board meetings or any of its sub-committees, which may amount up to ₹ 20,000 per meeting.
- 2) In the form of Incidental Expenses for attending the meeting. Expenses on travel, boarding and lodging etc are also incurred by the company.
- 3) In the form of Commission (under Section 309) on net profits up to 1% of net profit is allowed to be distributed to the NEDs.
- 4) In the form of monthly, quarterly or annual payment.
- 5) In the form of Fee for Services rendered in Professional Nature.
- 6) ESOPs can be granted to IDs and there is no upper limit specified.
- 7) IDs can be on the boards of subsidiary companies and this renders them eligible for remuneration from the concerned company.

GUIDELINES ISSUED BY THE MINISTRY OF CORPORATE AFFAIRS

The role of independent directors has generated an intense debate during the last few years. In this context, the Companies Bill, 2009 is expected to clear a lot of air and spell out clearly the role and qualifications of independent directors. The Bill, currently being vetted by a parliamentary standing committee, is yet to be put up for discussions in the Parliament, in the meanwhile, the Ministry of Corporate Affairs has gone ahead and released a set of “*Corporate Governance Voluntary Guidelines 2009*” [1].

These guidelines are proposed for voluntary adoption by the Corporate Sector and are based on the recommendations of the Task Force set up by Confederation of Indian Industry (CII) under the chairmanship of Mr. Naresh Chandra in February, 2009. Keeping in view the objective of encouraging transparent and investor friendly practices through voluntary adoption, the Ministry released a set of voluntary guidelines, which not only serve as a benchmark for the corporate sector, but help them in achieving the highest standards of corporate governance. This initiative has been taken with the objective to improve corporate governance practices in the country. As can be made out from the announcement by the Ministry for Corporate Affairs, Government of India, it is proposed to indemnify the Independent Directors so that they can perform without any fear [14].

Efforts shall also be made to clearly spell out their role and responsibilities. Moreover, Independent Directors may now have to be more careful with company board meetings and will have to be vigilant about their role, even when they miss one [7]. Under provisions in the New Companies Bill that proposes significant changes to company law, these directors, present or absent, will be held accountable for all board decisions that may involve governance issues. Further, the Government intends to restrict the number of Directorships held by any one individual to 5 or 6, because it has been felt that the present limit of 15 is too much [3]. Sources also say that it is also proposed to prescribe a certain minimum qualifications as eligibility conditions for the job of an Independent Director.

GLARING CASES OF NEGLIGENCE BY IDS

It is a matter of intense speculation that in spite of a high profile Board comprising of industry and academic heavyweights and eminent persons as Independent Directors, why the Satyam Scam involving a fraud of almost ₹ 8000 crores could not be avoided. It is generally believed that the IDs in the case failed to carry out their responsibilities of watchdogs. The IDs included stalwarts such as Krishna Palepu, Professor at the Harvard Business School; M. Rammohan Rao, Dean of the Indian School of Business; U.S. Raju, former Director, IIT Delhi; T.R. Prasad; former Union Cabinet Secretary; M. Srinivasan, a retired professor from highly rated US universities; Vinod K. Dham, known as the '*Father of Pentium*' and an ex-Intel employee, the Satyam misdemeanor could not be forestalled. The company Chairman, B. Ramalinga Raju on record admitted to doctoring the accounts for several years before making a public confession.

Satyam and its sister concern Maytas are not isolated examples, but there are hundreds of such companies where IDs are mute spectators to defrauding of credulous Indian investors and are siphoning off their hard-earned money worth crores of rupees. A large number of such firms have operated in the fishy domains of Real Estate and Financial Services like Sterling Holiday Resorts, Anubhav Plantations and many others.

Governance failures such as Satyam and Anubhav have harmed investors not only in India, but also in several developed countries. Collapsing banking giants like Lehman Brothers and Merrill Lynch in US left the global financial markets shaken in 2008. Earlier, at the turn of the century, '*The Twin Towers of False Promises*', as Enron and Worldcom were then called, were followed by a collapse of several other companies like Tyco, Arthur Anderson, Ahold, Vivendi, SK Corporation, Elf-Aquitaine, General Electric wherein Directors, including Independent Directors, were found conniving with the frauds.

RELATED DEVELOPMENTS

Interestingly, in the aftermath of the Satyam saga in January 2009, more than 600 IDs resigned [17], many of them in fear or anxiety over being held accountable for things beyond their control. This is especially true after the court directions [18] recommending action against the erring Directors of the company, including the Independent Directors for their connivance.

The prevalent state of affairs in this context has only emboldened the detractors of the concept in Indian business. One scholar, Umakanth Varottil [20], from the Law School, National University of Singapore has claimed in his study that

the concept of Independent Directors was ushered in the countries with a diffused ownership structure in order to operate as a monitoring mechanism in the interest of shareholders. A transplantation of the concept to a country such as India with insider ownership structure, without placing emphasis on local corporate structure and associated factors is not likely to produce the same results and effectiveness.

In a historical judgement [5], in this context in the *Central Government v. Sterling Holiday Resorts (India) Ltd.* and Ors on the Central Government petition under Section 408 of the Companies Act, 1956, it has been ruled by the court that “*the Board of Directors should be strengthened by appointing independent directors.*”

Further, it is not merely a coincidence that the Government of India has bestowed the prestigious Maharatna [11] status only to such of the CPSEs which, besides meeting the certain prescribed eligibility parameters, also have 50% of their Board comprising of Independent Directors. Only five [12] of the top-performing PSEs viz Coal India Ltd., IOC, NTPC, ONGC and SAIL have been rated eligible for the elite club.

CONCLUSION

1) The institution of Independent Directors has come a long way since its inception as an effective tool of checks and balances towards ushering a corporate governance regime in the Indian scenario. Yet, it is evident that their functioning in Indian companies leaves a lot to be desired. Satyam and Maytas in India, Enron and Worldcom in US are not just aberrations, but are glaring cases of the deep rot that has beset the business.

2) Further, the appointment of Independent Directors is a mandatory requirement only for the listed Companies in India. There is no such requirement for the non-listed Companies, estimated to be more than 10 lakhs.

3) The concept of IDs has faced its share of roadblocks since its introduction in the Indian business, yet, this does not necessarily mean that the efforts to give independent directors a significant role should be abandoned mid way. The sheer interest and the resultant public anxiety on large public investments deployed in the country is sufficient to ensure that this institution not only survives, but thrives to play a potent role in the times to come.

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