Guest blog

Pillars of Governance: Independent Directors

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The regulatory architecture under the Companies Act, 2013 ("**Act**"), and the SEBI (LODR) Regulations, 2015 ("**LODR**"), places independent directors ("**IDs**") at the forefront of India's quest for better corporate governance. Given that approximately 75% of listed companies in India are promoter-controlled, the MCA and SEBI have envisaged that the IDs will play a key role in safeguarding minority shareholders' interest.

The Irani Committee had, in its report on company law reforms, observed that IDs would be able to bring in an '*element of objectivity*' to the Board process, and that 'independence' should not be viewed merely as 'independence' from promoter interests, but from the standpoint of vulnerable shareholders who cannot otherwise get their voices heard[1].

IDs have been conferred with a plethora of responsibilities on various committees of the Board, such as the Audit Committee and the Nomination and Remuneration Committee ("**NRC**"). In fact, important aspects such as related party transactions (which can be approved by only the IDs on the Audit Committee) may not even be placed before the larger Board. The SEBI (PIT) Regulations, 2015, places additional responsibilities on IDs relating to compliance with insider trading norms and maintenance of structured digital database by the companies for sharing of UPSI.

Given the significance accorded to the IDs' role, Section 149(6) of the Act and Regulation 16 of the LODR set out detailed objective tests for 'independence', and perhaps no other jurisdiction in the world has prescribed such elaborate tests for 'independence'. However, given that 'independence' is also linked to behavioural and cultural aspects – can independence be ensured solely through statutory prescriptions?

[1] *Report of the Jamshed J Irani Committee on Company Law, at Para 8.1.*

Given the information asymmetry that exists between the MD/ WTD and the ID/ NEDs, the effectiveness of the IDs' role is also dependent on the quality of information provided by the management team.
Despite such challenges, have IDs added value to the corporate governance architecture? Through this blog, the authors have also suggested reforms in the present regulatory architecture to strengthen this institution.

Institution of IDs – Challenges and Issues

Appointment, re-appointment, removal, and resignation process

Under the newly notified SEBI regulatory regime, w.e.f. January 1, 2022, the appointment, re-appointment, and removal of an ID of a listed entity requires shareholders' approval by a special resolution[2]. No independent director, who resigns from a listed entity, can be appointed as a WTD on the Board of the listed entity, its holding/ subsidiary/ associate company or on the Board of a company belonging to its promoter group, unless a period of one year has elapsed from the date of resignation as an ID[3].

Further, in case of resignation of an ID before the end of his term, the resignation letter, along with detailed reasons for the resignation should be disclosed to the stock exchanges[4].

Some critics are of the view that the concept of ID is an oxymoron in the Indian context as IDs can never be 'independent'. Their appointment, extension of term, removal and compensation are all controlled by the promoters/ majority shareholders.

There have been several discussions on whether the law needs to be amended to take away the power of appointment from the majority shareholders, but no satisfactory solution has been found. This problem has become more profound in the Indian context due to the dominating promoter presence in most listed companies.

Boardroom Dynamics

Our socio-cultural norms make it difficult to openly question those in authority, or fear repercussions in case they are seen as being 'too critical'. Given this

[2] *Regulation 25(2A) of the LODR.*
[3] *Regulation 25(11) of the LODR.*
[4] *Part A of Schedule III of the LODR.*

constraint, it may be difficult for an ID to ask uncomfortable questions to the MD/ CEO - and raise sensitive issues formally within the Boardroom. This is exacerbated in situations where the Board consists of 'powerful personalities' – and it may be difficult for a single ID to take the lead.

Raising uncomfortable questions or being critical of the management's decisions may result in a situation where an ID is denied a second term. He may get labelled as a 'difficult ID' and his future directorship offers from other companies may also dwindle. In the absence of a Lead ID, an individual ID may feel uncomfortable raising his voice all by himself – for the fear of being singled out. Many IDs prefer to speak with the management privately about their concern on any issue, either before or after the Board/ Board Committee Meeting.

Further, whilst it is now mandatory for IDs to hold at least one meeting in a financial year, without the presence of non-independent directors and members of the management, this has not proven to be very effective in practice.

Information Asymmetry

Given that IDs are not involved in the day-to-day management of the company, IDs may not have access to the same level of information about the company's affairs, when compared to the MD/ CEO and other WTDs. By virtue of this, an ID is required to place reliance on the information/ inputs shared by the management team.

While an ID (like all other directors) has information rights under Section 128 of the Act, it is the management that is responsible for ensuring that all material facts are shared prior to the Board/ Board Committee meeting. Given that IDs on various Board Committees are now solely responsible for approving important matters like RPTs – the effectiveness of the IDs' role may be compromised if the information shared with them is inadequate.

Further, for time-sensitive proposals like M&A deals, an ID may be asked to convey his approval at a very short notice, without being provided with sufficient time to process the information that is being shared by the management team. As IDs are not involved in discussions relating to deal structuring and negotiation of transaction documents, it is challenging for an ID to provide his approval merely based on views expressed by the management and external advisors.

Given the potential liability risk, IDs are now expecting greater involvement even at the initial stages of a proposed M&A deal, as opposed to being informed about the deal at the last minute.

ID Database and Pre-Qualification Test

The database of IDs, maintained by the MCA under Section 150 of the Act, and the requirement of passing the pre-qualification test (conducted by the MCA) for the proposed appointee has not proved to be of any use or relevance.

The nature of questions asked in the test are more of a procedural nature for practising company secretaries and this provision needs to be deleted from the statute book as it fails to serve any purpose.

Liability of IDs – Are safe harbour provisions being respected?

As per Section 149(12) of the Act, an ID shall be held liable only in respect of such acts of omission or commission by a company, which had occurred with his knowledge, attributable through Board processes, and with his consent/ connivance or where he had not acted diligently. This is a very limited conditional immunity under the Act. However, it still exposes IDs to any violation of many other laws applicable to companies, like the Factories Act, various employment laws, Environment Protection Act, 1986, etc.

Moreover, in practice, the safe harbour provisions are not being respected by the Regulators and even by Courts, and IDs are being held liable for violation of the Act and the LODR – for aspects like misstatements in the financial statements, non-compliance with accounting standards, etc[5].

This risk of potential liability has acted as a deterrent in attracting talented persons as IDs – as there is a plausible fear that an ID may be asked to approve proposals without being presented with all material facts. Time-sensitive matters such as approving M&A deals is one such classic example. Given the associated risks and potential liability, India Inc has witnessed a spike in ID resignations in recent years. While the number of ID resignations have declined in the last two years, there were a record 1,393 resignations in 2019[6].

IDs' contribution to Board deliberations

Despite the challenges faced and the regulatory overload, the presence of IDs has undoubtedly improved the quality of deliberations at the Board level – by

[5] See, for instance, SEBI Adjudication order in the matter of Bombay Dyeing and Manufacturing Company Limited, dated October 31, 2022.

[6] In the recent past, there have also been instances of mass resignations of IDs, in situations where there is a change in control of a listed company.

ensuring that the 'right' kind of questions are asked of the management. IDs have acted as a sounding board for the management *inter alia* on strategic and financial aspects – and have played an important role in ensuring that 'material facts' are disclosed by the management.

Despite the limitations that may arise under our socio-cultural norms – IDs have, on certain occasions, also asked 'tough questions' on sensitive aspects such as disclosures in the financial statements, risk factors of proposed M&A deals, etc. Along with making the approval process more robust and ensuring quality deliberations, this has also ensured that more 'homework' is done by the management before proposals are placed before the Board. The process of 'Board approval' can no longer be taken for granted.

Concluding Thoughts and Recommendations

While IDs have undoubtedly acted as a catalyst in India Inc's quest for better corporate governance, certain reforms can further strengthen this institution.

Appointment of a Lead ID

Given the range of responsibilities, the time has come to now introduce the concept of a 'Lead ID' in India, that has been successfully implemented in the West. This can be initially introduced for the top 500 listed companies – and can subsequently be extended to cover all listed companies.

Along with providing effective leadership to the body of IDs, the Lead ID can 'bite the bullet' to initiate discussions on contentious/ sensitive issues – and take the first step in asking tough questions to the management. This is particularly useful when there is an Executive Chairman on the Board.

Perhaps, the regulators have so far shied away from introducing this concept, fearing that this may create a parallel power centre and dilute the authority of the CEO/ Chairman. However, keeping in mind the Indian context and the multifarious responsibilities of IDs, this concept will significantly strengthen the institution of IDs.

The Lead ID should also be provided with office space, secretarial support, and direct access to all the members of the management team/ internal auditor/ statutory auditor etc.

Objective criteria for performance evaluation

Currently, the Act and the LODR do not provide objective criteria for performance evaluation of IDs – which makes the performance evaluation process rather

tokenistic. While it would not be advisable to be over-prescriptive – the MCA and SEBI could consider formulating objective parameters for performance evaluation – that would serve as a guidepost for the NRC and the Board.

Dissent should be clearly disclosed in the Board's report

If an ID expresses his dissent on any Board-approved proposal, and specifically records a dissent note – such dissent may only be recorded in the Board/ Board Committee meeting minutes – and the minority shareholders/ other stakeholders would not be aware of it. Given that regulators have envisaged a key role for IDs in protecting minority interest, as a starting point, the MCA and the SEBI could make it mandatory for companies to disclose details of dissent(s) recorded by an ID in Board/ Committee meetings, in the Directors' Report for the financial year.

Appointment and removal process

Under the current regulatory regime, if a promoter holds 25% or more equity stake in the listed entity, the outcome of the appointment/ re-appointment/ removal resolution would depend on which way the promoter votes.

There are divergent views on what is the ideal process for appointment of IDs – and whether the appointment should be based on **(a)** majority shareholder-support; or **(b)** vote of the minority shareholders only; or **(c)** appointment by the Government/ regulators; or **(d)** a hybrid-model consisting of one or more of the above. There is no ideal solution found so far. It requires deeper reflection and serious debate.

There is a need for a review by SEBI of the current practice where CEO/s MDs of large listed companies getting appointed as IDs on the Boards of other large listed companies. Given that they already have a heavy responsibility of running their own companies, they may not be able to devote adequate time for their role as IDs on other Boards.

One needs to be mindful of the fact that statutory prescriptions can never ensure '*independence of mind*'. It is a cultural issue and culture takes a long time to change. Hopefully, the next generation of IDs would be more independent than their predecessors.

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