

INDEPENDENT DIRECTORS IN CHANGING LEGAL SCENARIO

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Introduction

Economic liberalization in June 1991 resulted in a slew of reforms in the industrial and service sectors. *Ipsa facto*, some proprietorial concerns began to be corporatized, and with the burgeoning middle class in India, investments in the securities market began to spiral. As per data available for the year 2011, there were 5,112 listed companies in India whose total market capitalization amounted to 55% of India's GDP². It is therefore vital that governance in listed companies is made transparent and accountable. The concept of independent directors was introduced in India for the first time in the year 2000 as a part of what came to be known as Good Corporate Governance.

During the last decade, the office of independent directors has evoked both laudatory comments and been deprecated after the *Satyam* scandal surfaced. While independent directors are perceived as protectors of investors' interests, a sizable section may not vigorously discharge their duties for fear of disharmony caused among directors *inter se* which in turn disturbs cordial working of management. With the passing of the Companies Bill, 2012³ ('Companies Bill') the Securities and Exchange Board of India ('SEBI') has envisaged a slew of changes in the existing law relating to the independent directors. The object of this attempt is to examine the impact of the concept of independent directors in India and to suggest amendments to ensure that the role of independent directors is in consonance with the role envisaged at the time of their introduction.

Origin of the concept of independent directors

The concept of independent directors can be traced to the developed economies of the West with the United Kingdom and the U.S.A. sharing credit for its evolution during the 1950s even before legislation mandated the induction of independent directors to ensure that corporate entities did not make deprecations into the public interest driven by the profit motive alone at the cost of other values. This is what gave rise to the concept of Good Corporate Governance which again owes its origin to the developed economies of the Western Hemisphere.

In India, the concept of independent directors was first introduced through voluntary guidelines issued by the Confederation of Indian Industry ('CII')⁴. The

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² World bank, < <http://databank.worldbank.org/> > accessed on 26 January 2013

³ (2012) 5 Comp LJ 1 (St.).

⁴ CII Task Force report, 'Desirable Corporate Governance: A Code', released on April 1998

Report suggested that any listed company with a turnover of Rs. 100 crores and above should have professionally competent, independent, non-executive directors, who should constitute at least 30 per cent of the board if the chairman of the company is a non-executive director or at least 50 per cent of the board if the chairman and managing director is the same person⁵. This CII recommendation was later on incorporated in SEBI's Kumar Mangalam Birla Committee Report. The Kumar Mangalam Birla Committee Report⁶ recommendation led SEBI⁷ to include clause 49 in the Listing Agreement in the year 2000.

Controversies surrounding independent directors

Some of the lacunae which limit independent directors from effectively discharging their roles are that most of them are reluctant to disturb the collegiality and conviviality of collective decision-making. This could have been a contributory factor in the *Satyam* scandal which was touted as the largest corporate fraud committed in post-independent India.

A Serious Fraud Investigation Office ('SFIO') investigation was ordered in, soon after A. Ramalinga Raju admitted to a fraud in the company amounting to Rs. 7,800 crore, wherein he disclosed that he had falsified profits for several years. After a thorough scrutiny, it emerged that Satyam's board of directors had unanimously approved a proposal to acquire two firms promoted by Raju's family—Maytas Infra and Maytas Properties. The SFIO concluded that the independent directors were kept in the dark by A. Ramalinga Raju⁸. Some of the independent directors later said the approval for Maytas was not unanimous because it was subject to certain conditions.

Following the outbreak of the Satyam scandal, 265 independent directors resigned from 211 listed companies which provoked uproar in corporate circles.⁹ Quick on the heels of the *Satyam* imbroglio, came the scandal where the very watch dogs of corporate governance were found guilty of insider trading. One such case is that of Mr. V.K. Kaul, an independent director in a pharmaceutical major, who was found guilty of insider trading by the Securities Appellate Tribunal ('SAT').¹⁰ Further, SEBI has issued a notices to independent directors where irregularities in companies going for initial public offerings¹¹. The Satyam

⁵ Ibid. Recommendation 2, at page 2.

⁶ SEBI, Report of the Kumar Mangalam Birla Committee on Corporate Governance, 1999: (2000) 2 Comp LJ 23 (Journal).

⁷ SEBI Circular No. SMDRP/POLICY/CIR-10/2000 dated 21 February, 2000: (2000) 2 Comp LJ 8 (St.).

⁸ Press Trust of India, '*Satyam's Independent Directors Clean: SFIO*' (Outlook India, 17 April 2009).

⁹ Sandeep Singh, '*Scrutiny effect: independent directors quitting boards*' (Livemint, 12 May 2009).

¹⁰ *V.K. Kaul v SEBI*, SAT Order dated 8 October 2012 in Appeal No. 55 of 2012.

¹¹ Business Standard, '*Sebi bans promoters, merchant banks for irregularities in 7 IPOs*' (Business Standard, 29 December 2011).

case prompted the question whether the law was too harsh for independent directors while cases like that of Mr. V.K. Kaul's raise the exact opposite question.

Extent of liabilities under the present law

It is to be noted that the board of directors of any company is collectively responsible for the decision of the company. It follows as a corollary that independent directors cannot abjure from their responsibilities which, *a posteriori*, after a resolution which is inimical to the public interest is passed, will result in the inference that they were mere dummies on the board of directors. In, *Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry v Griffiths*,¹² the court has expounded the law explaining the law that collective responsibility flows from individual responsibility of the director, which he cannot escape. The court's observations are reproduced below:

"... the collegiate or collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English company law. That collegiate or collective responsibility must however be based on individual responsibility. Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. A proper degree of delegation and division of responsibility is of course permissible, and often necessary, but total abrogation of responsibility is not. A board of directors must not permit one individual to dominate them and use them..."

It is important that independent directors assume responsibility and follow due process while undertaking the duties entrusted to them, or else they would lose the trust of the average small shareholders have in them. The court emphatically observed in *Dovey v Corey*¹³ that:

"The business of life could not go on if people could not trust those who are put in a position of trust for the express purpose of attending to details of management."

Section 291 of the Companies Act, 1956, makes provisions of powers of directors which would also include independent directors. With regard to section 291, the Delhi High Court has made an observation in the case of *Raj Travels and Tours Ltd. and others v Destination of the World (Subcontinent) Private Limited*¹⁴ with regard to the issue of directors' liability in a case regarding to section 138 of Negotiable Instruments Act, 1881, has made the following observation on the directors' role in companies:

"7. It is a matter of common knowledge that when companies are floated and public issues are brought, big advertisements are issued giving big names as directors and promoters of the company. These names are the names of

¹² (1998) 2 BCLC 646 at page 653: (1998) 2 All ER 124 at page 130.

¹³ (1901) AC 477 at page 486.

¹⁴ (2012) 6 Comp LJ 342 (Del).

successful CEOs, or directors who have achieved success in other fields. Due to these names at the very inception and formation of company, when there is no wealth or property of the company, the share of the company is sold at a premium promising big business and success. Once money is mopped up from the public, in all those cases where the companies were created only for the purpose of mopping up hard earned money of public or to befool them, it is found that those big names disappear and in almost every litigation those directors who formed part of the core of the company and gave promises that the company would do roaring business quietly disappear from the scene or take plea that they were not responsible for business of the company. That is how the problem arises. While the public stands cheated the persons who had mopped up wealth and pocketed the public wealth are not prepared to take responsibility.

8. Let us examine the role of board of directors, in terms of the Companies Act and other legal provisions. Company is a legal personality and the board of directors acts as its body and mind. Under section 291 of the Companies Act, board of directors is authorized to do what the company is authorized to do, unless barred by restrictions on their power by the provisions of the Companies Act. It is well settled that directors, while exercising their powers, do not act as agents for the majority or even all the members and so the members cannot by a resolution passed by a majority of even unanimously, supersede the directors' power and instruct them how they shall exercise their power. The powers of management are vested in directors and they and they alone can exercise these powers...."

Independent directors have an important role when they serve on the audit committee. They keep a check and approve the accounts of the companies so as to avoid the frauds in case of collusion between management and the statutory auditors. In a case relating to inflations of books of accounts and balance sheets, a SEBI order¹⁵ has tried to outline the liabilities of independent directors as follows:

"5. 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

¹⁵ SEBI, Mumbai Order dated 11 March 2011 issued in the Show Cause Notice No. SEBI/PSTL/AK/190939/2010 dated 13 January, 2010 issued to Mr. K.S. Kasiraman, Mr. K. Natarahjan and Mr. G. Ramakrishnan in the matter of Pyramid Saimira Theatre Ltd: see (2012) 6 Comp LJ 350 (SEBI)

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."

In reference to the above, so as to safeguard unnecessary victimization of independent directors the Ministry of Corporate Affairs ('MCA') issued a circular¹⁶ instructing all Regional Directors, Registrars of Companies and Official Liquidators that directors should be held guilty as indicated above and would be liable for any act of omission or commission by the company or by any officers of the company which constitute a breach or violation of any provision of the Companies Act, 1956, and which occurred without his knowledge attributable through board process and without his consent or connivance or where he has acted diligently in the board process. It further instructed that the timing of the commission of offence should also be considered to identify the director's responsibility; and Form 1AB should also be checked in case any person has been charged by the board under section 5(f) with the responsibility of complying with some particular provision or in case any director has been specified by the board under section 5(g) of the Act.

Proposed changes in law relating to independent directors

The definition

The Companies Act, 1956 (hereinafter referred to as the 'Companies Act' for the sake of brevity and convenience) did not envisage the concept of independent directors and so till date there is neither any definition nor mention of the words 'independent directors'. The concept first found mention in the listing agreements formulated by SEBI¹⁷ for compulsory acceptance by those public companies which sought to be listed on the recognized stock exchanges in India. In stark contrast to the Companies Act, the Companies Bill clearly and unequivocally defines an independent director in section 149 (6).

A careful comparing of the definition in the Companies Bill to the definition of clause 49 of the Listing Agreement is analyzed below:

- (i) The nominee directors are specifically kept outside the purview of being considered as independent directors. The Institute of Companies Secretaries of India ('ICSI') had recommended the same in its report to

¹⁶ MCA, General Circular No. 8/2011 dated 25 March 2011: (2011) 8 Comp LJ 91 (St.).

¹⁷ Supra (note 7).

the Government¹⁸. This is a welcome move as it was found that generally nominee directors represented the interests of the institutions they represent and not of the minority shareholders. It is seen that the current practice in many Indian companies has been to show the nominee directors of various institutions, to be as independent directors on their board.¹⁹

- (ii) The definition in the Companies Bill makes stringent provisions in regarding to persons having relationships with promoters and key managerial personnel and endeavoring to ensure that they should not be considered as independent directors. For example it can be seen in section 149(6) (d) of the Companies bill that an individual whose relatives has or had pecuniary relationship or transactions with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent or more of its gross turnover or total income or Rs. 50 lakhs or higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year, do not qualify as independent directors. This is in concert to the international practice whereby not just financial relations but also personal relationships of an independent with the promoters or management need to be scrutinized, to determine their independence.²⁰ This is to avoid the appointment of relatives as independent directors which is unfortunately a prevailing trend in Indian Companies²¹.
- (iii) The minimum age cap of 21 years as in clause 49 does not appear in the Companies Bill.
- (iv) The inclusion of individuals heading organizations which receive more than 25% of the total charity contributions from the company are prohibited from becoming independent directors of the said company.

Number of independent directors

The Companies Bill under section 149(4) makes a comparatively lighter provision than the current requirement of clause 49 of the Listing Agreement. The Companies Bill provides that at least one-third of the total number of directors would be independent directors and the Central Government has been authorized to prescribe the minimum number of independent directors in case of any class or classes of public companies. In contrast, clause 49 provides that not less than 50% of the board of directors would comprise of non-executive directors and where the chairman of the board is a non-executive director, at least one-

¹⁸ ICSI, 'ICSI Recommendations to Strengthen Corporate Governance Framework' released on 2009

¹⁹ Mehul Shah, 'Nominees still appointed as independent directors' (Business Standard, 29 September 2011)

²⁰ In re *Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003)

²¹ Press Trust of India, '75% of independent directors 'home' members: Prime Database'.

third of the board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors. And that where the non-executive chairman is a promoter of the company or is related to any promoter or person occupying management positions at the board level or at one level below the board, at least one-half of the board of the company shall consist of independent directors.

Remuneration

The Companies Bill under sections 149(4) provides that an independent director shall not be entitled to any stock option. This is a major leap over the law as it stands in form of clause 49(I)(B) of the Listing Agreement under which stock options are allowed and where a shareholders' resolution would determine the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

With regard to the sitting fees for independent directors, the current law²² prescribes for companies with a paid-up share capital and free reserve of Rs. 10 crores and above or turnover of Rs. 50 crores and above that sitting fees should not exceed the sum of Rs. 20,000 and in case of other companies sitting fee should not exceed the sum of Rs. 10,000. No similar provision can be seen in the Companies Bill as of now.

Term of office

Section 149(10) of the Companies Bill states that an independent director shall hold office for a term of up to 5 consecutive years on the board of a company and shall be eligible for reappointment only on passing of a special resolution by the company and disclosure of such appointment in the board's report. Further section 149(11) of the Companies Bill provides that an independent director can hold office for a maximum of two consecutive terms. After the expiry of such term, such independent directors will be eligible for appointment after the expiry of three years of ceasing to become an independent director with a condition that an independent director shall not, during the said period of three years, be appointed in or be associated with the company in any other capacity, either directly or indirectly.

No similar provision was found in the Listing Agreement. The provisions in the Companies Bill will assist in curbing the ill-effect of the same set of independent directors serving on the board.

Clarity in role and Code of Conduct

Section 149(12) of the Companies Bill tends to inculcate the spirit of the MCA circular²³ and restrict the liability of independent directors only in respect of such

²² Rule 10B of the Companies (Central Government's) General Rules and Forms, 1956.

²³ Supra (note 16).

acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently. By introducing the Guidelines of professional conduct in Schedule IV of the Companies Bill, the new law has brought about a substantial change by keeping India in tune with changing international norms in corporate law, commerce and trade.

New roles

Section 179(1) of the Companies Bill has mandated that the board of directors of every listed company should constitute a Nomination and Remuneration Committee consisting of three or more non-executive directors out of which not less than one-half shall be independent directors. The role of the Nomination and Remuneration under section 179 of the Companies Bill, inter alia is given the task to identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, recommend to the Board their appointment and removal and shall carry out evaluation of every director's performance. It is to also formulate the criteria for determining qualifications, positive attributes and independence of a director and recommends to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees. Although the current Listing Agreement provides for the constitution of the remuneration Committee, it is as a non-mandatory requirement.

Separate meetings and evaluation of independent directors

Under the heading of '*VII Separate meetings*', in Schedule IV of the Companies Bill, a provision has been introduced whereby the independent directors of the company should hold at least one meeting in a year, without the attendance of non-independent directors and managerial personnel. This provision has been inserted so as to safeguard the independent directors from being victimized by the board and the management on contrary opposite views. The object of the separate meeting is to review the performance of non-independent directors and the board as a whole, of the chairperson of the company, taking into account the views of executive directors and non-executive directors and to assess the quality, quantity and timeliness of flow of information between the company management and the board that is necessary for the board to effectively and reasonably perform their duties.

The Companies Bill, under the heading of '*VIII. Evaluation mechanism*' in Schedule IV also provides that the performance evaluation of independent directors shall be done by the entire board of directors, excluding the director being evaluated and a report of performance evaluation would be prepared, which would determine whether to extend or continue the term of appointment of the concerned independent director. It is to be noted that the evaluation procedure provides a good system of checks and balances whereby the board of

directors can evaluate the performance of the independent directors. No provisions relating to separate meetings or evaluation of independent directors is currently provided for.

Proposed changes to the Listing Agreement

In order to keep in tandem with the Companies Bill, SEBI has recently released a consultative paper²⁴ discussing in-depth the review of law regarding to independent directors. SEBI has stated in the said paper that it intends to bring the new Listing Agreement in consonance with the Companies Bill and where stricter provisions are available in the current Listing Agreement the same shall be retained.

Suggestions

As stated above, although the perceived role of independent directors is that of a watchdog of the shareholders and other stake holders' interests, some of them do not envisage themselves as such.

- (a) It is relevant to point out that it is the decision of the board of directors as to whom to accept and whom to reject as a potential independent director. If an incumbent who is seeking to be appointed as an independent director is rejected for some reason or other, he/she will find it extremely difficult to challenge this decision of the board of directors in a court of law. From a practical viewpoint, it is extremely difficult to challenge such a decision in a court of law although this is theoretically possible. It is suggested that this avenue should be explored by SEBI because those who are appointed as independent directors are normally acquainted with some of the directors which may be a facilitative factor in being inducted. It is important to clarify that this may not be a general rule because there may be notable exceptions.
- (b) There should be a prescribed upper age limit for an independent director to serve on the board of directors. Judges of the superior judiciary have an upper age limit on the assumption that with increasing age, there is a decline in physical and mental health. Hence, there is no reason to permit independent directors to continue when they metamorphose into nonagenarians.
- (c) Under heading '*III. Duties (1)*' in Schedule IV of the Companies Bill there are mandatory provisions for training of independent directors and a duty is cast upon them to update their knowledge with the company. It is recommended that some central self-governing professional body be created under the aegis of the Ministry of Corporate Affairs or SEBI and

²⁴ SEBI, *Consultative Paper on review of Corporate Governance norms in India*, issued on 4 January 2013: (2013) 1 Comp LJ 59 (Journal).

this corporate body be entrusted the task of to design a training module based of which the independent directors can be trained.

- (d) The audit committee of a listed company should be empowered to ask for independent second opinion or to appoint experts to review accounts in case of discernible discrepancies. A fixed budget may be allotted to the audit committee by the board.
- (e) The duties and liabilities of independent directors with regards to the audit committee should be well defined so that whenever issues such as inflation of balance sheets and accounts arises, the liability of the independent directors in the Audit committee who approved the same can be ascertained.
- (f) The chairman of the audit committee should be ineligible to be re-appointed again as chairman for at least 3 years of the same company and the term of the chairman of the audit committee should be not more than 2-3 years.
- (g) The creation of a central self-governing professional body for independent directors as stated above would also constitute a platform to represent the collective interest of independent directors. The duties under section 150 of Companies Bill to maintain a data bank containing names, addresses and qualifications of persons who are eligible and willing to act as independent directors should constantly be updated.
- (h) The shareholders should be given an opportunity to communicate with independent directors. Currently, clause 49 of the Listing Agreement mandates the chairman of the audit committee to be present at the Annual General meeting of the company.
- (i) Specific provisions should be provided giving a mechanism whereby the independent directors can ask the board of directors for due diligence or obtaining of records for seeking professional opinion by the board and powers to have the right to inspect records of the company and legal compliance reports prepared by the company; and in cases of disagreement, record their dissent in the minutes of the meeting.

“A company is guilty of contempt of court if its employees perform acts amounting to a contempt while acting in the course of employment even though in direct contravention of instructions from the company.”

—Re Supply of Ready Mixed Concrete (No. 2)
(1995) 1 ALL ER 135 (HL)