Role and Responsibilities of Independent Directors-The Way Forward

Rajesh Chakrabarti
Asst.Professor
Indian School of Business

Independent directors have been the bedrock of the corporate governance changes around the world in the decade since Enron. From Sarbannes-Oaxley in the US to the OECD code to Clause 49 in India, all have held up board independence as the bulwark of corporate governance. How well has the institution fared in practice? Have independent directors really been able to restrain runaway management or prevent expropriation of minority shareholder interests? In the following paragraphs I will attempt to discuss a few recent academic research papers on the subject to capture the evidence and thinking in this area.

Perhaps it is best to first lay down the expectations from the independent directors. What do investors and regulators expect them to do in the boards? Are their own thinking and perceptions in line with these external expectations? In general corporate board members are supposed to serve two broad functions: to provide direction and guidance to the business and to monitor management ensuring that it fulfills the objective of serving shareholder interests. In theory at least independent directors are valuable on both counts in that they can bring in external perspectives and insights relevant for business growth and at the same time, being not beholden to the management, ensure that shareholder interests are served. As a matter of corporate governance reforms, however, it is the second role that has assumed greater importance. It is fair to say that the regulators and society at large view independent directors primarily as the voice of the shareholders on boards.

Here too, however, there is a difference between the very nature of the dominant corporate governance problem that the monitoring role of independent directors is supposed to avoid. In developed country settings, particularly in the "Anglo-Saxon" system with dispersed shareholding, the primary corporate governance challenge is "vertical" – i.e. ensuring that the management serves the shareholders. In emerging market countries like India where effective control of most listed firms reside with the entrepreneur family, the central challenge is often "lateral" – i.e. ensuring the "promoters" do not misappropriate the interests of the minority shareholders by tunneling funds to other business group entities through related party transactions or other practices. The wards of the independent directors therefore are different in the two contexts – it is the shareholder in the first case and the minority shareholder in the latter.

The Role of Independent Directors as they themselves see it

But do independent shareholders themselves view their role in this manner? A partial and preliminary answer to this question is provided by a recent paper by Vikramaditya Khanna and Shaun Mathew[1] that uses interviews of independent directors in India to ascertain their own understanding of their role as part of larger study covering independent directors across different countries.

The preliminary results of the study are quite revealing. It finds that all, repeat *all*, independent directors view their role as that of being, first and foremost, strategic advisors to the company. The "watchdog" role is not something that independent directors are comfortable with at all. Most thought that any legal step stipulating such a role would be misplaced since currently the liability of independent directors in India were perceived to be very high and included non trivial risk of criminal liability while neither were the remuneration and benefits adequate nor was there proper insurance coverage available for them.

Almost all independent directors interviewed would missed basic protection against being served arrest warrant for things beyond their control liked bounced checks and factory accidents. Everyone of the independent directors interviewed considered the pay involved with their positions grossly inadequate given the risks involved.

The interviews also elicited more information about the boardroom environments. Most seemed to agree that the voice of independent directors was actually listened to in board meetings, even in the relatively rare situations of conflict and at times management projects were abandoned or modified in response to such comments.

The directors rarely interacted with minority shareholders and when they did it was almost always with foreign institutional investors. They were not particularly well-trained for their roles either. Some independent directors found training materials – in-house or external – insufficient for their roles.

This evidence of the independent directors' predominant self-perception of their roles is therefore quite at odds with what corporate governance theory would have us believe. The "watchdog" role of the independent director seems more of a figment of imagination than a common feature in real-life boards. This may hardly be surprising, if we consider the way individuals are selected to become independent directors. While regulators the world over have taken pains to rule out "interested

parties" including suppliers , vendors etc. and even relatives of promoters and executives from the definition of independent directors, it is only natural that the management, and the promoters in a promoter-controlled firm, would look for people on their boards who, while fulfilling the regulatory requirements, are known and friendly towards them. This is not an attempt to undercut the spirit of the law but just a natural way of doing things. Therefore by their very inclinations, as well as the time and training and incentives they get, independent directors are less than likely to be effective "watchdogs", a role they are not even willing to own up to.

How have the profile of Independent Directors changed in recent years

Two incidents – the widely reported Satyam fraud and the less well-known persecution of Nimesh Kampani – in December 2008 and January 2009 had sent shockwaves through boardrooms across India. In the Satyam case, a highly respected company with a stellar board was exposed to be having a long-standing accounting fraud bringing severe disrepute, inquiries and professional mishaps for the independent directors on its board. In the case of Nimesh Kampani the billionaire investment banker had an arrest warrant against him for malfeasance that happened in Nagrjuan Finance Ltd. almost nine years ago, a year after he had left its board. Mr. Kampani had to flee the country to avoid arrest and had to stay in exile for almost nine months. Suddenly the risks associated with board positions became apparent to many independent directors across firms in India leading to a spike in independent director resignations in January 2009 and higher levels of exits in the months that followed. A recent paper[2] has looked into how the profile of Indian boards and independent directors therein has changed in the time since the crises, and the results are quite revealing.

Consistent with a supply-side shock in the labor market for independent directors, the exodus of independent directors in large numbers from other Indian firms resulted in an overall decrease in the percentage of independent directors on corporate boards. Even more interesting than these effects are perhaps those on the quality of independent directors. Independent directors are now less likely to have relevant educational backgrounds (such as being equipped with a business or a law degree) or professional experience (including lawyers, financial experts, academics, civil servants and others government officials). At the same time there have been significant increases in per director remuneration following the Satyam crisis. Also, consistent with the perceived increase in risks, the proportion of variable compensation seems to have declined. Though workload, as measured by the attendance in board meetings, has increased, the increase in compensation is above and beyond that accounted for by the increase in workload, which may be interpreted as being consistent with the increase in risks story.

Overall, it seems that post-Satyam it is harder to find good quality independent directors and boards are paying more for a decidedly lower quality of independent directors. The reason behind this naturally is the compulsion of Clause 49 to maintain at least 50% board independence in case of an executive chairman and 33% with a non-executive chairman. So while on the one hand the supply of independent director services have shrunk, the demand has not gone down because of the regulatory constraints. The result: better paid but poorer quality independent directors.

However, some companies have sought to avoid this situation. There has been a rise in the share of companies with non-executive chairmen. While there may be other drivers of this change, the switch enables companies to make do with fewer independent directors. So notwithstanding the exit of independent directors, average board size has actually increased with a greater proportion of directors now being executive directors. Also, perhaps expectedly, the executive board appointments have been more common in firms switching to the non-executive chairman model.

The evidence may be interpreted in at least two different ways. Firstly, all of this may be a result of a simple supply-side shock with boards adjusting to scarcer independent director candidates. Alternatively, one could view this as a consequence of firms voluntarily forgoing independent directors as their efficacy has always been suspect and is even more so following the much publicized inability of Satyam's star-studded board failing to block its proposed acquisition of the Raju family-owned Maytas companies. The two effects may well be occurring together, with the supply shock dominating as reflected by higher average pay per independent director. So in some sense, India Inc. may well be voting the board independence driven corporate governance model out, while remaining within the regulatory constraints .

Is there an alternative?

But the question is whether there is actually any alternative to the view of independent directors as a pillar of corporate governance, a model that is widely accepted and heralded around the world and championed by regulators across countries. Here too an interesting new development in the area of theoretical corporate governance seems to be pointing in a new direction. A recent paper[3] by three influential economists, argues that "internal governance" implemented through the agency of a board constituted largely of corporate executives may be the way forward. So we will try to understand the argument in this paper a little closely.

In a rather radical departure from tradition. The paper argues that subordinate managers constitute an important stakeholders in the firm, and care about its future even if the CEO acts in his or her short-term self interest and shareholders are dispersed and powerless. By threatening to withdraw from the firm, they can force the CEO to act in a more "public-spirited and far-sighted way". This process is termed *internal governance*.

The intuition of the formal model here is largely derived from the fact that while the CEO may have a tendency to expropriate benefits here and now and possibly indulge in activities that may be risky or harmful for the firm the subordinate managers have a longer horizon and look forward to the day they would become the CEO. They would therefore protest against myopic and overly risky decisions by the CEO in their own interest.

The view is no doubt novel as this group has been scarcely thought of in the literature as a stakeholder that matters. Normally the executive voice has been synonymous with that of the CEO's. This new variant introduces a group that has both much greater knowledge about the firm to be effective monitors than independent directors and enough "skin in the game" to really care. The only issue is their independence. Are they not likely to be too beholden to the CEO for their own individual career prospects to be able to monitor.

The question of independence would presumably depend on at least three different features – the job market prospects so that the executive can move on easily if he is in disagreement, the number of subordinate managers in case there is a tournament model for succession of the CEO and the decision making authority. In other words if it is the CEO who chooses his successor then it is difficult for the subordinates to be an effective voice against him. On the other hand if an appointments committee makes that choice, the subordinate executives may have a greater say.

The obvious way to empower this group is through board seats. As informed and dedicated monitors they are likely to function better than independent directors. But some questions persist. While they may work well in the case of the "vertical problem" of management versus dispersed shareholding, how effective will they be in the "lateral problem" between controlling and minority shareholders? These are, of course, important issues to be thought through but as a concept subordinate managers constitute an important alternative to the current dispensation of independent directors.

Concluding thoughts

In recent year the institution of independent directors has come under fire – everywhere but particularly in emerging market settings with controlled firms. In India considerable ink has been spilt in arguing that the institution has been hijacked into cronyism and needs to be made more effective. But that is not a simple task. Unless investors start valuing firms with effective independent directors, promoters should see no reason to pack boards with honest critics rather than with friends or apathetic individuals. The independent directors themselves would have little ability, knowledge or incentive to fulfill their monitoring role; a task that almost all of them gladly deny to be theirs in the first place. And yet the legal system in India holds each director – independent or otherwise – equally liable for lapses in the company that are clearly impossible for them to be aware of, far less prevent. Also failures by other pillars of corporate governance – auditors for example in the case of Satyam – would endanger the reputation of the independent directors. The end product of all these inconsistencies is that the integrity of the system gets compromised and, as we have seen after the Satyam and Kampani wake-up calls, result in an overall worsening of the quality of independent directors. One way out is to go back to the old system of having more "insiders" – subordinate executives – on boards to ensure that the CEO does not have an unfettered regime. But of course, in a family controlled firm, loyalty to the owner may come in the way of effectiveness of this dispensation as well. Nevertheless, it is a possible alternative to the current system that deserves a serious consideration.

---

[1] Vikramaditya S. Khanna and Shaun J. Mathew, 2010, The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence, National Law School of India Review, 22: 35

[2] Rajesh Chakrabarti, Krishnamurthy Subramanian and Naresh Kotrike, 2011, The Unregulated Effect of a Corporate Governance Failure on Boards, Working Paper, Indian School of Business.

[3] Acharya, Viral, Raghuram Rajan and Stewart Myers, The Internal Governance of Firms, *Journal of Finance*, forthcoming.