

## CHAPTER 2

# PORTRAIT OF AN INDEPENDENT DIRECTOR : SOME DETERMINING FACTORS AND RELATIONSHIPS

*The best directors are those who think independently, regardless of their status. In other words, independence is a state of mind, not a resume item.*

—Ram Charan<sup>1</sup>

## INSTITUTIONALISING INDEPENDENCE: AN INDIAN PERSPECTIVE

Independence connotes fairness and transparency in the manner a company functions. Independent Directors are seen to be the drivers of ethical corporate governance and a force which inspires confidence, trust, and belief in a company's functioning. As the title itself exemplifies, Independent Directors are expected to act independent of the management.

Independence is difficult to define, especially when it concerns identifying the performance traits of an individual. An Independent Director is one among many directors within a company, and the Board acts collectively as a collegium. Then why does the Independent Director need to stand up and be counted? *What are the defining traits that law and society expect of an Independent Director?*

The Parliamentary Standing Committee on Finance in its report on the Companies Bill, 2009, observed, while commenting on the role of Independent Directors who were part of the erstwhile Satyam Board, that:

It is a moot point that such a huge scam could be perpetrated, and that too for several years, under the eyes of some of the most reputed and competent persons serving its Board as Independent Directors. It has raised questions that even highly qualified persons may not provide any insurance for corporate governance, as they tend to trust and provide blind support to the promoters.<sup>2</sup>

The committee felt that the appointment of Independent Directors should not be a matter of mere technical compliance for companies as was evidenced by the

1. Quoted from Ram Charan, *Boards That Deliver: Advancing Corporate Governance From Compliance to Competitive Advantage*, Jossey-Bass, Wiley, 2005.

2. 'Twenty-First Report of the Standing Committee on Finance (2009–2010) on the Companies Bill, 2009'. Available at [http://www.nfcgindia.org/pdf/21\\_Report\\_Companies\\_Bill-2009.pdf](http://www.nfcgindia.org/pdf/21_Report_Companies_Bill-2009.pdf) (accessed in June 2016).

perceived inaction of such directors in the case of Satyam. The committee further observed that the process for appointing Independent Directors should be sound and fair, and based on a thorough rationale and judgment.

The regulatory assessment that followed prioritised the need to empower Independent Directors, give them necessary protection, and raise the bar of accountability. The objective was to ensure that the best minds are not dissuaded to take up the role for the fear that they would be unfairly targeted by prosecutors for actions undertaken in good faith.

Immunity or principles of safe harbour, under the Companies Act, 2013, and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 [*SEBI (LODR) Regulations, 2015*], will relieve Independent Directors of liabilities for default, if they have acted in conformity with law, have been diligent, and have discharged their duties in good faith.

### **Increased Dominion in the Business Landscape**

The regulatory framework, based on the Companies Act, 2013, and the SEBI (LODR) Regulations, 2015, lays significant importance on the institution of Independent Directors, and reinforces the objective of making them integral to the functioning of the Indian business landscape. The framework is supported by a code of conduct (Code for Independent Directors) prescribed under the Companies Act, 2013, which is prescriptive and definitive. The significance attached to the position of Independent Directors is accentuated by the fact that they will now form part of a large cross-section of companies.

According to the Companies Act, 2013, a minimum one-third of the total number of directors of every listed public company should be Independent Directors.<sup>3</sup> This, according to the SEBI (LODR) Regulations, 2015, is applicable where the chairman of the Board is a non-executive director. In case, a listed company does not have a regular non-executive chairman, at least half of its Board must comprise Independent Directors.<sup>4</sup>

Significantly, the Companies Act, 2013, also makes it mandatory for all public companies having paid up share capital of INR 100 million or more, or having a turnover of INR 1,000 million or more, or which has, in aggregate, outstanding loans, debentures, and deposits exceeding INR 500 million, to have at least two Independent Directors on their Board.<sup>5</sup> Inclusion of public companies among those required to appoint Independent Directors comes in recognition of the growing importance of corporate governance principles.

3. Section 149(4), The Companies Act, 2013.

4. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, notification dated September 2, 2015. Available at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1441284401427.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1441284401427.pdf) (accessed in June 2016).

5. Section 149(4), The Companies Act, 2013 read with The Companies (Appointment and Qualification of Directors) Rules, 2014.

## DEFINING INDEPENDENCE: A QUALITATIVE TRAIT IN A QUANTIFIABLE WORLD

### What Makes a Director Independent?

Defining independence is a challenge as it is a state of mind and is demonstrated in its application. Since the first description in the Birla Report<sup>6</sup> in 1999, the norms delineating independence from the perspective of an Independent Director has gone through a world of change. The latest changes came with the passage of the Companies Act, 2013, and the consequent changes made in SEBI (LODR) Regulations, 2015.

Selection of Independent Directors is made on the basis of two broad parameters:—

- She/he must be a person of integrity and possess relevant expertise and experience, and
- She/he must not have or had held relationships (pecuniary, familial, and professional) with the company, as is excluded under law.

Evaluation of independence of directors could include fulfilment of additional criteria, as Moody's in their criteria for assessing director include.<sup>7</sup>

#### **Box 2.1. Additional Criteria of Assessing Director Independence (Moody's)<sup>8</sup>**

- **Board Interlocks:** Where two or more directors or senior executives sit on each other's Board, irrespective whether they are public or private company or non-profit. Moody's consider that such interlocks in private or non-profit companies create the same question of independence.
- **Links to founders:** On occasions, Moody's has viewed directors not to be independent when they have had long standing connections with the company founders. They do so when the founders remain on the Board and play an influential role in the company.

Let's take the example of Wipro Limited, which for instance, has included integrity, accountability and high performance standards as additional qualification criteria for its Board members, including Independent Directors.

Some of these factors are listed in Box 2.2 and can be considered a good industry practice.

6. 'Report of the Kumar Mangalam Birla Committee on Corporate Governance'. Available at <http://web.sebi.gov.in/commreport/corpgov.html> (accessed in June 2016).
7. 'Criteria for Assessing Director Independence: Moody's Special Comment', October 2006. Available at <https://www.moodys.com/sites/products/aboutmoodysratingsattachments/200610000425776.pdf> (accessed in June 2016).
8. Ibid.

### Box 2.2. Wipro Limited: Board Membership Criteria<sup>9</sup>

The qualification guidelines for Board membership criteria shall include, inter-alia, the following:

- Strong management experience, preferably with major public companies with successful multinational operations.
- Expertise or experience in IT businesses, manufacturing, international, financial or investment banking, scientific research and development, senior level government experience, and academic administration.
- Desirability of range in age so that retirements are staggered to permit replacement of Directors of desired skills and experience in a way to maintain continuity of Board members.
- Knowledge and skills independence as defined by the Board.
- Diversity of perspectives.
- Knowledge and skills in accounting, finance, business judgment, general management practices, crisis response and management, industry knowledge, labour laws, international markets, leadership, risk management and strategic planning.
- Attributes such as integrity, accountability, financial literacy and high performance standards.
- Commitment to attend a minimum of 75% of meetings which also include attendance through audio/ video conferencing.
- Ability and willingness to represent the stockholders' long and short term interests.

### Test of Integrity, Expertise, and Experience

*Who is a person of integrity? Is it possible to objectively assess whether a person is of integrity, an essential trait to be an Independent Director?*

The term 'integrity' is not defined in the Companies Act, 2013 or SEBI (LODR) Regulations, 2015. A general interpretation of the term could hence be made.

The word integrity is synonymous with 'probity', 'honesty', and 'uprightness'. *Black's Law Dictionary* defines integrity to mean soundness of moral principle and character. It is a qualitative trait which demands testing a person's character and honesty and hence must be demonstrated in her/his actions.

The traits of integrity of an Independent Director who is considered for appointment can be judged at two levels. First, by the Board of Directors which is required to form an opinion if the person to be appointed as an Independent Director is of integrity and possesses relevant expertise and experience.<sup>10</sup>

9. Adapted from 'Board Membership Criteria', Corporate Governance Guidelines of Wipro Limited, Effective: April 20, 2016. Available at <http://www.wipro.com/documents/investors/pdf-files/Corporate-Governance-Guidelines.pdf> (accessed in June 2016).

10. Section 149(6)(a), The Companies Act, 2013.

Thereafter, at the level of the Independent Director who provides a declaration that she/he meets the independence criteria.<sup>11</sup>

While the exclusionary conditions under Schedule V of the Companies Act, 2013, which lays down the conditions for the appointment of directors, are applicable in case of Independent Directors as well, the Nomination and Remuneration Committee of a company has the right to devise higher selection criteria.

### **Box 2.3. RBI Norms for Directors of Banks and Financial Institutions**

The test of integrity for an Independent Director could also be seen from the perspective of RBI's 'fit and proper' test for directors which is used as a criterion for appointing directors in banks. The 'fit and proper' test for directors is significantly more stringent than that prescribed under the Companies Act, 2013, and includes criteria such as an indictment for professional misconduct or pending disciplinary proceedings by an institute of which she/he is a member or has been found guilty of economic offences under criminal laws, securities laws, corporate laws, laws of income tax, excise, and foreign exchange, amongst others.

Increasingly, companies are looking for diverse and substantive qualities among its directors and are exercising greater degree of caution in their selection. L&T Infrastructure Finance Ltd., for instance, has listed, as part of the role for its Nomination and Compensation Committee,

to ensure 'fit and proper' status of existing/proposed Directors by obtaining necessary information and declaration from them and undertake a process of due diligence from them to determine the suitability of the person(s) for appointment/ continuing to hold appointment as a Director on the Board, based upon qualification, expertise, track record, integrity and other relevant factors.<sup>12</sup>

In addition to their qualifications and expertise as set forth in law, Independent Directors could be measured not only by their professional track record but could also be exposed to integrity reviews among other assessment methods.

Companies should conduct a number of diligence reviews on a prospective director, either themselves or through a specialised firm, to reduce any risks associated with the selection process. Proxy advisory firms and, in some cases, institutional investors use additional criteria for determining suitability of a director which a company may also include in their search.

### **Exclusionary Relationships Test**

The Companies Act, 2013, has stipulated certain relationships which one must not hold or have held in the past to be eligible to become an Independent Director in a company. The exclusions criteria are aimed at ensuring that an Independent Director does not hold or carry over any relationships — pecuniary, familial, and professional — which could potentially jeopardise her/his performance in an independent manner.

11. Section 149(7), The Companies Act, 2013.

12. 'Annual Report 2012–13', L&T Infrastructure Finance Company Limited. Available at [http://www.ltinfra.com/media/162242/ar\\_2013\\_3-9-2013\\_text.pdf](http://www.ltinfra.com/media/162242/ar_2013_3-9-2013_text.pdf) (accessed in June 2016).

This test is modelled on the following exclusionary criteria, broadly divided into three.

- Relationship with Promoters and Management
- Restrictions on Shareholding
- Professional Relationships

### *Relationship with Promoters and Management*

An Independent Director must not be related to the promoters of the company, and must be independent of the management of the company. In accordance with this,<sup>13</sup> an Independent Director

- must not be or have been a promoter of the company or of its holding, subsidiary, or associate company;
- should not be related to promoters or directors in the company, its holding, subsidiary, or associate company;
- should not have or had any pecuniary relationship with the company, its holding, subsidiary, or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
- none of her/his relatives should have or have had any pecuniary relationship or transaction with the company, its holding, subsidiary, or associate company, or their promoters, or directors, amounting to 2 per cent or more of its gross turnover or total income or Rs 5 million, whichever is lower, during the current financial year or the two immediately preceding financial years.
- neither herself/himself nor any of her/his relatives holds or has held a Key Managerial Position (KMP), or is or have been employee of the company or its holding, subsidiary, or associate company in any of the preceding 3 financial years.

The Companies (Amendment) Bill, 2016, introduced in the Lok Sabha on March 16, 2016 has proposed to relax the exclusionary relationships criteria by introducing materiality tests for pecuniary interest. It also seeks to specify the scope of restriction on pecuniary relationship entered into by a relative of an independent director.<sup>14</sup> As per the proposal, the government would prescribe, inter-alia, the threshold amount for treating pecuniary relationship [as under section 149(6)]; prescribe a higher amount of securities or interest for holding by relatives which shall not be construed pecuniary relationship for Independent Directors.

### *Restrictions on Shareholding*

An Independent Director should not have substantial ownership and voting rights in the company which may compromise her/his independent judgment on the

13. Section 149(6), The Companies Act, 2013.

14. The Companies (Amendment) Bill, 2016. (Bill No. 73 of 2016). As introduced in Lok Sabha. Available at [http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/73\\_2016\\_LS\\_Eng.pdf](http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/73_2016_LS_Eng.pdf) (accessed in June 2016).

affairs of the company. She/he cannot hold equal to or more than 2 per cent of the voting power of the company individually or collectively along with her/his relatives.<sup>15</sup>

Some believe that if an Independent Director has substantial ownership stake in the company, the focus could be more on short term value creation, which may prompt excessive risk taking in decision making. There are contrarian views among observers on this subject. There is an argument that an Independent Director should not have ownership rights in the company so as to remain fully independent in the decision making role. However, others are of the view that some degree of ownership makes such directors more vigilant and exercise greater oversight. The jury is out on which model is more effective.

### *Professional Relationships*

The Companies Act, 2013, states that an Independent Director should not<sup>16</sup>

- herself/himself or any of her/his relatives currently be or have been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year, of
  - a firm of auditors, company secretaries, or cost auditors of the company or its holding, subsidiary, or associate company, or
  - any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to 10 per cent or more of the gross turnover of such firm.
- be a Chief Executive or director, by whatever name called, of any non-profit organisation that receives 25 per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2 per cent or more of the total voting power of the company.

#### **Box 2.4. Who Is a ‘Relative’?**<sup>17</sup>

A relative with reference to any person means anyone related to another if they are members of a Hindu undivided family, or are husband and wife or, if they are related to in the following manner.

- (1) Father (including step-father);
- (2) Mother (including step-mother);
- (3) Son (includes step-son);
- (4) Son’s wife;
- (5) Daughter;
- (6) Daughter’s husband;
- (7) Brother (including step-brother); and
- (8) Sister (including step-sister)

15. Section 149(6)(e), The Companies Act, 2013.

16. Ibid.

17. Section 2(77), The Companies Act, 2013, read with The Companies (Specification of Definitions Details) Rules, 2014.

SEBI (LODR) Regulations, 2015 has introduced some additional conditions as part of the independence criteria in the case of listed companies.

Accordingly, an Independent Director of a listed company shall, apart from complying with the criteria for independence specified in the Companies Act, 2013, meet the following criteria.

- She/he must not hold together with her/his relatives 2 per cent or more of the total voting power of the company;
- She/he is not a material supplier, service provider or customer or a lessor or lessee of the company; and
- She/he should not be less than 21 years of age.

These standards set out under the law must be considered as minimum, as many iconic companies have set forth higher thresholds and criteria for the office of Independent Directors and have independent committees to review them.

### What Differentiates Independent Directors from the Rest of the Members in a Board?

The role of Independent Directors is viewed differently owing to the knowledge and skills they bring to the table. It begins with the presumption that they do not owe any allegiance to the company, or sections within the company that could result in biased decisions. Further, they are considered people with knowledge and expertise, a criterion which must be demonstrated in the decisions they make.

For Independent Directors, the application of their knowledge and skills is, therefore, important. They should have certain personal attributes to satisfy the requirement of independence. Attributes of knowledge, relevant experience, and expertise have gained significant attention in the 2008-09 financial crisis.<sup>18</sup> Lack of positive attributes is likely to compromise an Independent Director's independence.<sup>19</sup> Positive attributes augment their monitoring role which requires them to ask questions about management decisions, and, on occasions, may require them to stand against the majoritarian view in the Board.

While expertise is paramount for Independent Directors in effective discharge of their responsibilities, a large number of failures in the governance of companies worldwide has highlighted that having such a quality was actually a myth. In the financial crisis of 2008–09 in the US, an OECD report highlighted that several Independent Directors of financial institutions did not possess the relevant experience and expertise to understand complex financial products which seriously affected their monitoring responsibility.<sup>20</sup>

The use of this knowledge and skill would vary according to the committee(s) Independent Directors are associated with. They are, however, expected to show soundness in judgment and neutrality regarding the decisions made by the Board and its committees. However, in the changing world of

18. G. Kirkpatrick, 'Corporate Governance Lessons from the Financial Crisis', *OECD Journal: Financial Market Trends*, 2009/1, 2009.

19. R. Adams, 'Governance and the Financial Crisis', *International Review of Finance*, 12(1), 2009, pp. 7–38.

20. P. Yeoh, 'Causes of the Global Financial Crisis: Learning from the Competing Insights', *International Journal of Disclosure and Governance*, 7(1), 2010, pp. 42–69.

complex transactions, lesser known economic and business risks, disruptive technologies, etc., past knowledge and experience of directors often become redundant and can become a pervasive risk for the company. The financial crisis is a case in point. An Independent Director needs to continuously update her/his skills and knowledge, in order to be effective and relevant.

What are the essential knowledge and skills that an Independent Director needs to have?

The knowledge and experience of an Independent Director would depend on the requirements of a Board and further on the committees she/he is supposed to serve. Large companies and their management often evaluate the skills they need in their Board for effective discharge of their fiduciary duties and set up metrics for such skills, roles, and expectations.

Finance, law, management, sales, marketing, administration, research, corporate governance, technical operations, or disciplines related to company's business have been listed out as qualifications by the law. While these qualifications form the minimum standards of expertise, as Independent Directors they are required to possess an appropriate balance of skills, experience, and knowledge in one or more of these fields of study. For instance, it is important for Independent Directors on a company's Audit Committee to have the ability to read and understand financial statements.<sup>21</sup>

The Board of Directors of a company is obliged, under the Companies Act, 2013, to disclose and justify in their report that the Independent Director possesses an appropriate balance of skills, experience and knowledge required by the company.<sup>22</sup> It is a self-disclosure, which takes away the contention of many Independent Directors that they could not follow the technical nature of discussions in the Board.

Boards and companies continually look for people who add value and bring in a mix of complementary skill not just to fulfil their fiduciary duties but to give strategic and operating impetus for greater success. Since the Code for Independent Directors puts onus on such directors to keep themselves well informed about the company and the external environment in which it operates, it is only expected that the Independent Directors stay ahead with respect to industry specific information, competitor strategies, recognised best practices, and industry trends.

## MANAGING STAKEHOLDERS: INDEPENDENT DIRECTORS AS GUARDIAN OF STAKEHOLDER INTERESTS

As the Adi Godrej Committee Report on Corporate Governance succinctly puts, 'Good corporate governance is the reconciliation of otherwise (possibly) diverging interests.'<sup>23</sup>

21. Section 177(2), The Companies Act, 2013.

22. Section 134, The Companies Act, 2013.

23. 'Report of the Committee Constituted by Ministry of Corporate Affairs to formulate a Policy Document on Corporate Governance', chaired by Adi Godrej. Available at <http://www.nfcgindia.org/pdf/Guiding-Principles-of-CG.pdf> (accessed in June 2016).

The Companies Act, 2013, lays a significant emphasis on stakeholders in a company requiring companies to ensure that they do not act in a manner which could negatively impact the interests of its stakeholders. Under section 166 of the Companies Act, 2013, all directors — executive, non-executive, or independent — are required to take actions in the best interests of the company, its employees, shareholders and for protection of the environment. The responsibility fixed under this duty is significant with financial penalty attached in case of a breach. The responsibility is far reaching and will be open to many interpretations in the coming years.

The role of the Independent Directors towards a company's stakeholders is an extension of the duty stipulated under section 166(2) of the Companies Act, 2013, even as it is tilted more towards the minority shareholders. According to the Code of Independent Directors (Schedule IV of the Companies Act), Independent Directors are required to safeguard the interests of all stakeholders, particularly the minority shareholders.

### Who are the Stakeholders?

The term 'stakeholder' has a wide connotation in modern business, and includes any person, group, or organisation that has an interest, or who may have an influence in the manner in which a company functions. Stakeholders, from the perspective of any business, commonly include anyone having a stake or claim in some aspect of a company's products, operations, markets, industry, and outcomes. Thus, for a company, its customers, investors, shareholders, employees, suppliers, government agencies, communities, and environment — all have a stake in the company's affairs, and hence, would constitute its stakeholders.

Protection of the interests of stakeholders is a priority area under the Companies Act, 2013. Every director, including the Independent Director, has to act in good faith to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community, and protection of the environment.<sup>24</sup> By including the interests of the community, employees, and that of the environment alongside a company's shareholders, the Companies Act has identified constituents that have an influence or is influenced by the company.

The Companies Act, 2013, does not define the term 'stakeholders'. In the absence of a definition, the term should be understood in the normal business context. Stakeholders have assumed attention in recent years with the government making significant strides in sustainability reporting for companies.

Under the National Voluntary Guidelines on Social, Environmental & Economic Responsibilities of Business (NVGs),<sup>25</sup> companies are required to identify stakeholders, divide them into segments like internal and external, and identify the disadvantaged, vulnerable, and marginalised groups. SEBI in 2015 extended the requirement of preparing business responsibility reports to top 500

24. Section 166(2), The Companies Act, 2013.

25. National Voluntary Guidelines on Social, Environmental & Economic Responsibilities of Business, Ministry of Corporate Affairs, July 2011. Available at [http://www.mca.gov.in/Ministry/latestnews/National\\_Voluntary\\_Guidelines\\_2011\\_12jul2011.pdf](http://www.mca.gov.in/Ministry/latestnews/National_Voluntary_Guidelines_2011_12jul2011.pdf) (accessed in June 2016).

listed companies based on market capitalisation as on March 31<sup>st</sup> of every year.<sup>26</sup> Table 2.1 below is based on an analysis of Business Responsibility Reports of public listed companies, to understand the stakeholders and their priority areas.

**Table 2.1. Key Priority Areas for Stakeholder Groups<sup>27</sup>**

Stakeholder Category	Key Priority Areas
<b>Customers/Clients</b>	Product availability; product safety and quality; timely delivery of product; services
<b>Employees</b>	Compensation and benefits; occupational health and safety; workplace satisfaction; healthy and safe operations; employment benefits and safeguards.
<b>Investors</b>	Value of investments; business growth; business strategy; transparency; governance practices
<b>Shareholders</b>	Increased dividends, higher market value for shares, increase in facilities and privileges
<b>Local Communities</b>	Impact of company's operations on livelihoods; local socio-economic issues (like employment, health, education, sanitation); public health and safety protection; conservation of natural resources
<b>Government</b>	Regulatory compliance; greater employment, employment to locals, CSR investments for local communities, equitable growth
<b>Creditors</b>	Timely repayment of dues and interest payments, sustainable financial health, safeguarding their interests in the case of insolvency action

This could be seen as a benchmark or inclusiveness criteria of stakeholders for the company and its Board to uphold and protect. The priority areas identified may not be exhaustive, and may require additions depending upon business dynamics and the area of operation of an individual company or a group.

### Business Ethics and Duty to Stakeholders

Contemporary industrial history offers several examples which shows that a systemic neglect of business ethics led to mass scale environmental damage and loss to human life.

26. As decided in SEBI Board Meeting, dated November 30, 2015. Available at <http://www.sebi.gov.in/sebiweb/home/detail/32461/yes/PR-SEBI-Board-Meeting> (accessed in June 2016).

27. The chart represents a general assessment of the key priority areas for major stakeholders in a company. It is prepared based on actual reporting made by companies selected from across multiple sectors.

A research on directors' duties and responsibilities towards other stakeholders,<sup>28</sup> considered six cases of industrial failures worldwide, to assess how irresponsible corporate actions/ decisions have significantly contributed to large scale corporate disasters. Examples analysed, included: Bhopal gas tragedy (India, 1984); Exxon Valdez disaster (Alaska, 1989); James Hardie case (Australia, 1980s); BHP and Ok Tedi (Papua New Guinea, 1989); BP Oil Disaster (Gulf of Mexico, 2010) and Telstra National Broadband Installation (Australia, 2013), where companies were found wanting in terms of their duty of care towards the environment they were operating in.

The boards of directors of these entities adopted policies, which systematically over a period of time, damaged the environmental balance in the adjoining areas and goes contrary to ethical business practices.

"In the Bhopal case withholding medical information by the directors and officers of the organisation was unethical and irresponsible. Cost cutting, in Exxon Valdez resulting in substandard work, BP oil and Telstra approved insufficient safety systems and in Bhopal, reduction in staff resulted in unavailability of experts. Directors were in breach of their duty of care as a result of the announcement of misleading information in James Hardie. In Ok Tedi work in the mine by BHP resulted in polluting the Ok Tedi river and damaging the life style of people living there. Where was their duty of care for the people, environment and the communities?"<sup>29</sup>

Demonstration of high level of business ethics by companies have a significant impact on how businesses deal with stakeholder issues. An inclusive approach to stakeholder engagement reduces overall business risks in comparison to companies which are driven solely by shareholder returns. The Companies Act, 2013 casts the responsibility on independent directors to uphold this ethical value in companies and deal with competing stakeholder concerns.

### Stakeholder Conflicts: What Does Law Expect from Independent Directors?

Independent Directors are expected to be the conscience keepers within a company. In pursuit of this, an Independent Director may come across situations in which the interests of various stakeholders clash. Going by the rule book, she/he shall safeguard the interests of all, particularly the minority shareholders. While it is easy to deal with a situation involving the minority stakeholders, the difficulty arises when the conflict involves only non-minority shareholders.

Under the Code for Independent Directors,<sup>30</sup> an Independent Director is required to 'balance the conflicting interest of the stakeholders'. According to Schedule IV of the Companies Act, 2013, in case of a conflict between the management and shareholders, her/his role is to moderate and arbitrate.<sup>31</sup>

28. Heenetigala, K and Lokuwaduge, CSDS (2013) *Directors Duties and Responsibilities towards other Stakeholders: A Discussion of Case Studies on Corporate Disasters*. Journal of Business Systems, Governance and Ethics, 8 (1). 51 - 58. ISSN 1833-4318

29. Ibid

30. Schedule IV, The Companies Act, 2013.

31. Code for Independent Directors, Schedule IV, Part 11, Clause 8, The Companies Act, 2013.

The Companies Act, 2013, does not lay in clear terms the approach an Independent Director is expected to take in resolving stakeholder conflicts. Law is silent as to whether an Independent Director, in the wake of a conflict between minority shareholders and other stakeholder groups, takes a position which is inherently biased in favour of minority shareholders.

In a typical case of conflict between stakeholders, both sides could be vocal about their rights and would expect a favourable response from the company. Independent Directors are expected to practice neutrality in such cases. The guidelines for professional conduct, provided under the Code for Independent Directors, offer a limited solution. Emphasis on minority shareholders does not mitigate the single most fiduciary duty of loyalty which requires directors to act in the best interests of the company. So, the demands of any minority investor must not stifle the company's long-term growth strategy which could yield productive results for the company.

The law does not clearly spell out the priorities for Independent Directors when it comes to identifying the class of stakeholders whose interests are significantly high. They have, in particular, the duty to ensure that the interests of minority shareholders are not impacted by any of Board's decisions.

But if there is a conflict between the minority shareholders and other stakeholder groups, does it lead to a bias in favour of the former? Mr. Nawshir Mirza, an Independent Director of Tata Power Limited, feels that the relationship between a company and its various stakeholders is one of the areas that have seen the least engagement from various quarters of lawmakers, practitioners, and companies. 'The evolving dynamics of this relationship can become a substantial and unmitigated risk for a number of companies. It is imperative to have defined processes of engagement, evaluation of actions and robust implementation plans for any company dealing with this risks', adds Mr. Mirza.<sup>32</sup>

Law defines the role and responsibilities of Independent Directors in relation to minority shareholders but gives little guidance on how other stakeholders need to be dealt with. What an Independent Director must ensure, however, is that the concerns of the minority shareholders or other stakeholders are not curbed and not left unaddressed. Though, at the same time, given their limited understanding of entrepreneurial vision and lower associated risks of ownership, Independent Directors must exercise fair judgment and discretion, and not stall discussions that set new directions for the company judgment.

## Conflict Resolution

It is never easy to balance the conflicting interests of several stakeholders. Therefore, the objective of an Independent Director should be to take a position which will be in the long-term interest of the company.

Balancing conflicts among the stakeholders may need strategic prioritisation, based on the circumstances of a particular situation and assessment of the medium to long-term impact of a decision. Discussions and deliberations are the

32. As discussed with the Authors.

keys to achieve such a balance. Legal and contractual agreements or those governed by law create direct responsibilities for the Board with respect to certain groups of stakeholders, and these need to be prioritised.

In this context, it would be useful to keep in mind the words of former SEBI Chairman GN Bajpai.

While the ultimate purpose of all corporations is to create wealth for its shareholders, it is important to recognize that shareholders are indeed the residual stakeholders. The obligations towards the contractual stakeholders such as customers, employees, vendors, creditors and the society get precedence over the interests of the shareholders. The contribution of other stakeholders to the success of the corporation is not less important than that of the shareholders. Unless the company blends a harmonious relationship among all the stakeholders, it may jeopardise its ability to create wealth on a sustained basis.<sup>33</sup>

Pursuing the long-term interests of the company on a sustained basis could address the potential conflict areas between one group of shareholders and others.

### Proxy Advisors and Independent Directors

Within the fold of stakeholders, a section of proxy advisors serve as external vigilance for listed companies. The growth of proxy advisors is new but their impact has been significant in influencing the performance of companies on various parameters of corporate governance. Proxy advisory firms have played a stellar role in countering corporate intentions which have the potential to affect the interests of minority shareholders. Recent instances of intervention by proxy advisors reflect on the trend that has been emerging in India. Their voice is essential to maintain a healthy check on the way listed companies handle issues.

The existence of proxy advisors is an essential tool available with Independent Directors to ensure that governance-related procedures run smoothly. It is also an effective medium to keep a tab on developments that may have an impact on governance.

Proxy advisories are often based on market perceptions, and hence, following them could provide timely warnings about developments which may not be proper in terms of good governance. As an Independent Director, one is expected to be aware of developments not just within the company but outside too. Under the existing corporate governance scenario, set into motion by the passage of the Companies Act, 2013, and strengthened by SEBI (LODR) Regulations, 2015, Independent Directors are also required to report to the Board any concerns about the company's performance and governance. Proxy advisories can be a potent tool in this endeavour.

Shareholder activism, which has been rising in recent years, has been strengthened with the emergence of proxy advisory firms and greater participation of institutional investors.

33. Speech delivered by former SEBI Chairman G N Bajpai at the Corporate Governance Forum's Meeting, Paris, 4 November 2003. Available at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1293011165899.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1293011165899.pdf) (accessed in June 2016).

Proxy advisory firms use various assessment metrics to measure corporate governance in companies. These firms size up company performance against existing laws, regulations, guidelines, as well as international best practices. For instance, an India-based proxy advisory firm, In Govern, in its annual evaluation and review of companies, uses the following governance criteria.<sup>34</sup>

### Box 2.5. Assessment Criteria of Proxy Advisory Firm

<b>Board</b>	<ul style="list-style-type: none"> <li>Appointments, Compensation, Meetings, Remuneration, Responsibilities, Chairperson, Code of Conduct, Company Secretary, Independent Directors etc.</li> </ul>
<b>Board Committees</b>	<ul style="list-style-type: none"> <li>Audit, Nomination, Shareholders, Risk, Remuneration Committees</li> <li>Composition, Meetings, Powers, Responsibilities</li> </ul>
<b>Management &amp; Operations</b>	<ul style="list-style-type: none"> <li>Code of Conduct, Remuneration Policies, Risk Management, Whistle Blower Policies</li> </ul>
<b>Audit &amp; Accounts</b>	<ul style="list-style-type: none"> <li>Audit &amp; Accounts, Auditor Independence, Ethical Standards for Audit</li> </ul>
<b>Shareholders Rights</b>	<ul style="list-style-type: none"> <li>Related Party Transactions, Shareholders Meetings &amp; Voting, Other Rights</li> </ul>
<b>Disclosures</b>	<ul style="list-style-type: none"> <li>Audit &amp; Accounts, Board (Appointments, Composition, Remuneration, Meetings), Board Committees, Independent Directors, Management &amp; Operations, Ownership, Shareholder Meetings, Whistle Blower Policies, etc.</li> </ul>

Apparently, companies get to know gaps when it comes to their governance standards. While the concept of proxy advisory may be relatively new in India, it has caught the attention of regulators like SEBI, and has, in recent years, seen significant success in terms of its interventions in company decision. One may recall interventions regarding executive compensation, merger of companies, and setting up industrial units to mention a few.

The Securities and Exchange Board of India, on its part, has encouraged shareholder interventions. Current SEBI Chairman UK Sinha, in an interaction, pitched for a ‘responsible business’ regime for companies based on three guiding principles: shareholder democracy, transparency in operations, and protection of minority investors.<sup>35</sup>

34. Criteria for Annual Evaluation and Regular Review, InGovern. Available at <http://www.ingovern.com/services/corporate-governance-scorecards/> (accessed in June 2016).

35. ‘Shareholders waking up to their rights, says SEBI Chairman UK Sinha’, *The Economic Times*, 9 December 2014.

According to him, the key attributes of an effective Board member should include

- operational, functional, and relevant expertise in relation to business—combination of specialist/generalist;
- diversity and robustness in thinking;
- ability to give ‘outside-looking in’ advice to the management;
- stand and be counted: speak out on issues of conflict;
- possess sound business judgment skills; and
- ensure cohesion and mutual respect for one another.

While the broad contours of the role of an Independent Director are defined, their exact nature of duties may vary according to the nature of business of the company. This is especially with respect to the dynamics of business, its stakeholders, and market forces. However, certain universal principles do apply in case of Independent Directors. They are required and expected to be neutral and balanced in their judgment while making decisions. Integrity, as the word is used to define the character traits of an Independent Director, is of significant value. Their actions must exude this integrity and they must safeguard it by all measures.