Legal Updates

Independent directors: Moving towards a commoditized director

Discussions on Independent directors in the Parliamentary Standing Committee Report on Companies Bill

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Quick shot:
This article shows that it is clear from the Standing Committee report that corporate legislations and regulations in time to come would continue to cultivate an "independent director" who is a standardized commodity, packaged and quality-certified by professional bodies who would eagerly participate in developing such a product. Such a standardized, commoditised director may not have contribution to functional areas of a company, as directorship itself would, in time to come, be seen as a function. This article is an incisive, to an extent tongue-in-cheek analysis of the Standing Committee's report. This article raises several questions on the institution of independent directors which are important questions, though which may have been regarded as too basic by the Report.

One of the key highlights of the Parliamentary Committee report on the Companies Bill is discussion on independent directors. Nearly 12 pages have been devoted to discussion on various aspects of independent directors.

There has not been any discussion on whether and why independent directors should be required on corporate boards, but discussions have gone on

- Number of independent directors, including
  - whether independent directors are needed for unlisted companies as well (see our discussion later in the article);
  - higher number of independent directors in case of insurance companies, etc
- Definition of independent directors, which a surprising suggestion from CII that the quantitative test of materiality of pecuniary transactions may be reduced from 10% to 5%, and further suggestion that in accordance with the NYSE regulations, a test of 2% of gross turnover of the firm may be adopted, with the MCA agreeing to bring it down to 2%.
- Duties of independent directors and a code of conduct for them
  - Including an MCA suggestion that the Central govt will makes rules to lay down rules, powers and duties of independent directors
  - Including a weird and completely perfunctory clause which while defining independent directors seeks to add that such person will be a person of

integrity, having "relevant expertise or experience", leaving completely unclear as to what experience or expertise is relevant for an independent director, and how does integrity of the director become a part of the definition of an independent director.

- That nominee directors cannot be treated as independent directors.
- Limit of independent directorships to 10
- That independent directors need to be remunerated but not so much that they lose independence
- A very important safeguard suggested by one of the chambers about limit to liability of independent directors- thankfully, this suggestion has been accepted and is discussed below.

This article discusses significant issues regarding independent directors.

Need for independent directors:

The question as to why do we need independent directors on boards is quite a vexed question. On one side, independent directors have been mandated to ensure that the decisions of the board are not intended to serve sections of interests, as corporates of today serve multifarious stakes and interests which may have mutually conflicting pulls. On the other hand, it is also felt that the board is burdened with persons who, by definition, have no stake in the company at all.

Admitting the need for independence on boards, independence is a virtue that is required in all decision-making. After all, what does a decision-maker do weigh rival considerations and find a solution that balances between rival contentions. So, a decision-maker cannot allow personal biases to come in the process of decision-making. That is the Geeta's idea of "sthitpragya". Independence of this type may exist with or without personal pecuniary interests. Maharshi Janak was known to be unattached to the wealth of the kingdom while still being in the midst of it all. However, for lesser mortals, having pecuniary interests, and still being independent, is a difficult call, and therefore, the condition of independence requires that one must not have personal financial interests in a matter. Hence, listed company regulations of the NYSE, and those of other countries, require presence of "independent" directors on board.

But then, the key question is – if these directors have no stake in the company, what exactly do they bring on the table? Technical expertise pertaining to the product of the company, market knowledge, industrial experience, financial expertise, or expertise in corporate governance? Or, are they people who have been bred and grown to be simply

"professional directors" of companies, complete with the cult, decorum and formalities of board meetings, to be able to ask purely procedural questions in board meetings and insist on board agenda papers to be thicker and less readable?

Breeding independent directors:

Currently, though regulations require independent directors, but there is no insistence on who an independent director can be, leaving ample discretion for management of companies to select directors who they think are best suited for the mantle. Most managements select people with diverse backgrounds – finance and accounting, technical, relevant industrial experience, and so on. Having an independent director is an imposition of the statute, but prudent managements make the most out of it by filling those positions with people who can really contribute to the governance of companies.

However, with the professional bodies and the draftsmen of legislations seemingly are inclined to develop a standardized product called "independent director". Much like a National School of Drama would produce a person who is trained to be an actor, and act for whatever role given, such cultured independent director may not know much of what a company does or needs, but he would still be expected to know how to direct companies. Prima facie, the idea cannot be detested on the face of it. Like a good driver knows the job of driving, and can drive what vehicle he is given to drive, a good director must know the art of balancing between the brake and the accelerator, and still keep the steering wheel in control. There are basic traits of directing companies, which suit every company. However, it is quite obvious that such "professional directors" will be strong on matters of corporate law, corporate governance principles and procedural issues of board meetings, but may not have significant understanding of functional areas on which a corporate board needs mentoring.

Hence, the professionalistion or commoditization of a director is an issue that needs to be discussed with substantial deliberation.

Certified to be independent:

The Parliamentary Committee report on the Companies Bill 2009 takes the issue of independent directors several steps forward. Not only does it talk of independent directors, it provides for a "certification of independence". The idea of certificate of independence on the face of is quite curious. If one does not read the Report, one would have several funny thoughts as to how the certification would work. Who would certify independence? The Registrar of Companies, a spiritual guru, or yet another certifying

body such as the Independent Directors Regulatory Authority[1]? And how exactly would they certify – conduct an investigation into the sources of income or assets of the person concerned, to see if he has material pecuniary involvement with the company, or test the state of mind of the individual to assess whether his decision are subjective or objective, and so on. In fact, the idea of certifying independence is much more shallow than anyone would think. It is a simple case of self-certification. If it is self-certification, then it is purely a perfunctory idea, as the interest of independent directors is disclosed, even as per current practice, at the time of appointment.

Independent directors in unlisted companies:

It is notable that in both USA and UK, the requirement of independent directors comes via listing regulations. The UK Companies Act 2006, for example, does not contain any requirement for independent directors[2]. Hence, obviously, independent directors are required only in case of listed companies.

In India, we take regulation as the prerogative, and liberty as an exception. Hence, it is not unexpected that regulators take the puritan line of argument – why independent directors should not be required in case of unlisted companies, if they have a particular size? The answer is simple – unlisted public company may purely be a family concern or private enterprise. After all, it is public interest that is the basis of the imposition of independent directors on boards. Where such an imposition is mandated by law and wisdom of companies, the question is, why, and not, why not.

The idea of Central Govt by rules laying down size of companies for which independent directors will be required was originally mooted in Clause 132 (3) of the Bill. Surprisingly, there does not seem to have been any opposition to this before the Standing Committee[3]. On the contrary, the MCA seems to have vehemently supported the idea of independent directors for unlisted companies, on the argument that the basic principles of corporate governance are to be applicable to all companies, listed or unlisted. So, it is

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[1] If you thought the idea of the regulatory authority is a pure joke, it is not. In fact, the Committee report notes that the ICWAI has suggested "It is proposed that in order to ensure complete independence of the independent directors the government should constitute a regulatory body consisting of representatives of Ministry of Corporate Affairs, Securities and Exchange Board of India, Reserve Bank of India, SCOPE, Professional Institutions, Chambers of Commerce and Industry etc., for preparation of a panel of persons of integrity and who are having relevant expertise and experience useful in the management of business of the company."

[2] There is a general duty to exercise independent judgment [section 173], but that is applicable to all directors, not any particular section of directors.

[3] In fact, a CII representation has only recommended for thresholds to be fixed.

almost certain that the new Act will require independent directors for unlisted companies as well, and, as in case of plethora of examples in the past[4], the Central Govt will prescribe some impractical size, and all discussions in future will possibly concentrate on such notified sizes, rather than on the fundamental question of – why at all?

When is material interest material?

As discussed above, discussions have gone before the Select Committee whether definition of independence, based on material interest, should be based on a limit of 10% of receipts.

The MCA seems to have suggested that the percentage be brought down to 2%, apparently in line with NYSE guidelines. However, the MCA has conveniently ignored to mention that the NYSE rules mention higher of 2% of consolidated turnover, or $ 1 million. There are two points to be noted – first, the turnover is "consolidated", which applies to the group turnover and not just turnover of the company in question. Second, the de-minimis exemption for pecuniary transactions upto $ 1million is significant threshold.

[4] For example, turnover-based criteria for private companies to be deemed public under sec 43A, requirement for managing director, audit committees, company secretaries, etc.