

# LEGALFOXES LAW TIMES

## INDEPENDENT DIRECTOR AND CORPORATE GOVERNANCE

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Loyalty means nothing unless it has at its heart the absolute principle of self sacrifice.<sup>1</sup>

Independent Director- No doubt a catchy word which is in fashion these days. But it not merely a word it's a movement that has changed the cornerstone of corporate governance worldwide raising bar of corporate governance standards. It has been hailed as an effective solution to fraud mismanagement unaccountability, inequality and all other evils of bad corporate governance. However wizard of Omaha had been quite critical of independent Director, according to him director should be business savvy, interested and shareholder oriented and every director lacked either of one qualities.<sup>2</sup> The director simply either did not have full time or interest for shareholder wellbeing or knowledge of business. According to him from legal point of view all were fine they were truly Independent but still not enough to change the view of boardroom. Simply they were not principled enough!!! In this paper I will write about what independent director are, why are they appointed, how they strengthen corporate governance vis a vis protection of minority shareholders and concluding with some reforms and suggestion.

Memory of Satyam scam is still fresh in our minds. I can still recall that when the scam came into ,light the newspapers and journalists were writing dearth's of articles about strengthening our corporate governance system, bring more transparency and credibility and what not. At that tender age my little mind did not had capability to even fathom such terms let alone comprehend their true meanings in wider scheme of things. Now as I have grown and studied more I realized that corporate governance is nothing but an old concept chased with a new vigour at that time. Corporations have undergone vast change in past 2 decades specially with the advent of institutional investors, they had not only allowed the corporation to transcend to cross nation boundaries but they also started something called as shareholder activism calling for greater transparency in working of company and asserting their rights.

<sup>1</sup>Woodrow Wilson quote taken from Randall Morck paper.

<sup>2</sup>See Warren buffet "Letter to Shareholder" available on <https://www.berkshirehathaway.com/letters/2002pdf.pdf>  
Last accessed on May 11, 2020.

Change must follow change and advent of independent director signifies this change only. It takes one step further to reduce the agency problem of minority-majority shareholder which was at first tried to achieved by separation of management and owners in company. Independent directors literally means director who are independent from company, in a way that they cannot be influenced or put under duress to work at the wiling of company. Independent director is an outsider, kind of a watchdog who keeps an eye on functioning of company and make sure that all regulatory and statutory requirement are compiled with in letter and spirit. This also boast the confidence of investors as they fell confident that an outsider a truly independent person is there to monitor the functioning of company.

#### *WHAT IS AN INDEPENDENT DIRECTOR?*

Companies Act, 2013 lays out definition for independent director, according to section 149 (6) of it an independent directors means any director other than managing director or whole-time director or a nominee director.<sup>3</sup>

Section 149 (6) further lays down condition that are needed to be fulfilled before appointing any person as an independent director. These conditions are-

1. Section 149 (6) (a) stipulates that the person, To be appointed must be in the eyes of board a person of integrity and must possess relevant expertise and experience
2. Section 149 (6)(b) along with 149 (6)(c) stipulates that person to be appointed as independent director must not be neither promoter of a company nor must be related to director promoter or any other senior officer of company or its holding, subsidiary or associate company in any way. Section 145 (9)(d), further stipulates that he or his relatives must not have any pecuniary interest with company.
3. Section 149 (6)(e) further mandates that any person to be appointed independent director neither he nor any of his relatives must hold or held any of the following positions-
  - Employee or partner or proper tier of key firm which is in business with firm in any way (audit, legal, cost and company secretary firms).
  - Position of key managerial person.
  - Together with his relatives two percent or more of total voting power.

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<sup>3</sup>Section 149 sub-section 6 of companies act, 2013

- Chief executive or director or NGO which receives major donation from company or which holds more than 2 percent voting rights in company<sup>4</sup>

Listing requirements mandates that every listed company should have at least one-third of number of directors as independent directors, where the chairperson is non-executive director<sup>5</sup> and if a chair person is executive director than such requirement rises up to half the size of board as per LODR regulations<sup>6</sup> and as per the Companies (Appointment and Qualification of Directors) Rules, 2014, the following types of companies must have at least 2 *directors* as independent directors.<sup>7</sup>

- Public Companies with paid-up share capital of Rs. 10 crores or more.
- Public Companies with turnover of Rs. 100 crore or more.
- Public Companies with aggregate outstanding loans, debentures, and deposits, exceeding Rs. 50 crore

#### *LIABILITY OF INDEPENDENT DIRECTOR*

Companies act have limited the liability of independent director as per section 149 (12) the liability of independent director is limited to “*only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or where he had not acted diligently*”<sup>8</sup>

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#### *ROLE IN COMMITTEE MEMBERSHIP*<sup>9</sup>

“OUR MISSION YOUR SUCCESS”

The Companies Act, 2013, provides for mandatory appointment of independent directors in following committees so as to meet the corporate governance requirements:

- Nomination committee
- Remuneration committee

<sup>4</sup>Section 149 sub-section 6 sub clause a,b,c,d,e of companies act, 2013

<sup>5</sup>Section 149 sub-section 4 of companies act, 2013

<sup>6</sup>Regulation 17 sub-regulation 1 sub-clause b of LODR regulations

<sup>7</sup>Companies (Appointment and Qualification of Directors) Rules, 2014 rule 8

<sup>8</sup>Section 149 sub-section 12 of companies act, 2013

<sup>9</sup>Sudhir Ranjan Bagri, “*role of independent director*” available at- [https://blog.ipleaders.in/roles-independent-directors-corporate-governance/#\\_ftn3](https://blog.ipleaders.in/roles-independent-directors-corporate-governance/#_ftn3) (last visited on May 11, 2020)

- Committee related to investor relations,
- Audit committee.

### *NOMINATION AND REMUNERATION*

Although independent directors are required to be elected by shareholder. Companies act, 2013 introduces a mandatory appointment of nomination and remuneration committee for appointment of all director including independent director. Such committee must comprise of majority of independent director.<sup>10</sup> Appointment of nomination and remuneration committee brings greater transparency in the appointment of independent director and bring more credibility to the whole process.

### *INDEPENDENT DIRECTORS AND CORPORATE GOVERNANCE*

At first we need to define and increase our understanding of corporate governance to see that how independent director not only fits in but facilitates corporate governance. There is no universally accepted definition of corporate governance. everyone has their own understanding, even I have my own understanding. If someone asks me what is corporate governance, My reply would be that it is way of governing, more of steering the company in direction which not only, maximises the profits but also takes care of all its stakeholder including shareholders, managers, contractor and even society in which it operates with a greater transparency and high ethical integrity. But who am I to speak of such big things so I will elucidate below some more popular and generally accepted definition of corporate governance so that you can get a complete picture of what is all the fuss about.

1. Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”<sup>11</sup>
2. "Corporate governance - which can be defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society -....", <sup>12</sup>

<sup>10</sup>Section 178 sub-section 1 of companies act, 2013

<sup>11</sup>The Journal of Finance, Shleifer and Vishny [1997, page 737].

<sup>12</sup>Wolfensohn, president of the World bank, as quoted by an article in Financial Times, June 21, 1999.

So how do independent directors strengthen the corporate governance? Well independent directors provide positive criticism in the policy decision and company strategies. They hold management accountable for their actions and as they lack affiliation toward anyone they do not act out of prejudice and fulfill their task efficiently. If one look at the schedule IV of the companies act which lays down role of independent directors. One will find that the act envisages significant function for independent directors such as safeguarding interest of minority shareholder, analysing performance of management, harmonizing conflicting interest of stakeholders, mediating in conflict between management and shareholder etc. these all functions point towards strengthening corporate governance.<sup>13</sup>

Companies act no doubt limits the liability of independent director but, it does not make director completely free from their liability. An independent director is held equally liable if they do not take action against the wrong decision taken in his knowledge as upheld by Hon'ble supreme court in Municipality of Bhiwandi & Nizampur v. Kailas Sizing Works in which court has observed that "the authority is not acting honestly where an authority has a suspicion that there is something wrong and does not make further enquiries. Being aware of possible harm to others, and action in spite thereof, is acting with reckless disregard of consequences. It was worse than negligence, for negligent action is that, the consequences of which the law presumes to be present in the mind of the negligent person, whether actually it was there or not."<sup>14</sup>

#### *A FULLPROOF STRATEGY OR JUST ANOTHER COPIED MINDLESS REQUIREMENT?*

Adam smith in as early as 1777 talks that that self interest lies behind the motivation of proliferation of business. But sometimes greed and overzealousness brings out the worst of men.<sup>15</sup>

Randall Morckin his paper on *Independent Directors and Behavioral Finance in Corporate Governance* talks about how misplaced loyalties lied at the heart of some of the most infamous scandals of corporate governors- where the directors slept through their duties toward shareholders and obedience towards law due to their loyalty to the overzealous company executive officers.<sup>16</sup> These directors could have easily prevented some of the biggest corporate scams such as Enron, Hollinger, WorldCom and even our own Satyam scam.

<sup>13</sup>Schedule IV of companies act, 2013

<sup>14</sup>See Municipality Of Bhiwandi And ... vs M/S. Kailash Sizing Works 1975 AIR 529, 1975 SCR (2) 123

<sup>15</sup>See Adam Smith in *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776)

<sup>16</sup>See Randall Morck, *Behavioral Finance in Corporate Governance: Independent Directors & Non-Executive Chairs*, May, 2004, available at <http://www.economics.harvard.edu/pub/hier/2004/HIER2037.pdf> (Last visited on May 11, 2020).

Now coming back to our parodica lSatyam scam. At the time when Satyam scan came into light Satyam Softwares had won many awards. It boasted of its corporate governance standard highest in India with composition of board that was unheard at that time in Indian corporate scenario compromising largely of independent, distinguished and reputable fellows. Satyam complied with not only Clause 49 of SEBI listing requirement but also with sarbenes-oxley act ( as it was also listed in NYSE). It also had got its financial statement audited by “big four audit” firm. Nevertheless the scam occurred. The confession letter of the promoter and then chairman conceded that “[n]one of the board members, past or present, had any knowledge of the situation in which the company is placed.”<sup>17</sup>This clearly brings out the flaw in the system and points that simply ideas and method from outside cannot be transplanted here to get desired effect. One big reason cab be our corporate scenario, which is very different compared to west so it is logical that will require different strategies to bell the cat.

### *INDIAN SCENARIO*

Indian corporate scenario is very different. Whereas in west the big names are Google Facebook, Apple here the big names are Tata, Birla, Bharti, Reliance which brings out the major contrasting point between west and us is that almost all major business are family owned in India. Over 75 percent of listed companies are family owned. And it is natural that the family members of these family owned business will like to run the company with tight control without relinquishing any power to others after all it is their hard worked business that they have scaled to such heights. It also natural that they will keep their interest at paramount even ahead of companies interest and this is where problem starts. Normally the interest of company and promoter coincides with each other, but interesting developments happen when they are in contrast to each other. These family member do not like to reveal much information outsider including independent director to whom they consider of ceremonial post. It becomes increasingly difficult for independent director to keep accountability and transparency in check where are very few board meeting in year and it also makes it increasingly difficult for them to comprehend many diverse and difficult issue surrounding these conglomerates.

A recent study by AT Kearney, AZB & Partners and Hunt revealed that around 90 per cent of the companies they surveyed appointed independent directors using referrals from the CEO or Chairman.

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<sup>17</sup> See Confession letter of Chairperson of Satyam Softwares available at <https://timesofindia.indiatimes.com/business/india-business/Full-text-of-Rajus-resignation-letter-to-the-Board/articleshow/3946538.cms> (last visited on May 11, 2020)

The result is obvious director appointed are more of flexible and cooperative nature rather than principled or rigorous one.<sup>18</sup>

All this is in striking contrast with the more efficient western enterprises where independent directors are viewed as partners of management and as “outside guardians”, whose job is to make sure that the management stays focused on delivering shareholder value.<sup>19</sup>

### *INDEPENDENT DIRECTOR AND MINORITY SHAREHOLDER*

It can be said without any iota of doubt that independent director can play a more important role and useful role in the functioning the board if they ensure protection of the interest of minority shareholders. Minority shareholders are predominantly retail shareholder who had parked their saving in such companies in hope for a good return. By protecting the interest of these shareholder, by making sure that company does not take any action decision that will adversely effect value of the company such as fraudulent representation, malice acquisition etc. and thus making minority shareholder loose on their investment, the independent director are essentially fulfilling the task they are supposed to do.

### *SCOPE FOR REFORMS AND SUGGESTIONS*

To do away with shortcoming of independent director system some radical changes are required to be brought which will increase overall transparency and credibility of infamous Indian corporate scenario. One of the such radical suggestion is that SEBI should completely take away with companies nominating the independent director instead of that it or one of its agency should take task if nominating, appointing, training, compensating all the independent directors. This would ensure that appointed director are truly independent and are well versed with their task. Second suggestion will be that independent director must involve themselves more with functioning of company so that they can comprehend the nature of issue that surround company and facilitate positive criticism otherwise they will remain ceremonial figures

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<sup>18</sup>See Study by AT Kearney, AZB & partners and HUNT available at [http://www.hunt-partners.com/displays/uploaded/File/TheIndiaBoardReport\\_2007.pdf](http://www.hunt-partners.com/displays/uploaded/File/TheIndiaBoardReport_2007.pdf) (last visited on May 11, 2020)

<sup>19</sup>See Jitendra Singh, Mike Useem & Harbir Singh, *Corporate Governance in India: Is an Independent Director a Guardian or a Burden*, February, 2007, available at <http://knowledge.wharton.upenn.edu/India/article.cfm?articleid=4157> (Last visited on May 11, 2020).

only, who will see whatever the company's management shows them. And above all the culture needs to be changed. Companies need to realise that with increasing transparency it will benefit them only in long run with greater confidence of investor they can achieve more profitability. The former SEBI Chairman, Mr M. Damodaran, described corporate governance as a continuing process beyond the scope of mere legislation.<sup>20</sup>By which he meant that the governance mandates are starting point which the companies should not pay heed due to fear of punitive action but because in absence of such mandates the company would never be able to achieve true profitability. Above mentioned steps are not doubt harsh steps but law specially company law is all about dealing with over-smart people and in India we do not have shortcoming of those.



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<sup>20</sup>See Prime Directors, *CII Summit Stresses on Importance of Independent Directors in Corporate Governance*, September 14, 2005, available at [http://www.primedirectors.com/ PressReports/CII2.pdf](http://www.primedirectors.com/PressReports/CII2.pdf) (Last visited on May 11, 2020).