AN INSIGHT INTO THE INDEPENDENCE OF INDEPENDENT DIRECTORS

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Abstract

Independent directors are playing a very crucial role in good corporate governance system especially in the Indian context where one third of the publicly listed companies are promoted, controlled and managed by families. But there are theoretical debates on how independent the independent directors are. Besides this, dilemma prevails on who should monitor the Board structure - Securities Exchange Board of India (SEBI) or Department of Company Affairs (DCA)? Both of them come up with different recommendations and guidelines for corporate governance. As a result, there is confusion regarding the number of independent directors in the Board. In this backdrop, this article has made a serious attempt to look into the above mentioned crucial aspects of corporate governance as a guide for precautions from scams, scandals and flagrant violations under the veil of corporate impenetrability. Finally, some recommendations towards achieving good corporate governance through implementing independence in real sense have been suggested to enable the corporate leaders to build and restore trust among stakeholders.

INTRODUCTION

In the Indian context where one third of the publicly listed companies are promoted, controlled and managed by families, independent directors are probably playing a vital role to ensure transparency in corporate reporting. But, there are contradictions in legal requirement regarding the number of independent directors to be present on the Board. According to *Clause 49 (SEBI)*, at least 50% of the Board should consist of independent directors when the chairman is executive and one-third in case of a non-executive chairman. Contrary to this, as per the recommendation of the *Irani Committee*, the number of the independent director should be one-third of the total size of the Board. The Committee suggests that one-third of total directors as independent directors should be adequate for a company having significant public interest, irrespective of whether the chairman is executive or non-executive, independent or not. To avoid conflict with *Clause 49*, the Committee has recommended that the directors of other regulators for companies

within their domain may prevail, if they are at variance with its recommendations on the subject *(Kumar, N., p. 36).*

Basically the conflict is regarding identifying the fine line of regulatory power between *SEBI* and *DCA*. *SEBI* is mainly focusing on the practices and processes of governance while the structure for governance shall be vested with *DCA*. As all incorporation regulations are monitored and controlled by *DCA*, issues like structure, formation or composition of the Board should be looked after by *DCA*. *SEBI* has nothing to do in this respect. So any recommendation or guideline relating to the structure of the Board should come under the territory of *DCA*. But sometimes fulfilling legal requirements on these aspects may become fulfillment of mere 'form' rather than the underlying 'substance' of the law. As a result, good corporate governance system may cease to exist in reality. In this backdrop, it is time to look into the matter seriously, whether independent directors are independent in the real sense or not.

The remainder of this paper is structured as follows: Section 2 has discussed different practical problems to achieve independence in true sense by the independent directors. Section 3 has made some recommendations to overcome the problems. In Section 4, concluding remarks are presented.

PRACTICAL PROBLEMS TO ACHIEVE INDEPENDENCE IN TRUE SENSE:

As per the scheme of the company law, directors are elected by shareholders at the annual general meeting to manage the affairs of the company. They are the agents of the company and have a fiduciary duty to act in the best interest of the company *(Kumar, N., p. 33).*

The J.J. Irani Committee has recommended that the expression 'Independent Director' shall mean a non-executive director of the company who:
a) apart from receiving director's remuneration, does not have, and none of his relatives or firms/companies controlled by him have, any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associate companies which may affect independence of the director;
b) is not, and none of his relatives is related to promoters or persons occupying management positions at the Board level or at one level below the Board;
c) is not affiliated to any non-profit organization that receives significant funding from the company, its promoters, its directors, its senior management or its holding or subsidiary company;
d) has not been, and none of his relatives has been, employees of the company in the immediately preceding years;
e) is not, and none of his relatives is, a partner or part of senior management (or has

not been a partner or part of senior management) during the preceding one year of any of the following: ➢ The statutory audit firm or the internal audit firm that is associated with the company, its holding and subsidiary companies; ➢ The legal firm(s) and consulting firm(s) that have a material association with the company, its holding and subsidiary companies;
f) is not, and none of his relatives is, a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director;
g) is not, and none of his relatives is, a substantial shareholder of the company i.e. owing two per cent or more of voting power.
Explanation: For the above purposes: ➢ "Affiliate" should mean a promoter, director or employee of the non-profit organization. ➢ "Relative" should mean the husband, the wife, brother or sister or one immediate lineal ascendant and all lineal descendents of that individual whether by blood, marriage or adoption. ➢ "Senior management", should mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads. ➢ "Significant funding" should mean 25% or more of funding of the non-profit organization.

The heart of governance is the independence of directors *(Raghavan, R.S., p.27).* The basic tenet of good corporate governance is that independent, non-executive directors are appointed to provide checks and balances against the possibility of misusing the power by the Executive Board and the promoters. Besides this, it is expected that independent directors should bring in independent thinking and sound experience in their respective field. They should act independently in the general interest of the company to benefit all stakeholders, including minority and small shareholders. In order to do this, they should be capable of striving against the influence and pressures of the company or of the particular group of the shareholder who appointed them. They should independently perform all of their activities like decision-making, implementing strategy including key appointments and standards of conduct and also should ensure that proper monitoring mechanism is prevailing in the system. In fact, truly respected and valued independent directors are those who are competent, committed and have an independent 'state of mind' to challenge and ask the right/uncomfortable questions *(Kumar, N., p.33).* So the importance of independent directors to implement a healthy governance system in any corporate cannot be undermined. But due to different measures (which are indispensable to keep the standard of corporate governance) that have been taken by government, obtaining right quality directors becomes an issue. The *SEBI* code of corporate governance stipulates that an individual

cannot join Boards of more than ten companies so that they can spend reasonable time in each company in which they are directors. But in order to implement this provision, at least 3600 individuals are needed for listed companies if each company is required to have six independent directors on the Board. The basic purpose behind the appointment of independent directors is to win shareholders' confidence by issuing signals to the market that the company has an internal mechanism to monitor the decisions of owner-managers. Therefore, it is only the reputation due to the professional attainment that can fulfill the purpose of signaling the capital market. Companies always attract persons having the right public image. As the number of such person is insufficient, only companies having a good track record of corporate governance can attract them. Besides this, *Companies Act 1956* stipulates a ceiling on the remuneration of outside directors. In most of the cases, remuneration that is linked with profit is insufficient to attract the best talent as independent directors. In this respect, a new concept introduced by *J.J. Irani Committee Report* regarding freeing the managerial remuneration limits is very significant. The Committee has recommended removal of all ceilings on payment of directors' remuneration *(Managerial remuneration in India has so far been restricted to certain limits in the case of public companies and private companies which are subsidiaries of public companies with the overall limit being 11% of the net profits of the company during the financial year).* Shareholders of companies have been empowered to decide as to how to compensate their directors. However, this process is to be transparent and based on principles that ensure fairness, reasonableness and accountability. It is important that there should be a clear relationship between responsibility and performance vis-à-vis remuneration, and that the policy underlying directors' remuneration be articulated, disclosed and understood by investors/stakeholders. To ensure transparency, it is recommended that directors' remuneration report should form part of the annual report of the company and should contain details of remuneration package of directors including company's policy on directors' remuneration, the performance graph of the company and the remuneration of directors' vis-à-vis the performance of the company. Another important feature of the recommendations relating to managerial remuneration is the removal of all government approvals. The Committee felt that in the current competitive environment, where Indian companies have to compete for specialized manpower globally, it might not be feasible or appropriate for the government to interfere. Instead of the restrictive regime based on *'government approvals'* the *'shareholder approval'* regime can be adopted. Decision on how to remunerate directors should be left to the company. However, this should be transparent and based on principles that ensure fairness, reasonableness and accountability. It has been recommended that shareholders should be empowered to decide the remuneration of non-executive directors including independent directors with no government interference. The criteria for remuneration/compensation of non-executive / independent directors should be based on their attendance and contribution and performance of the company. This may be in the form of sitting fees for Board and Committee meetings attended physically or participated in electronically and/or profit related commissions. Further in order to ensure accountability, *the Companies Act 1956* stipulates that directors are individually responsible for the non-compliance of corporate and other laws and for frauds perpetrated by the company *(Bhattacharyya, A.K., p.399).J.J. Irani*

Committee also recommended that if the independent director does not initiate any action upon knowledge of any wrong, such directors should be held liable. This implies that, if they do not act pro actively and protect the interest of the company even after coming to know of irregularities, they should be held responsible. All these discourage qualified persons from joining the Board. Besides this, most Indian companies do have independent directors on the Board, comprising men of distinction like bureaucrats, academicians etc, purposely put together to discuss, analyze and not accept blindly the views of the management. But most of such directors either don't have sufficient knowledge of business matter or they are reluctant to look after the business matter due to lack of time or intent or both *(Chakraborty, K., p.14).* Moreover, there are theoretical debates on how independent are the independent directors. In fact, there are enough evidences in Indian corporations where *'independence'* itself is questionable. Just one case of *Tata Motors,* belonging to the Tata group will clear the concept of real independence. Till sometime back *Ratan Tata* was the executive chairman of the company. He relinquished the post at sixty-five, and became the non-executive chairman. According to *Clause 49,* the independent component will be based on whether the chairman is the executive or the non-executive chairman. But the power equation within the company due to *Ratan Tata's* giving up the post of executive chairman and becoming non-executive chairman, may still remain unchanged – which may not satisfy the interest of all *stakeholders.* (The Tatas have done neither that nor will do that in future. We have used the hypothetical example to highlight how the law's intent can be avoided and misinterpreted if promoters want to do so.) If independent directors are not independent in true sense, then the base of corporate governance will become weak.

SOME RECOMMENDATIONS TO OVERCOME THE PROBLEMS:

Independence of thought:

In case of public limited company the promoters should act as trustees on behalf of all shareholders and should concentrate on the good of the company and not just on their own interest. What has to be kept in mind is that independence should be independence of thought and practice, and not merely structural independence. In this respect, *Infosys'* corporate governance philosophy that the company will try to 'satisfy the spirit of the law and not just the letter of the law' is notable. Big business groups should also keep in mind their group structure before nominating independent directors to maintain independence in the true sense. Presently, the regulation prescribes that independent directors shall not hold more than two per cent because regulators feel that their independence will be lost, as they (independent directors) may indulge in the interest of shareholders if they are allowed to hold more than two per cent. But what is the guarantee that independent directors will not align more with shareholders even if they are allowed to hold two per cent? So it is better that independent directors do not hold any share in the company. On the other hand, independent directors should be paid well. In fact, a decent compensation will prevent them from developing vested interests and restrict their number of directorships. *The Company's Amendment Act 2000* has reduced the number of independent directorship from twenty to fifteen companies, and *Confederation of Indian Industry*

(CII) in its code on corporate governance published in 1997 recommended that maximum limit of directorships that an independent director can hold is ten. However, implementing a law may result in shortage of talents to hold the position of independent directors. The possible solution to this problem is a decent payment, which will prevent independent directors from taking more directorships and will make them more involved in the present job. Real independence that is indispensable for good governance system is difficult to achieve. Sometimes, a long tenure makes them emotionally attached to the management, preventing them from being independent in true sense. In this respect, *Lord Nolan's principles of public life* (showed below) may help these directors to be independent in the true sense.

Lord Nolan's principles of public life
• **Selflessness:** Holders of public office should serve the public interest, not seek gains for themselves or their friends.
• **Integrity:** They should not place themselves under financial obligation to outsiders who might influence their duties.
• **Objectivity:** They must award public appointments on merit.
• **Accountability:** They should submit themselves to appropriate scrutiny.
• **Openness:** They should give reasons for their decisions.
• **Honesty:** They should declare conflicts of interest.
• **Leadership:** They should support these principles by personal example. They should have the courage to say "no", which might sometimes mean sacrifices in the form of not-so-small financial losses.

Recruitment process for independent directors:

Recruitment of independent directors is a most serious job as it introduces fresh talents and skills to the organization. Legislation has been developed with the growing demand for transparent and independent board with the compliance of those (legislation) matters. Besides this, directors should have an insight into the unique nature of the company including its people, products, philosophy and strategy. Before recruiting the independent directors, there should be a thorough systematic assessment of needs in accordance with the company's strategic plan. An elaborate and scientific recruitment process should be followed in order to nominate them. Companies may also advertise for these positions. After recruitment, they should undergo an induction program under senior independent directors to enrich themselves with the knowledge that is necessary. A formal comprehensive induction should always be provided to ensure early contribution of these directors on their boards *(Prasanna,P.K., p. 64)*. At present, *SEBI* has prescribed a non-mandatory requirement that independent directors shall not serve for more than a continuous period of nine years on the board of a company. It is also recommended that each term of appointment should not exceed three years *(Prasanna,P.K., p. 63)*. This is also helpful to maintain independence in the true sense (discussed earlier). *SEBI* should also prepare and keep a

list of suitable people who can be approached for appointment of independent directors. In fact, if they could be appointed by some (external in respect to the company) professional body, then in one sense, it will help to preserve board's independence also. In this respect, companies may contact professional consultants as they (professional consultants) can carry out a professional process to recruit independent directors. Generally professional consultants adhere to the following steps before recruiting them:

The process will include:
* a full-fledged profile of the candidate
* thorough reference checking and evaluation
* a rigorous and transparent process, which the board and appointments committee can refer to
Source: www.alexanderhughes.com

CONCLUSION:

Though in India company failure due to corporate governance is negligible and there exist a number of outstanding examples of companies with enlightened leadership, the current scenario has a lot of scope for improvement like convergence with international accounting and audit standards, better protection of minority investors' rights and stronger enforcement of existing laws and regulations. These areas require more attention in the near future *(Sur, D., & Chakraborty,K., p. 27).* In fact, till now stakeholders were either ignorant or uninterested about the importance of good governance. We should not forget that some management gurus also used to rate Enron very high when it was in its full bloom. Therefore, we should be determined not to commit the same mistake by ignoring the importance of independence of independent directors in its true sense.

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