

Independent director is not a 'Phantom' or 'Spiderman'



Nitin Potdar
Partner
J.Sagar Associates

Independent directors seem to have onerous fiduciary responsibilities, but no resources or tools to discharge them

First came the news about the prosecution of independent directors and several other entities in a string of financial irregularities involving big corporates. Personal liability was imposed on directors who were seen to have failed in discharging their governance responsibilities. The Supreme Court in the Jaypee Infratech case prohibited directors from alienating their personal properties or assets in any manner. Recently, it allowed the arrest of the directors of Amrapali Group. The National Company Law Tribunal restrained the directors of IL&FS from transferring or creating any charge on movable or immovable properties owned by them.

These examples, though extreme, are early rumbles of a definitive move in corporate jurisprudence to hold directors personally liable for the failings of companies.

Then came the news that the government was contemplating taking a series of steps to restore faith in corporate governance standards in the country, by bringing in amendments. This was followed by another news: that persons looking to join the board of a listed company as independent directors may have to clear an exam before taking up the role.

This was probably the last straw for according to a recent Economic Times report, several former executives, ex-bureaucrats and others are increasingly quitting or declining to accept jobs as independent directors (IDs), reflecting a growing trust deficit in India Inc.

Former CEOs and directors have been reported as saying they are refusing offers over reputational concerns and fears about legal liabilities as independent directors are increasingly being held accountable for the actions of promoters and management.

As per Nseinfobase, Nifty 500 companies saw 316 exits by independent directors in FY19, 31.7% more than the year earlier, when 240 had quit. Of the FY19 total, 99 left after terms expired. Others cited preoccupation (54), personal reasons (31) and health (10) for leaving. About 50 quit without giving any reason.

This development does not come as a surprise.

While there is no doubt that independent directors have to be accountable for their roles, there is only so much they can know as much as is shared by the management with them. It is not the exam itself, but the philosophy behind the exam that is problematic.

Role of Independent Director

The Companies Act of 2013 does not give any specific definition of an independent director; but an elaborate code has been prescribed in Schedule IV including Role and Functions and Duties. If one were to strictly implement the role and functions given in Schedule IV, the Independent Directors will necessarily have to work full time in the Company and be responsible to every and all persons directly or indirectly connected with the Company. It travels much beyond merely improving corporate credibility and governance standards or act as a watchdog as was earlier envisaged. Most importantly, he is now supposed to bring independent judgment on strategy, performance, risk management, resources, key appointments and standards of conduct. He is supposed to scrutinize the performance of management in meeting agreed goals and objectives and also monitor the reporting of performance. He is supposed to satisfy on himself on the integrity of financial information and that the financial controls and the systems are robust and defensible. On top of it he is expected to safeguard the interests of all stakeholders, in particularly the minority shareholders. And much more.

The role and function expected from the Independent Directors cannot be fulfilled even if they were appointed by a committee comprising of MCA/ SEBI/ CBI/ ED. We are forgetting that the independent director is not a phantom or Spiderman who can even identify or even attempt to solve all problems as soon as he gets appointed. Nor is he a villain as is made out to be by everyone. He, at the most, meets the board once a quarter and is dependent on the information provided by the board and the auditors, who are in turn appointed by the company. There is no way, he can do due diligence or any independent enquiry on his own.

This fact - that an independent director is a non-executive who suffers from information asymmetry vis a vis

executive directors / management - seems to be ignored when the company is in trouble. After all, the board's role is to provide guidance. Independent directors cannot be assumed to have connived, conspired or colluded - when they were at best negligent. That would not be a fair way to treat them.

Unless independent directors are actively involved in the affairs of the company and are able to access internal documents and attend key meetings where maybe controversial decisions are taken, it is impossible for them to spot a wrongdoing. They seem to have onerous fiduciary responsibilities, but no resources or tools to discharge them. It is right to expect independent directors to be diligent. However, to expect them to be 24/7 vigilant across all operations of the Company is totally wrong. They will become sacrificial lambs and governance will suffer even more as a result.

In high profile corporate frauds, if the government is going to assume that everyone is guilty until proven innocent, it is going to send a wrong picture. It will make life difficult for good companies because genuinely independent and conscientious people will not volunteer to become independent directors. We are already seeing that happen. As a result, nominally independent directors will have to be appointed which may see more wrongdoing.

THE ISSUE OF CORPORATE GOVERNANCE

The year 2018 was an eventful one for the corporate governance regulatory framework in India. The Securities and Exchange Board of India (SEBI) not only approved a host of recommendations made by the Kotak Committee on Corporate Governance (Kotak Committee), but also gave these recommendations the required regulatory impetus by notifying the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018.

The government has now come out with a list of amendments with an emphasis on independence, diversity and transparency of the Board of Directors.

The majority of the Amendments are dedicated to achieve the twin objectives of stopping directors “dividing their attention and time amongst too many stakeholders, and increasing the diversity of each board”. The Amendments will now place restrictions on the maximum number of directorships (independent and otherwise) that each director can hold in a listed entity.

An additional layer of scrutiny has been added for independent directors, which requires such directors to make declarations to the board on an ongoing basis regarding their independence, and the board to formulate a policy for evaluating the performance of all independent directors. The compliance requirements stretch even after the resignation by an independent director – the board is now required to disclose to stock exchanges the why as well as the when regarding the resignation.

All this is fine, and probably needed. However, this overzealous approach to resolving corporate frauds without understanding the ethos of good governance can be counter-productive.

The key to better corporate governance lies in the working relationships between boards and managers, in the social dynamics of board interaction, and in the competence, integrity, and constructive involvement of individual directors. Legislation cannot resolve this. If boards are want improvements, they should think aspirationally and act practically drawing a roadmap on the path they want the company to take. They cannot depend on solutions imposed from outside.

Corporate governance is a culture – the earlier we understand and accept this, the better it would be. It cannot work in isolation by simply creating rules and regulations. It needs to be an eco-system that would bring in transparency, accountability and integrity in decision making.

Obviously, this ecosystem cannot be built by independent directors or a few others by injecting a vaccine in the form of rules. It would have to be injected into the DNA of all stakeholders of any corporate entity viz. promoters, managers, all directors including the independent ones, vendors, customers, employees, government, investors, minority shareholders, regulators et al.

This can be built by regulators or institutions like stock exchanges, lending institutions, banks, investor groups, forums, educators, global organisations like the World Bank, International Monetary Fund (IMF), etc.

It is management’s responsibility to ensure that boards get the right information at the right time and in the right format to perform their duties. The best boards design processes to deliver formal information that combines both leading and lagging performance indicators, which will vary by industry and company.

Without the right information, in the right format, at the right time, board members may be left in the dark and will not be able to perform their fiduciary duties. Corporate governance, after all, is a process, a journey and not an end in itself.

List of Corporate Governance Codes in Select Emerging Markets

Country	Last Updated	Name of Code and Link to Document
Brazil	2016	Brazilian Corporate Governance Code (Código Brasileiro de Governança Corporativa)
Chile	2012	General Norm 341 (La Norma de Carácter General (NCG) N° 341)
China	2018	Code of Corporate Governance for Listed Companies in China (in Chinese)
India	2018	Report of the Committee on Corporate Governance
Indonesia	2006	Indonesia's Code of Good Corporate Governance
Malaysia	2017	Malaysian Code on Corporate Governance
Mexico	2010	Code of Corporate Best Practices (Codigo de Mejores Practicas Corporativas)
Philippines	2016	Corporate Guidelines for Companies Listed on the PSE
Russia	2014	Russian Corporate Governance Code
Saudi Arabia	2018	Corporate Governance Regulations
South Africa	2016	King IV Report on Corporate Governance for South Africa 2016 (known as 'King IV')
South Korea	2016	Code of Best Practices for Corporate Governance The most recent code is available in Korean.
Taiwan	2016	Corporate Governance Best-Practice Principles for TWSE/GTSM Listed Companies
Thailand	2017	Corporate Governance Code
Turkey	2014	Corporate Governance Principles—Capital Markets Board of Turkey