

Independent Directors Role and Responsibility in Corporate Governance in India

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Abstract: *This paper explains the concept of independent directors in Indian as well as global context. It also discusses the roles, responsibilities and the liabilities of the independent directors in the governance of Indian companies.*

Keywords: Corporate Governance, Independent Director, Clause 49 of SEBI, Indian Companies Act 2013, Criminal Liability, Sarbanes-Oxley Act USA.

1. Introduction

Independent directors are the cornerstones of good corporate governance. Theirs is the duty to provide an unbiased, independent, varied and experienced perspective to the board. Corporate scandals of ENRON & WorldCom have revealed how this independence has been compromised by a cozy relationship between the CEO even with the so-called independent directors.

We must not forget that we are talking of corporate India where a vast majority of listed companies have destroyed shareholder's value. A survey by the Society for Capital Market Research & Development indicated that of the 6330 BSE listed companies only 21.5% had paid dividend in 2002-2003. Of all the 9644 listed companies only 16% is dividend paying. 83% of the listed companies in B2 Group, T Group and Z Group have destroyed shareholders value.

A solution to eliminate, the cozy relationship between independent directors and their companies can be found by creating an independent body under SEBI. It is this organization, which will be charged with the role of screening and recruiting independent directors and placing them with listed companies. All fees and allowances to the independent directors to be paid by the independent organization under SEBI. The organization should be funded through a special levy charged by SEBI from each listed company based on the turnover of the company.

In the selection of independent directors we must not look simply for high profile names. The issue is not of lending a brand but having someone with an independent state of mind. In an economy fired by innovation, our biggest threat is obsolescence. Periodic training of directors is a must. Unfortunately there are few courses designed primarily for directors. Warren Buffet recently lamented about the failure of independent directors to protect the interest of shareholders. He blamed the cozy "boardroom culture" with "well-mannered people" finding it almost impossible to suggest replacing the chief executive. He said that questioning their remuneration would be like "Belching at the dinner table". Independent directors are our only hope to instill some discipline in the murky world of corporate finance. We have to make sure that greed plays no part in their appointment - even if it means "belching at the dinner table".

2. International Definition of Independent Directors

The purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the Company, judgment that is not clouded by real or perceived conflicts of interest. It is expected that in each case where a director is identified as "independent" the board of directors will affirmatively determine that such director meets the requirements established by the board and is otherwise free of material relations with the Company's management, controllers, or others that might reasonably be expected to interfere with the independent exercise of his/her best judgment for the exclusive interest of the Company. An indicative definition follows. In each case, the Company and IFC should consider changes tailored to those sorts of relationships that would impair a director's independence, taking into account the circumstances of the particular Company. "Independent Director" means a director who is a person who:

- 1) Has not been employed by the Company or its Related Parties in the past five years;
- 2) Is not, and is not affiliated with a company that is an advisor or consultant to the Company or its Related Parties;
- 3) Is not affiliated with a significant customer or supplier of the Company or its Related Parties;
- 4) Has no personal service contracts with the Company, its Related Parties, or its senior management;
- 5) Is not affiliated with a non-profit organization that receives significant funding from the Company or its Related Parties;
- 6) Is not employed as an executive of another company where any of the Company's executives serve on that company's board of directors;
- 7) Is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the Company or its Related Parties as an executive officer;
- 8) Is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the Company or of a Related Party; or
- 9) Is not 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, And for the purposes of this definition, a person shall be deemed to be "affiliated" with a party if such person (i) has a direct or indirect ownership interest in; or (ii) is employed by such party; "Related Party" shall mean, with respect to the Company, any person or entity that controls, is controlled by or is under common control with the Company.

3. Indian Scenario

India is increasingly becoming the preferred destination for funds that seek better returns in a fast-growing economy. These funds have championed rigorous governance norms in their home countries and, as they enter the Indian market, they are not going to be kind to Indian company boards.

The rules in India on corporate governance have been largely influenced by the Sarbanes-Oxley Act in the United States. SEBI revised Clause 49 of the Listing Agreement to amplify its scope and usher in a new era of governance. The changes deal with board composition; independent directors' compensation and disclosures; code of conduct for board members and senior management; audit committees; compliance certificates; and a host of other matters. The new Clause 49 requires listed companies to have a minimum number of independent directors, which is 50 per cent of the board strength if the chairman is an executive director; if he is not, the board is expected to have at least one-third of its members as independent directors.

4. Who is an Independent Director?

Clause 49 says you are not independent if you are related to the promoters or persons occupying management positions. There is an embargo of three years for executives and partners of legal, statutory audit, internal audit, and consulting firms associated with the company. There are other restrictions too.

The result of these stipulations is that there is now a scramble for independent directors. While some companies have been proactively dealing with this requirement, many are yet to fulfill their obligations under Clause 49. There is even a Web site that provides résumés of potentially eligible candidates for companies to choose.

If you have posted your résumé on the Web site, you may well get a call to join a board as an independent director. If so, read on. (And if you are already a veteran director, you may want to take stock of matters and determine if you need to re-jig your approach. The landscape has surely changed). Given this backdrop, the offer of a board position has to be weighed very carefully. It should never be accepted in a moment of exuberance, for it is not very different from

taking a seat in the cockpit of an airplane. Here are the 10 commandments of risk management for directors:

- 1) Question whether it is a company that you really want to work with.
- 2) Question whether you have the equipment and knowledge to meet the expectations of the company and its regulators, without assuming disproportionate risks.
- 3) Demonstrate that you are independent, as stipulated by law.
- 4) Enquire whether the company has developed formal control and oversight procedures, and determine whether you can rely on them.
- 5) Resist unreasonable pressures and maintain objectivity.
- 6) Keep yourself up-to-date on the subject matters where you are expected to contribute to board deliberations.
- 7) Obtain copies of the Code of Conduct and ensure that you can abide by it.
- 8) If you are in doubt, always seek professional help from experts.
- 9) Always demand all board-related papers well in advance, to prepare for board meetings.
- 10) Act wise.

The role of independent directors is back in focus. The corporate affairs ministry might soon be looking into how boards of listed entities came to ratify decisions to apply for 2G spectrum, amid a swirl of allegations that scarce radio frequency was offered at extremely cheap rates, robbing the government. The Registrar of Companies (RoC) would examine the Articles of Association of each company that got the new licenses, to ascertain whether these firms had submitted incorrect paid-up capital, revenue and profit figures at the time of applying for licenses. "Independent directors have to ensure that business activities of a company are done as per legal requirements, though they are not responsible for any executive or day-to-day functions," Manoj Kumar, legal expert and managing partner, Hammurabi and Solomon told Hindustan Times.

The corporate affairs ministry will look into the shareholding details of these companies to find out whether they were promoted by entities that were listed on stock exchanges. The role of independent directors on the boards of these companies would be critically examined to find out whether the boards had been kept fully informed about violations of conditions while applying for licenses.

Salman Khurshid, Former Union minister for corporate affairs, said earlier that his ministry will not play "a proactive role" in the investigation process, and would plunge into action only if directed by any of the enforcement agencies. In its recent report, the Comptroller and Auditor General (CAG) has observed that at least 12 entities which had applied for 2G licenses did not have the requisite paid-up capital, nor was telecom-related business incorporated in their Memoranda of Association.

Two of these entities—Unitech and Videocon (promoters of Datacom) — are listed on stock exchanges. Another entity, Swan Telecom (now known as Etisalat DB), had Reliance Communications as a significant stake-holder. As

many as 85 licenses to 12 companies, out of the 122 new licenses issued in January 2008, were granted to firms that did not satisfy the eligibility conditions prescribed by DoT. Seventy-two licenses were given to companies that did not have the stipulated paid-up capital at the time of application. Twenty-seven licenses were issued to companies that failed stipulations on their Memoranda of Association and share holding patterns. "Our group had no shareholding in Swan Telecom Ltd at the time of grant of license to them or any time thereafter, and that issue is accordingly not relevant to our company," a Reliance Communications spokesperson said. "Reliance Communications has always been in full compliance with all applicable laws, rules and regulations, and there has been no violation of our license conditions at any stage on account of cross-holdings in excess of 10%," he said.

5. Criminal Liability of Independent Directors

Until now, 'Samaritans' is not how the Independent Directors are purported by Clause 49 in the Listing agreement. An Independent Director is somebody who receives the normal remuneration, which any other Director is entitled in ordinary course of business, but incidentally also one who hammers at the wrong doing of the Board of Directors by putting himself into the stake holder's shoes. The Companies Act 2013 specifically disallow the Independent Directors from receiving any amount other than sitting fees and other approved profit related commissions and stock options, whereas as per the clause 49, an independent Director can receive the normal Director remuneration. This is a position that calls for enough empathy as a human being by putting aside all his/her aggressive materialistic ambitions. Of course when it comes to laws and regulations, there will not be enough 'carrots' but certainly a lot many 'sticks' especially if public interest is jeopardized and hence even they become the motivating factors. The Key distinctions between any other Director and an Independent Director are a host of 'detachments' as set out below which make the Director an 'independent' individual,

- 1) Lack of Pecuniary relationship or transaction with a host of specified persons (promoters, senior management, holding or subsidiary or associated companies)
- 2) Lack of any relationship with Promoters, Top most management or just one level below that
- 3) Not a substantial shareholder, supplier, customer, service provider, partner or executive of a statutory audit firm, consulting firm or a legal firm during the last three year
- 4) Not an executive in the immediately past three financial year

As far as India is concerned a Criminal liability involves doing something willfully which is prohibited by law. As of now a 'Corporate' criminal liability is something alien to our jury. 'Corporate criminal liability' has slowly gained acceptance in the West. It is founded on the basis of this ruthless Principle of Agency, which holds the Principal vicariously liable for illegal acts committed by his Agent in course of the employment. We all are aware of the fact that Directors get into a deemed agency relationship upon signing the contract for service. The mindset of the

community at large in this backdrop has now been to acquit the Independent Directors by deeming them as innocent at least with respect to offences in routine business. The shield is given under the context that law itself wants a person who is non-executive both present and in past and therefore it cannot point fingers at the independent director. As of now the position of an independent Director carries no legal sanctity except for the tag of independence and therefore attaching a criminal liability to them is no blasphemy either. All that is required is the proven guiltiness of mind and then charging them for criminal offence will not be against law.

Consider a real case that we had recently. Independent Directors of a company moan of having received notices for appearing in the magistrate for an allegation on heavy misstatement in the Balance sheet by adding extra zeroes! (Inadvertently or not). This cannot be construed as committed in the regular course of business and certainly such blunders do not allow sparing a person who is presupposed to know the usual magnitude of the Balance sheet numbers (though he may be off the site most of the times). This is a case where our judiciary rightly presumed that with reasonable diligence such mistakes could have been avoided. The Companies Act 2013 has come up with rules governing the appointment of Independent Directors with special mention about their Chairmanship and Majority strength in the Audit Committee. At least one Director in the committee is supposed to be knowledgeable of the accounts and audit. To add to this requirement the Ministry of Corporate affairs wants a Chartered Accountant to head the Audit committee. An audit committee has a wide range of duties including examination of financial statements, transaction with related parties etc. Under these circumstances a layman definitely gets to understand that such Independent Directors would be reasonably accustomed to the Company financials. Such mishaps only highlight the ineffective functioning of an Audit committee.

As long as the law or the judiciary does not harass them for other defaults given their asymmetric roles and responsibilities backed up by a non commensurate remuneration, people who offer to come on board as independent directors may turn out to be our Bibles 'Good Samaritans'!

6. Actions-Indian Context

On March 11, 2011, SEBI passed an order in relation to Pyramid Saimara Theatre Limited (PSTL) restraining three of its independent directors (Mr. K.S. Kasiraman, Mr. K. Natarajan and Mr. G. Ramakrishnan) from being independent directors or members of audit committees of any listed company for a period of two years from March 11, 2011.

The order was passed on the ground that these independent directors of PSTL failed to perform their role in preventing false and misleading disclosures made by the company in its accounts, which were found to contain inflated profits and revenues through fictitious entries. SEBI refused to accept the independent directors' arguments that they were not responsible for day-to-day affairs of the company and that they participated at board meetings where only broad policy

matters were discussed. In its order, SEBI has made strong observations regarding the role of independent directors on listed companies.

- 1) A company acts through its board of directors. It is the duty and responsibility of the directors to ensure that proper systems and controls are in place for financial reporting and to monitor the efficacy of such systems and controls. While the extent of responsibility of an independent director may differ from that of an executive director, an independent director has the duty of care. This duty calls for exercise of independent judgment with reasonable care, diligence and skill which should be reasonably exercised by a prudent person with the knowledge, skill and experience which may reasonably be expected of a director in his position and any additional knowledge, skill and experience which he has. The audit committee exercises oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible. It reviews the adequacy of internal control system and management discussion and analysis of financial condition and result of operations. The institutions of independent directors and audit committee have been established to promote corporate governance and enhance the protection of interests of investors. These have a critical role to play in the regulation and development of the securities markets and protection of interests of investors in securities.
- 2) I find that the noticees overlooked numerous red flags in the trend in revenues, profits, receivables, advances, etc. which could not escape the attention of an independent director, who is also a member of the audit committee. ... Such aberrations in financial figures would alert any person of ordinary prudence. The appropriate questions at the right time from the noticees would have unraveled the fraud being played by the company on the innocent investors. By failing to ask the right questions at the right point of time, I find that the noticees have failed in their duty of care as an independent director. They failed to review, as members of the audit committee, the internal control systems, which generated misleading financial statements. I find that the noticees were either too negligent to notice the aberrations in performance of the company and the fraud behind such aberrations or acted as shadow directors of the board / members of the audit committee. In either case, they facilitated the company to make false and misleading disclosures and thereby created artificial prices and volumes in the securities of PSTL in the market, to the detriment of innocent investors. I, therefore, conclude that the charge of disclosure of false and misleading statements, as alleged in the [show cause notice] against the noticees is established.
- 3) Such conduct on the part of the noticees is disgrace to the institutions of independent directors and the audit committee of a listed company. This cannot be viewed lightly and warrants regulatory intervention. SEBI's warning signals to independent directors are loud and clear. While this enunciates the importance of the monitoring role of independent directors, it remains to be

seen whether SEBI's order operates as a serious disincentive to otherwise competent and capable individuals from taking up or continuing with their board positions. As we have seen in the past, the Satyam episode resulted in a several hundred independent directors relinquishing their positions from boards of Indian listed companies.

7. Actions-International Context

The approach recently adopted by a court in Singapore is even severe. An independent director was sentenced to a four months' jail term for a misleading statement made by the company to the Singapore stock exchange SGX. A Straits Times news report states:

Singapore's corporate scene has been stunned by a jail term given to an independent director under stock trading and disclosure laws.

Lawyer Peter Madhavan, a former independent director at scandal-hit air cargo firm Airocean, was sentenced to four months' jail for his part in making a misleading statement to the Singapore Exchange. He was also fined \$120,000. This is believed to be the first time an independent director here has been sentenced to jail for breaking securities laws. Independent directors are non-executives not involved in day-to-day management. District Judge Liew Thiam Leng said Madhavan had played a major part in issuing a statement to the SGX in 2005 that tried to downplay a bribery probe involving the firm's former chief. He said that as a lawyer, Madhavan was regarded by fellow directors as more familiar with legal proceedings. Although Madhavan had no shares in Airocean, he was the 'most active' in making the misleading statement, the judge found. He drafted the document and was the 'main contact person' with Airocean's lawyers who amended it.

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8. Conclusion

Important amendments made recently to Clause 49 of Listing Agreement that are relevant to this paper as well as of those that need to be noted are:

- Independence of Directors – “no material pecuniary transaction affecting their independence”
- Non-executive / Independent Directors Fees require approval of shareholders
- Audit Committee – recommending reappointment or replacement of auditors, review performance of statutory auditors.
- Independent Director to be on Board of “material non-listed Indian subsidiary” (new)
- Disclosures –Proceeds from all issues, annual statement of “utilization other than stated” to be certified by Statutory Auditor.
- Board to be responsible for compliance with laws and regulations. (Earlier this was the role of independent directors)
- CEO/CFO - Certification on fraudulent, illegal or violation of company’s code of conduct

To execute their role, independent directors, have similar responsibilities to those of other directors. The fiduciary duties of care, diligence and acting in good faith apply equally to independent directors as to other directors. In view of faith imposed on them by various agencies they are more bound to execute their functions with impartiality. It is necessary for the independent directors to:

- 1) Prepare them thoroughly for the meeting.
- 2) Be objective in forming sound decisions relating to the company and its business.
- 3) Be open minded, free and frank in expressing their opinions and at the same be willing to engage in meaningful debates
- 4) Be committed to decisions made as a Board.
- 5) Continuously seek information both from within and if required outside professional knowledge to keep abreast with the latest developments in the areas of the company’s operations.
- 6) Be informed on laws and regulations influencing their functioning as directors.
- 7) Utilize the expertise they possess to the good advantage of the company.

A final point on their responsibility, and indeed the whole boards, is a requirement to act in the larger genuine interest of true growth & development of the company.

SEBI wants trustees and independent directors to become more proactive in the functioning of fund houses and enhance their roles to ensure investor protection. The market regulator aims to make trustees and independent directors of asset management companies (AMCs) familiar with the best practices and keep them updated with the technical know-how of the mutual fund (MF) business.

SEBI also wants trustees to have more involvement in reviewing the performance of MF schemes. In a recent event organized by Tamil Nadu Investors’ Association, K N Vaidyanathan, executive director of Sebi, who is in charge of MFs, had said trustees should question the variations in performance of similar types of MF schemes offered by a fund house. “A lot of regulatory changes have come in the MF industry in the recent past. SEBI’s objective is to make trustees and independent directors more knowledgeable

about the business,” said the managing director of an MF house. NISM will run at least three workshops every year, which will focus on technical subjects and the regulatory perspective.

SEBI norms require at least four trustees to supervise the functioning of an MF house and at least two-thirds of them need to be independent persons, not associated with the sponsors or the AMC. The general power of monitoring and directing an AMC is vested with the trustees, who have a fiduciary responsibility to investors.

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