

INDEPENDENT DIRECTOR UNDER INDIAN STATUTE AND ITS EVOLUTION

B Pallavi Patro* & Vikalp Srivastava**

Abstract

The paper deals with the notion of Independent Directors and their necessity in order to reduce scandals and frauds which have been continuing since decades. The paper further discusses the 'Evolution of independent directors that was understood by the legislators only after such scams that triggered the world economy' with regard to *Enron and Satyam* scam where the need of Independent director was felt by most of the company as it has hailed as an effective deterrent against fraud, misconduct and mismanagement and inadequacy in decision making policy. Further paper talks about Independent directors and their role in harbouring the decision making policies and maintaining the balance between the shareholders, stakeholders and managers interests. Corporate Experts have always urged the need for the directors to be independent and free from the influence of the Board. This paper deals with evolution of Independent Directors and their role in Corporate Governance in both national and international perspective, gives brief knowledge about various reforms, and committees which brought in the concept of independent directors, the paper also talks about the role, function duties of independent director in relation with Clause 49(1B) of listing agreement and the definition appointment, reappointment, removal, remuneration provided to the independent director and statutory provisions related to independent directors as per Companies Act, 2013. The paper concludes with the complications which are faced in maintaining the independency of independent directors.

Keywords: Independent Directors, Evolution of Independent Directors, Listing agreement, Independency of Independent Director, Schedule IV Companies Act, 2013

* Student @ School Of Law, KIIT University, Bhubaneswar (Odisha); Email: pallavi.patro95@gmail.com

** Student @ School Of Law, KIIT University, Bhubaneswar (Odisha); Email: vikalpsri85@gmail.com

INTRODUCTION

“Independence is a status of mind and cannot be arrayed through a statute. A lot of promoters bring someone on the board that they have acknowledged for long. The chosen individual is either expected to add value or toe the line without practical encounters. However, if the non-executive director chooses to engage in positive challenge within the board room, that is actual independence. In the long run, such positive dissent is bound to result in more operative decision making.”¹

Independent directors as mostly understood are those who apart from receiving remuneration have no material interest in a company.² Reason for appointment of Independent on the board is to strengthen the internal control in lack of effective shareholder control.³ A majority of the independent directors on Indian boards are retired experts with a just proportion of accountants and legal experts.⁴ The broad definition of independent directors is ‘those directors, who apart from accepting director’s remuneration do not have any other material monetary relationship or business with the company, its promoters, and its management of its subsidiaries, which in the decision of the board, may upset independence of the decision of the directors’.⁵ Others regarded it as directors ‘who apart from accepting director’s remuneration do not have any other material fiscal relationship or relations with company, its promoters, its management or its subsidiaries, which in the conclusion of the board may affect their impartiality of judgment’.⁶ Furthermore, definition of independent director should be ‘adequately extensive and flexible’ so that it does not ‘become a restraint in the assortment of independent directors on the boards of companies.’

EVOLUTION OF INDEPENDENT DIRECTORS

The notion of Independent Directors developed in the US in the 1950’s. The general notion of the American Boardroom Practice was that Independent Directors used to aid as a solution to the Manager-Share Holder Agency problem. Independent Directors was presented as a voluntary mechanism in the US with the belief that a board with some level of independence will introduce neutrality in decision making, add to the diversity and advisory capabilities of the Board and hence perk up the performance of the company. Later innumerable arms of the government accepted this idea in a phased manner.⁷

¹ www.kpmg.com/IN/en/IssuesAndInsights/ThoughtLeadership/Role_of_Independent_Directors.pdf (Accessed on 12 January ,2016)

² Indrajit Dube ,*Corporate Governance*, Lexis Nexis Butterworths Wadhwa Publications : New Delhi , 2009, Pg. No. 124

³ Berle, Adolf A & Means, Gardiner C, *The Modern Corporation and Private Property*, The Macmillan Company Publications: London, 1962, Pg. No. 19

⁴ *Supra* at 3

⁵ See Section IB of the circular SMDRP/POLICY/CIR-10/2000

⁶ Report of the Committee Appointed by SEBI on Corporate Governance, Kumar Mangalam Birla Committee,(Academic Foundation) Pg. No. 13

⁷ www.indianacademylaw.com/role-of-independent-directors-in-corporate-governance/ (Accessed on 13 January 2016)

The first committee to be established in this regard was the Cadbury Committee. It aimed at reporting on the financial aspects of corporate governance. Similarly, Greenbury Committee was also established in January 1995 which focused on the Directors' Remuneration, its report was published in July 1995.⁸ Further in the year 2003 although substantial improvements in corporate governance had been stimulated in UK's listed companies, certain areas were highlighted for further improvements by the Higgs Committee. In the same year the UK Government in response to the Enron scandal commissioned a committee known as the Smith Committee which passed its report known as the Smith Report⁹.

In India the Independent Director concept was traced to the recommendations made by the Kumara Mangalam Birla Committee (1999), Naresh Chandra Committee (2002) and Narayana Murthy Committee (2003).

Kumara Mangalam Birla Committee (1999): Committee defined independent director as non-executive directors, who have a significant role in the entire mosaic of corporate governance. The Committee was of the view that it was important that independence be suitably, correctly and practically defined, so that the definition itself does not become a constraint in the selection of independent directors on the boards of companies. The definition should bring out what in the view of the Committee is the benchmark of independence, and which should be sufficiently broad and flexible.¹⁰ It was agreed that "material monetary relationship which affects independence of a director" should be the litmus test of independence and the board of the company would exercise adequate degree of maturity when left to itself, to determine whether a director is independent or not.¹¹ The Committee therefore agreed on the following definition of "independence"- Independent directors are directors who apart from getting director's remuneration do not have any other material pecuniary relationship or dealings with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may alter their independence of judgement.¹² Further, all pecuniary relationships or transactions of the non-executive directors should be released in the annual report.¹³

Naresh Chandra Committee (2002): Defined an independent director as an individual free from business and any other relation with the company. The committee recommended that the appointment of independent director should be done through a Nomination Committee being setup in listed companies, comprising a majority of independent directors including its chairman; their job would be to search, evaluate, shortlist and recommend appropriate independent directors.¹⁴

⁸ Adrian Cadbury, *Corporate Governance and chairmanship*, Oxford University Press Inc.: New York, 2002, Pg. No. 15

⁹ *Id*

¹⁰ www.sebi.gov.in/commreport/corpgov.html (Accessed on 12 January, 2016)

¹¹ www.ecgi.org/codes/documents/corpgov.pdf (Accessed on 12 January, 2016)

¹² *Id*

¹³ *Supra* at 12

¹⁴ www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf (Accessed on 13 January, 2016)

Narayan Murthy Committee (2003): It was suggested that SEBI should work towards harmonizing the provisions of clause 49 of the Listing Agreement and those of the Companies Act, 1956.¹⁵ The Committee noted that major differences between the requirements under clause 49 and the provisions of the Companies Act, 1956 should be identified.¹⁶ SEBI should then recommend to the Government that the provisos of the Companies Act, 1956 be changed to bring it in line with the requirements of the Listing Agreement. 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 reasons of such removal/resignation (specifically whether there was any difference with the independent director that caused such removal/resignation).¹⁷ Any independent director sought to be removed or who has resigned because of a discrepancy with management should have the opportunity to be heard in general meeting.¹⁸

Further to these proposals the term Independent Director was introduced for the first time in India when the Securities and Exchange Board of India (SEBI) incorporated Clause 49 of the Listing Agreement.¹⁹ There are interesting differences between the New York Stock Exchange (NYSE) regulations and the SEBI regulations with respect to the determination of 'independence' of directors. The NYSE regulations define Independent director as one who 'has no material relationship with the listed company' which is similar to the original version of the Clause 49 enacted in SEBI. However, the NYSE regulations require affirmative determinations of independence of each director by the board by considering 'all relevant facts and circumstances' unlike the original version of Clause 49.²⁰

WHO IS AN INDEPENDENT DIRECTOR AS PER THE STATUTE? DEFINITION, APPOINTMENT AND REMOVAL

Before 2000, the Companies Act had no provision regarding the Independent Director in the Board. The word "Independent Director" was first taken into account in the clause 49 of the Listing Agreement under the heading Corporate Governance. Company Act, 2013 made new provisions regarding Independent Director.

Act lays down that, 'independent director' means an independent director mentioned to in sub-section (5) of section 149.²¹

The Companies Act, 2013 says that every listed public company shall have not less than one-third of the total number of directors as independent directors²² and the Central Government

¹⁵ www.geocities.ws/kstability/inbank/corpgovern2/last.html (Accessed on 13 January, 2016)

¹⁶ *Id*

¹⁷ www.sebi.gov.in/commreport/corpgov.pdf (Accessed on 13 January, 2016)

¹⁸ *Id*

¹⁹ Jayanti Sarkar and Subrata Sarkar, *Corporate Governance in India*, SAGE Publications Pvt Ltd : New Delhi, 2012, Pg. No. 237

²⁰ *Id*

²¹ Section 2(47), Companies Act, 2013

may recommend²³ the minimum number of independent directors in case of any class or classes of public companies.²⁴

Section 149(6) of the act²⁵ lays down that an Independent Director in relation to a company, means a director other than a managing director or a whole-time director or a nominee director. Further, the said section lays down the following criteria for a person to be appointed as an independent director. Section 149(6) (a) of the act, says that the person to be appointed, in the opinion of the board should be a person of integrity and should possess relevant expertise and experience. Any person who himself is or is related to the promoter or is related to the director in the company or its holding, subsidiary or associate company cannot be appointed as an independent director of the company.²⁶

Sub-section (c) of the above mentioned section lays down that such individual to be appointed should not have any monetary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during two immediately previous financial years or during the current fiscal year.

Sub-section (d) says that appointment as independent director can be done of an individual, None of whose relatives has or had Pecuniary relationship or business with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to 2 % or more of its gross turnover or total income or 50 lakh rupees or such higher amount as may be prescribed, whichever is lower, during the 2 immediately preceding financial years or during the current financial year.

Section 149 (6) (e), lays down that individual neither himself or his relative should hold any key managerial office in the company, nor should be an employee or proprietor or a partner in the company in which he is supposed to be appointed, he should not hold together with his relatives 2% or more voting power of the company; also he should not be a Chief Executive or director of any non-profit organisation that receives 25% or more of the receipts from the said company.

Another explanation regarding who may consist of an Independent Director has been laid down in Clause 49 of the listing agreement. It contemplates that the expression ‘independent director’ shall mean a non-executive director of the company who apart from receiving director’s remuneration, does not have any material fiscal relationship or transaction with the company; further it says that the individual should not be related to the promoters or any other personnel who is occupying any management position at the board level.²⁷ The

²² See Circular No. 14/2014, dated 9-06-2014 [Clarification on Independent Director] (Division Three)

²³ See rule 4 of the Companies (Appointment and Qualification of Directors) Rules, 2014. See also Clause 49 of the Listing Agreement.

²⁴ Section 149(4), Companies Act, 2013

²⁵ Section 2(47) of the Act states that criteria for independent directors is described under section 149(5), but in fact the correct reference is under 149(6)

²⁶ See Section 149(6)(b), Companies Act, 2013

²⁷ www.indianboards.com/files/clause_49.pdf (Accessed on 16 January, 2016)

individual should not be an executive of the company in the immediate 3 preceding financial years; the individual should not be a partner or an executive of the statutory executive firm or the internal audit firm which is associated with the company or any other legal firm or consulting firm having association with the company. The independent director should not be a material supplier or service provider or customer of the company, as these may affect the impartiality of the director; also, he should not be a substantial shareholder of the company and nor should be less than the age of 21.²⁸

Further, the act lays down that the said appointment of an independent director should be approved by the company in the general meeting in accordance with Section 152 of the Companies Act, 2013; also an explanatory statement has to be annexed to the notice of the general meeting containing the justification as to selecting the very individual for the appointment as an independent director.²⁹ The explanatory statement annexed should also include a statement that “In the opinion of the board, he fulfils the conditions specified in this Act for such an appointment.”³⁰

Manner of Appointment of an Independent Director has been laid down in Clause IV of Schedule IV of the Companies Act, 2013. Companies as well as the Independent Director have a duty to abide by the provisions as specified in the said rule.³¹ Schedule IV lays down following manners of appointment:

- Firstly, that the appointment of the director shall be independent of the company’s management; also that the board shall ensure that the individual being appointed has appropriate skill, experience and knowledge.
- Secondly, the said appointment should be approved by the company in general meeting of the shareholders.
- There should be an explanatory statement annexed to the notice of the meeting as discussed in Section 150 (2) of the act.
- Fourthly, the appointment should be formalised through a letter of appointment, which shall contain:
 - Term of appointment.
 - Expectations of the board for the individual being appointed.
 - Fiduciary duties and liabilities.
 - Provisions regarding Directors and Officers insurance, if any.
 - Code of Business Ethics which the company expects its employees and directors to follow.
 - List of actions not to be done by the director while functioning in the company.
 - Amount of remunerations, fees, reimbursement of expenditures for participation in the Board and other meetings.

²⁸ *Id*

²⁹ See Section 150 (2), Companies Act, 2013

³⁰ See Section 152 (2), Companies Act, 2013

³¹ See Section 149 (8), Companies Act, 2013

- Provisions empower any member of the company to inspect the terms and conditions of the appointment of independent director, at the registered office during normal business hours.
- The terms and conditions regarding the appointment should also be posted on the company's website.

Further, the act lays down the provisions regarding the resignation and removal of an independent director. It contemplates as, that the registration or removal of an independent director should be in accordance with the provisions as laid down in sections 168 and 169 of the Act; Secondly, that the director so removed from the board shall be replaced by a new independent director within 180 days of such removal or resignation; further, it says that where the company fulfils the requirement of independent director in its board even without filling the vacancy, the requirement of replacement by new independent director shall not apply.³²

Reappointment of independent director shall be on the basis of report of performance evaluation. The performance evaluation will be done by the Board to determine the reappointment.³³

Companies act, 2013 also talks about director's remuneration. The overall ceiling on managerial remuneration has been specified in in section 198 of the Act. Within those limits, an independent director shall be entitled only to profit related commission as may be approved by the members; in addition to that a director would be entitled to a sitting fee³⁴, reimbursement of expenses for participation in the board and other meetings, profit related commission as may be approved by members; however, no stock options can be given to independent director.³⁵

CODE FOR INDEPENDENT DIRECTORS

The Code is a guide to professional conduct for independent directors. Code of independent directors has been specified in Schedule IV of the 2013 Act. The independent director shall act as per the provisions specified in Schedule IV of the 2013 Act - section 149(8) of the 2013 Act.³⁶ Adherence to these standards by independent directors and completion of their responsibilities in a professional and faithful manner will encourage confidence of the investment community, particularly minority shareholders, regulators and companies in the institution of independent directors.

Guidelines of professional conduct - The independent director shall act in a bona fide manner. He shall devote sufficient time and attention for balanced decision making and

³² Clause VI of Schedule IV, Companies Act, 2013

³³ See Clauses V and VIII of Schedule IV, Companies Act, 2013

³⁴ Refer Section 197 (5), Companies Act, 2013

³⁵ See Section 149 (9), Companies Act, 2013

³⁶ www.taxguru.in/company-law/independent-directors-companies-act-2013.html (Accessed on 13 January, 2016)

upload ethical standards. The independent director assists company in corporate governance.³⁷ Not allow any extraneous considerations that will vitiate his exercise of objective impartial judgment in the paramount interest of the company as a whole, Not abuse his position to the loss of the company or its shareholders or for the purpose of gaining direct or indirect personal advantage or advantage for any allied person; Refrains if he thinks can lose his independence. If certain circumstances arises which make an independent director lose his independence, the independent director must immediately inform the Board accordingly³⁸.

Duties of Independent Director - The Independent Director shall update and refresh their skills, knowledge and familiarity with the company; Seek appropriate clarification or take and follow appropriate professional advice and opinion of outside experts at the cost of the company; Strive to attend all meetings of the Board of Directors; Participate constructively and actively in the committees of the Board in which they are chairpersons or members; Strive to attend the general meetings of the company; insist that their concerns are recorded in the minutes of the Board meeting; keep themselves well informed about the company and the external circumstances in which it operates; not to unfairly obstruct the functioning of an otherwise proper Board or committee of the Board; pay sufficient attention and ensure that adequate deliberations are held before accepting related party transactions and assure themselves that the same are in the interest of the company; Report concerns about unprincipled or unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy; acting within his power, assist in protecting the legitimate interests of the company, shareholders and its employees; not unveil confidential information, unless such disclosure is expressly approved by the Board or required by law.³⁹

CONTROVERSY OF THE INDEPENDENCY OF THE INDEPENDENT DIRECTOR

How far an independent director is really independent, this question is possibly raised in every corner of the world. In the days of inception, a company was necessarily developed as an instrument of business for some group of individuals. So, those people who have an interest in that business venture will send their representation in the board or they themselves will manage the affairs of the company. Appointment of the promoter as the default director or first director in board was necessary conclusion. The first director always looks for keeping control over the board by selecting trusted people. Selection of a director in board is always made from family or from group of trusted people.

A truly representative process would have the shareholders nominating and electing individuals to represent them. For a number of reasons, however this process is not practical.

First, many shareholders do not behave like long term investors; indeed, they are essentially traders, who move in and out of stocks and are not particularly interested in participating in

³⁷ V.S .Datey , *Company law Ready Reckoner*, Taxmann's Publications : New Delhi , 2014 , Pg. No. 510

³⁸ www.psalegal.com/upload/publication/assocFile/ENewlineFebruary2014.pdf?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Origina (Accessed on 13 January, 2016)

³⁹ www.idbi.com/pdf/Code-for-Independent-Directors-of-the-Bank.pdf (Accessed on 14 January, 2016)

the governance of corporations in which they own stock. institutional shareholder (including mutual funds, pension funds, and insurance or mutual companies) generally do not want to be directly represented on the boards of companies in which they invest because would make them insiders, which, in turn, would limit their flexibility in deciding whether to buy or sell.

Finally, the broad group of small, public shareholders is not a cohesive body that is organized to act together. In theory, they could identify and nominate directors, but they seldom do. This leaves the nomination process to either the existing board, which may be inclined to postulate itself, or to major shareholders becomes disenchanted with management, they may nominate a slate of directors and engage in a proxy battle. Consequently, the nominating process for directors is usually managed by controlling shareholders and the current board through its nominating committee.⁴⁰

The question of independency of an independent director gets challenging in a publicly held corporate structure. Most of the annual reports of the company do not ascertain the background of the independent director; on the company they designate some of them as independent directors. Even so, in some corners of academia, debate about the value of independent directors continues. Pragmatic studies have shown that a majority independent board does not improve firm performance, i.e., firms with a majority of independent directors do not perform better for shareholders than those with a minority of independents.⁴¹

The data indicates that independence does not lead to improved firm performance and may even be associated with sub-optimal performance. Likewise, independence fails to correlate with improved performance in specific areas. Studies on the performance of independent audit committees, for example, found no relation between committee independence and performance.⁴² In contest to the conventional account of 'independence' are both transaction-specific and have a 'situational' or 'contextual' character.

The word "independence" should connote not just a lack of financial ties to management, but also a willingness to bring a high degree of consistency and sceptical objectivity to the evaluation of company management and its plans and proposals. The imprecision inherent in the word "independence" means that the empirical studies necessarily must use rough proxies for independence: the simple absence of a job with the company, a lack of a close family connection, or (perhaps) the absence of a regular stream of income from the company apart from directors' fees and dividends are all that it takes to qualify under these restrictive definitions, many directors who lack any real desire to take their monitoring role seriously

⁴⁰ Indrajit Dube, *Corporate Governance*, Lexis Nexis Butterworths Wadhwa: New Delhi, 2009, Pg. No 132

⁴¹ Usha Rodrigues, *The Fetishization Of Independence*, Vol. 33, Journal Of Corporation Law, 2008, Pg. No. 447

⁴² Roberta Romano, *The Sarbanes-Oxley Act and Making of Quick Corporate Governance*, Vol. 114, Yale Law Journal, 2005, Pg. No. 1521

who are on the board for reasons of status-seeking, sociability, or the prerequisites that come with board membership fall into the ‘independent’ category, thereby muddying the data.⁴³

CONCLUSION

Independent Directors plays a very crucial role in a company, they are much needed in a company to reduce the rate of biasness, they also helps in regulating a company in proper decision making process and increases the level of independency in a Corporate Sector. The Scandals like as Enron and Satyam which drastically changed a scenario of a well-established company and exposed to the whole world for the economic crises which was faced by them can be reduced by an independent director in a company for prevention and detection of fraud, in view of the limited roles performed by them in the company. These scandals guided the legislators and corporate experts in India and abroad, which propelled them to take adequate curative measures.

As regards India, the legislators after such collapses enacted the new law which made a considerable effort to bring the role of independent director in line with the changing needs of the economy. The primary objective behind the Act of 2013’s provision on independent directors is to ensure transparency and independence and at the same time to bring adequate changes to the company by providing input on strategy, business, marketing, legal, compliance and other matters including performance of monitoring functions. They act as a policy formulator in the company.

⁴³ Usha Rodrigues, *The Festishization Of Independence*, Vol. 33, Journal Of Corporation Law, 2008, Pg. No. 463