INDEPENDENCY OF THE "INDEPENDENT DIRECTOR" SHOULD BE PROTECTED

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The term "Independent Directors" was introduced after the publication of the Kumar Mangalam Birla committee report, which was of view that definition, should bring out what in the view of the Committee is the touchstone of independence, and should be sufficiently broad and flexible. It was agreed that "material pecuniary relationship which affects independence of a director" should be the litmus test of independence[1]. And the board of the company would exercise sufficient degree of maturity when left to itself, to determine whether a director is independent or not.

Definition which was agreed upon was: Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment .Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report. This introduced clause 49 in listing agreements, which also prescribes that Audit Committee should comprise of majority of independent directors[2].

Issues pertaining to compensation paid to independent directors and its limit, what are the disclosures to be made to ensure transparency and different criteria for being Independent Director is being defined in Naresh Chandra committee report[3].

Non-executive directors, i.e. those who are independent and those who are not, help bring an independent judgement to bear on board's deliberations especially on issues of

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[1] Report of the Kumar Mangalam Birla Committee on Corporate Governance 1999, clause 6.5

[2] SEBI inline with its counterparts worldwide has been moving to get listed companies to constitute 50% of the board as independent directors with a view to improve standards of corporate governance.

[3] Naresh Chandra committee report, Report of the Committee on Corporate Governance 2002, clause 3.9 &3.10.

strategy, performance, management of conflicts and standards of conduct[4], which lays down caliber of independent directors. Nominees of institutions shouldn't be considered as independent as they represent sectional interests[5].

Integration of the Indian economy into the world economy has made corporate leaders to believe that the corporate governance in India should be in conformity with international norms and standards. In India the appointment of independent or non-executive directors has become a matter of mere legal compliance. In most of the companies non-executive directors has hardly any say in the management of a company. Hardly any relevant information is passed on to the directors and the meetings of the Board discuss minor and routine matters. The Board meetings are normally held once in three months and that too for few hours only.

The question that arises here is that is it enough to handle all issues of a company? In this case, it is obvious that promoters would prefer to appoint their cronies and faithful persons on their board to have minimum interference of the outside directors.

The whole idea of the institution of independent directors is simple. It is up to each company and management to establish trust and credibility to attract independent directors who have the confidence to be on its board. They are expected to be independent from the management and act as trustees of shareholders, which mean that they are obliged to be more "aware" and to question the company on issues that are relevant. In other words, no criminal liability should be attached to independent directors unless it is proved that he/she has personally committed a willful crime. They should be held liable only if they were either in charge of the matter or had knowledge of the offence and failed in their responsibility to ensure compliance.

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[4] Blue Riband Committee of the USA.

[5] Recommendations of Irani committee on independent directors.

This differentiation in liability can be achieved if independent directors ask the right questions at the right time. Raising appropriate red flags at the opportune moment would help avoid occurrence of such untoward situations to a great extent. Asking questions assumes utmost significance. One of the most important tools that independent directors possess is the right to insist on a particular agenda and have an in-depth discussion of such items at board meetings. Independent directors should also make sure that the agenda put before them is informative and, at the same time, provides the "big picture" without burdening them with too many details.

One third of a listed company's directors are required to be independent. The erstwhile majority of the minimum seven directors of public companies having share capital in excess of Rs. 5 crore should be independent[6].

Benefits of Independent directors: The reason to have them on the Board:

Providing a Different Perspective:
Independent directors often bring a fresh perspective to issues and are able to identify problems and suggest solutions that management might simply be too close to see. Especially with regard to financial matters between inside directors and the company.

Independently Approving Certain Board Actions:
Under general corporate law principles, directors owe a duty of loyalty I.e. conduct themselves for the benefit of the company and its stockholders. They shouldn't take actions that would be detrimental to the company for the purpose of conferring a personal benefit, their family members, or their business associates. This does not, however, mean that directors can never have any direct business dealings with the companies they serve. It does mean that such related-party transactions should not be approved by a director who stands on both sides of the transaction. A special committee

[6] Company (Amendment) bill 2003.

of independent directors can negotiate and approve such transactions on behalf of the company, provided that its members are sufficiently independent from the directors whose interests are adverse to the company. This also raises the confidence level of shareholders and outside constituents if impartial persons approve the transaction and also mandate Independent directors for foreign unlisted subsidiaries[7].

Independent Directors: Business advisor or watchperson:

Independent directors are to contribute to the development of corporate strategy, reviewing the performance of management also protecting interests of the public shareholders by opposing questionable management policies and establishing adequate controls against unjust enrichment by the promoters and the management.

Counterbalance management weaknesses in a company.

Ensure legal and ethical behavior at the company, while strengthening accounting controls

Be a source of well-conceived, binding, long-term decisions for a company.

Help a company survives grow and prosper over time through improved succession planning through membership in the nomination committee etc

Scenario of independent director in India:

In India, independent directors are handpicked by the promoter himself, who then puts the name to the nominations committee, which the nomination committee of the independent directors then generally approves. If a company truly needs independent directors, they have to be nominated by the SEBI which is a regulatory authority[8]. If they have a right to regulate, then surely they have a right to even suggest the appointment of certain directors. So, in the case of listed companies, SEBI must have the right to nominate independent directors, and if such legislation is brought in, a lot of people good

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[7] Clause 49 presently requires all domestic subsidiary companies of a listed company to also have IDs. As a suggestion This Requirement should be extended to foreign unlisted subsidiaries of the Indian listed companies.

[8] SEBI has specified principles of corporate governance and introduced a new clause 49 in the Listing agreement of India's Stock Exchanges.

competent independent people will apply to SEBI and ask for nominations. There are a lot of people who are prepared to work as independent directors and are truly independent because then they'll be accountable to SEBI, and not to the promoter. On the contrary it can be argued that the authority may not be given to an outside party to place a director on a company. There may be some merit in having an approved list which means that the SEBI could perhaps decided that there are certain qualifications which directors need. They could screen them for positive negative attributes and have a panel to say that these are independent directors that can be on listed companies and let management select or the nomination committee selects who they want.

Hence, it can be said that the notion of independent directors is actually beneficial for a company, but only in concept. The system with which independent directors are appointed and regulated is the major gap that has been put to a harsh test because of the Satyam case. If the system can be improved in its core and its objective can be expanded, there will be a far lower chance of another embarrassment like Satyam ever happening again.

Independent Director Exemptions:

Legal provisions must specifically exempt non-executive and independent directors from criminal and civil liabilities under certain circumstances[9]. SEBI should recommend that such exemptions need to be specifically spelt out for the relevant laws by the relevant departments of the Government and independent regulators, as the case may be. However, independent directors should periodically review legal compliance reports prepared by the company as well as steps taken by the company to cure any taint[10]. In the event of any proceedings against an independent director in connection with the affairs of the company, defense should not be permitted on the ground that the independent director was unaware of this responsibility. With regard to delineating legal liability of independent directors, the Companies Bill 2009 is a step in the right direction as apart from broader disclosures aimed at improving corporate governance, it also seeks to

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[9] Section 4.10 of Naresh Chandra Committee Report, 2002

[10] The Narayana Murthy Committee Report in 2003.

provide greater levels of protection to independent directors if they are not accomplices to wrong doings by the promoter-directors or other executives of the company.

Removal of Independent Directors[11]:

It was suggested that companies should inform SEBI / stock exchanges within five business days of the removal / resignation of an independent director, along with a statement certified by the managing director / director / company secretary about the circumstances of such removal / resignation (specifically whether there was any disagreement with the independent director that caused such removal / resignation). Any independent director sought to be removed or who has resigned because of a disagreement with management should have the opportunity to be heard in general meeting.

Role of the Independent director:

The major securities markets require that a majority of the directors of all listed companies be independent and require that key oversight committees (such as audit, compensation, and nomination/governance committees) be composed solely of independent directors. The rationale behind the use of independent directors is that including outsiders in corporate decision making provides an effective mechanism to monitor the actions of management, to prevent abuses of power, and to provide a more balanced perspective on important corporate issues. The use of independent directors also broadens the experience base of a company's governing body.

Eligibility Criteria for Independent Directors[12]:

The eligibility criteria are: independent directors should not

(i) Have material or pecuniary relationships

(ii) Be related to the promoters

(iii) Be an executive in the company in the immediately preceding three years.

[11] Section 5.3 of Naresh Chandra Committee Report, 2002.

[12] Clause 49 of listing Agreement.

The single exception is that all members of the audit committee of the board should be 'financially literate' and at least one member shall have accounting or related financial management expertise. The eligibility criteria singularly lack laying down any relevant standard of professional competence that may be required to exercise oversight over the affairs of the management.

In order that corporate governance objectives are met through the offices of independent directors, it is imperative that certain structural changes are made to Clause 49[13].As of now companies which are required to comply with clause 49 is 4327[14]. The clause should clearly lay down –

(i) Minimum acceptable professional qualifications for eligibility;

(ii) Appropriate limits on payment of fee, compensation benefits and stock options so as not to introduce an element of 'reward' for independent directors which could establish an incentive and preclude their objective judgment

(iii) Limit the number of independent directorships which a person can hold simultaneously.

PROTECTION TO INDEPENDENT DIRECTORS:

Maximize financial protections for independent directors:

The first line of financial protection for independent directors is indemnification from their companies. Although all companies are permitted to indemnify their directors and officers for certain types of loss, companies are generally required to indemnify their directors and officers only as provided in bylaws or certificates of incorporation.

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[13] On 26 April 2003 SEBI advised all Stock Exchanges in India to ensure compliance of the revised clause 49 on or before March 31, 2004. The clause applied to all listed entities having a paid up share capital of Rs 3 crores (£400,000 approx) or net worth of Rs 25 crores (£3 million) at any time in the history of the company.

[14] Data source www.directorsdatabase.com , as of November 6 2010, Total no of Companies listed in BSE : 4920, companies which are not required to follow clause 49 :593, companies who have filed the information: 2618, filed but data incomplete: 23, companies yet to file :431.,visited on 9th November 2010 at 21:00 hrs.

Therefore, a company's internal indemnification provisions should be periodically reviewed in the light of applicable state law to assure that they provide the maximum protection permitted by law.

The provisions may require the company to reimburse the director for any expenses incurred in a claim by the director against the company to enforce his or her indemnification rights if the director is successful in recovering indemnification in whole or in part from the company.

The provisions may provide that, if the company denies indemnification, the director has A right to an appeal or an independent *de novo* determination as to indemnification.

Quality Directors and Officers (D&O) Liability Insurance Coverage:

It is more critical than ever that companies maintain adequate insurance for its officers and, more important, for its IDs. Insurance protection should be given for IDs.

Creating a Financial Instrument:

To ensure adequate funding for any indemnification claim, the company may secure its indemnification obligation by establishing a reserve fund or trust or by purchasing a surety bond, a letter of credit, or another similar financial instrument.

Legal immunity should be provided to the IDs:

New noises are being heard about the need for legal immunity to IDs. Clearly, IDs want only the upside-fee, commissions, ESOPs and the perquisites-but not any downside. Undoubtedly, IDs should not be responsible for every wrong in a company as they have no control over or knowledge of it. In case they are, we will only see a further exodus of IDs, at least of the value directors. However, the IDs need to be accountable for decisions that they were a party to, with negligence being also treated as connivance.

CONCLUSION:-

Satyam episode is proven to be tragic for the Indian corporate world, but it should be considered as a wake-up call to many. The Satyam case brought out the failure of the present corporate governance structure, in which independent directors failed to perform their responsibility effectively. As in Satyam case independent directors lacked commitment; they failed to live up to the stakeholders' expectations. The only way independent directors can stop wrong doing by acting collectively. Independent directors today operate under a microscope. More is expected of them than ever before, and shareholders, employees, competitors, the government, the media, and others are watching them and their decisions closely under the light of the Sarbanes-Oxley Act. Understanding the scrutiny under which they work, independent directors must take every Precaution to protect them. Two of the most important steps they can take are to follow principles of good corporate governance and ensure broad financial protection.

Across the world companies have appointed luminaries to the boards, secure in the knowledge that their presence would lend a badge of respectability to the boardroom. There is no need to implement new laws; all we need to do is to renew existing laws. Independent directors may not be in a position to stop management fraud perpetrated at the highest level, but with high level of commitment and due diligence they should be able to identify signals that indicate that everything is not going right.

Recommendations:

1. The definitions should include both negative as well as positive attributes: Positive attributes should emphasize independency and objective judgment and negative attributes should highlight potential conflicts of interest that could arise. A through definition will help to guide nomination committee in its search for independent directors.
2. Independent exceptions should not be allowed: giving opportunities to companies to allow a director to be deemed independent, when he fails to meet defined

guidelines can create problems, providing company with a way out encourages them to use this option rather than find another suitable candidate and meet required guidelines.

3. Chairmen should be an independent director: Separating role of chairmen and CEO is not enough to ensure effectiveness of board of directors. f chairmen of a company becomes an independent director then board can maintain its objectivity and appropriate balance of power.
4. An induction course to introduce new independent directors to the company, ts operations, its strategy and applicable legal and regulatory framework is the absolute minimum level of training that should be required.
5. The companies should have an entirely nomination committee which should determine the qualifications for board membership and should identify and evaluate candidate for nomination to board.
6. Code of Corporate governance of a company should specifically include qualifications and attributes that the company seeks of an independent director. They must not be only independent according to legislative and stock exchange listing standards, but also independent in thought and action. I.e. qualitatively independent.
7. IDs should be appointed by Government or by SEBI, considering appointment of IDs in PSU sectors, but it is to be seen that there is no room for corruption and unnecessary political interference.
8. Minimum 33 years and Maximum 65 years should be capped physically old and mentally tired people cannot be expected to be vigilant (in fact, they are likely to often go off to sleep during the board meetings), minimum qualifications and experience should be mandated.