



INDEPENDENT DIRECTORS: RAISING RED FLAGS

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ABSTRACT

Keywords:

I. INTRODUCTION

An Independent director (also sometimes known as an outside director) is a director (member) of a board of directors who does not have a material or pecuniary relationship with company or related persons, except sitting fees. He is not allowed to own shares in the company. As defined by their name- independent, they are supposed to function like a watch dog i.e. keeping an eye on each & every activity of the company. The job role can be defined as one who is sleeping when others are awake and awake when others are sleeping. He is duty bound to raise the red flag (warning) raise red flags whenever suspicion occurs. They are expected to be more aware. The role of the director in a company's Board of Director is to protect the interest of the shareholder and monitor the manager such that they implement the projects to maximize the shareholders' wealth. To fulfill the objective of the BOD the composition of the board is extremely crucial so that the board can perform the responsibilities independently and fairly.

The emergence of the concept of "independent directors" can be seen in the light of evolution of the term "corporate governance" over time. A corporate form of entity has stakeholders viz. shareholders, creditors, banks and financial institutions, employees, community and environment. The working of the corporate system depends on how well the interests of these stakeholders are served. In the year, 1999, the Securities and Exchange Board of India (SEBI) set up a Committee under the chairmanship of Kumar Mangalam Birla to promote and raise standards of corporate governance in India. The recommendations put forward by the KM Birla Committee led to the addition of "Clause 49-Corporate Governance" in the Listing Agreement in the year 2000.

Independent directors are likely to act the same as inside directors in an attempt to gain control. They are likely to oppose the change because they are likely to believe that their stewardship is good and the changes in control poses danger to the public stockholders they are there to protect. When independent directors are majority on board, they control how the company reacts. The Companies Act, 2013, sets to overhaul the provisions relating to independent directors entirely by conferring greater power and responsibility in the governance of a company. There are no explicit provisions for independent directors under Companies Act 1956 and only clause 49 of the Listing Agreement prescribed for the induction of independent

directors and made it mandatory for listed companies. It also prescribes other aspects such as maximum tenure of independent directors, separate meeting of independent directors, tenure, their qualifications, liability, appointment, remuneration and other aspect. Thereafter, the Ministry of Corporate Affairs carried out corresponding changes to the provisions of 1956 Act, in an attempt to include the requirement of having an independent director on the board of listed companies to oversee corporate governance. However, such attempts proved to be futile as the changes failed to explain the roles, duties or liabilities of independent directors lucidly. Board's independence from external influences is critical and directly proportional for effective corporate governance. Thus, the need for comprehensive and strong legislation relating to independent directors became vital and eventually led to the enactment of the Act.

II. INDEPENDENT DIRECTOR: ANALYSIS

Section 2(47) states that Independent director means an independent director referred in Section 149(5) of Companies Act, 2013. In fact reference should have been made to sub section 6 of 149 as it describes the attributes of independent director with clarity. As per section 149 (6), Independent Director means any director other than a managing director or whole-time director or a nominee director. New Act now makes it mandatory for every listed public company to appoint at least one-third of the total strength as independent directors (fraction is to be rounded off to one). Central Government may, in case of any class or classes of public companies prescribe the minimum number of independent directors to be appointed. Since it will be difficult to meet this requirement, one year time has been given to the existing companies from the effective date to fall in line with the requirement.

as per Rule 4 of companies(appointment and qualification of directors) rules 2014, unlisted companies are required to have atleast two independent directors, if they meet one of the following criteria:

- Paid up share capital of INR 10 crore or more
- Turnover of INR 100 crore or more, or
- Outstanding loans/ debentures/ deposits exceeding INR 50 crore.

If an unlisted companies is required to appoint a higher number of IDs due to composition of its audit committee, then such unlisted companies would have to appoint higher number of IDs.

Further the new rule provides that the above given provisions will not be applicable to following classes of unlisted public company.

- A joint Venture
- A wholly Owned Subsidiary
- A dormant company

Criteria for selecting Independent Director:

Section 149 lays out Certain conditions need to be fulfilled, before appointing any person as an independent director are-

- i. Any person who is to be appointed must in the opinion of the Board, be a person of integrity and must possess relevant expertise and experience;
- ii. Person who is to be appointed must neither be a promoter of a company nor must be related to the promoters or directors of that company.
- iii. He must have no pecuniary relationship with the company, and that none of his relatives must have been having any pecuniary relationship with the company.
- iv. Neither he nor any of his relative, must hold following positions in a company:
 - (i) the position of a key managerial personnel
 - (ii) employee or proprietor or a partner, in any of the three financial years, proceeding.
 - (iii) Holds together with his relative two percent or more of the total voting power of the company; or
 - (iv) Chief Executive or director, of any non-profit organization.

1.1 Manner of Appointment

Section 150 (1) of the Act, indicates that the independent directors may be selected from a data bank of eligible and willing persons maintained by any Institute or Association as may be prescribed by Central Government. This section further stipulates that the appointment of independent directors has to be approved by members in a General meeting and the explanatory statement annexed to the notice must indicate justification for such appointment. Following procedure have to be followed

- With due diligence select a person proposed to be appointed as an ID and ensure that there is appropriate balance of skill, knowledge and experience in the board. Person may be selected from a data bank of eligible and willing persons maintained by any Institute or Association as may be prescribed by Central Government
- Ensure that person to be appointed comply with provision of 149(5) & Rule 5 .

- Person has to submit a declaration that he/ she is not disqualified to be appointed as a Director as per provisions of Section 164(1) & (2) of the Companies Act, 2013 in Form DIR-8 to the Company.
- Ensure that hemust have DIN before being appointed as director.
- The ID has to submit the Consent to act as Director in FormDIR-2 to the Company.
- The appointment of Independent Directors shall be formalised through a letter of appointment, which shall set out: (a) The term of appointment; (b) The expectation of the Board from the appointed Director; the Board-level committee(s) in which the director is expected to serve and its tasks; (c) The fiduciary duties that come with such an appointment along with accompanying liabilities; (d) Provision for Directors and Officers (D and O) insurance, if any; (e) The Code of Business Ethics that the company expects its Directors and employees to follow; (f) The list of actions that Director should not do while functioning as such in the company; and (g) The remuneration, mentioning periodic fees, reimbursement of expenses for participation in the Boards and other meetings and profit related commission, if any.
- The terms and conditions of appointment of Independent Directors shall be open for inspection by any member.
- The above terms and conditions shall also be posted on the company's website.
- Lastly the Company has to file the consent of Independent Director with Registrar of Companies within 30 days of his/her appointment in Form DIR-12

2.2 Re-appointment

Independent director can hold office for a term of 5 consecutive years and such term can be extended by another 5 years, if a special resolution is passed by shareholders and disclosure to that effect is made in Directors Report. Another relaxation given is that the same person can be considered for re-appointment after a lapse of 3 years period from the date of cessation of directorship.

The re-appointment of Independent Director shall be on the basis of report of performance evaluation.

2.3 Roles & Functions

Independent Directors shall

- (i) Help the board in taking independent judgements on issues of Risk Management, Strategy, Key appointment etc.,
- (ii) Help in evaluation of performance of board and management;
- (iii) Scrutinise the performance of management in meeting agreed goals and objectives and monitor there performance;
- (iv) Safeguard the interests of all stakeholders, particularly

the minority shareholders

- (v) Balance the conflicting interest of the stakeholders.
- (vi) Report concerns about unethical behavior, actual or suspected fraud or violation of the company's code of conduct or ethics policy.

2.4 Duties

The independent directors shall:

- i. Conduct induction programmes and regularly update & refresh their skills, knowledge etc.
- ii. Attend the GM.
- iii. Check whether the matters of concern are communicated to the board and which are not resolved insist to record them in minutes of BM.
- iv. Attend all meetings of BOD's & Board Committees in which he is a member.
- v. Participate actively in committees of Board in which he is a chairperson or members.

III. SOME PROCEDURAL PROVISIONS

It may be noted that some procedural provisions provided under Companies Act, 2013 relating to Independent Directors are as under:

1. Section 149 (4) provides that every listed public company shall have at least one-third of total number of directors as independent directors.
2. Section 152(3) provides that all directors (including Independent Directors) of a Company (including a Private company) shall obtain Director Identification Number (DIN).
3. Section 167(1)(b) provides that a Director (including an Independent Director) of a Company (including a Private Company) shall vacate his office if he does not attend all the meetings of the Board held during a period of 12 months, with or without seeking leave of absence of the Board. It may be noted that under section 173(2) participation of directors in a Board Meeting through video conferencing or other audio visual means is permitted.
4. U/s. 173(3) at least 7 days notice is required for Board Meeting. If shorter notice is given, at least one Independent Director should be present at the meeting. If no Independent Director is present at such meeting, the decisions taken by the Board should be circulated to all Directors. These decisions shall be final if they are ratified by at least one Independent Director.
5. Where Audit Committee is required to be appointed by a listed or other specified Company under section 177, it should have at least 3 Directors. Majority of Directors in this committee should be Independent Directors.
6. Section 178 is a new section which provides for appointment of nomination and Remuneration Committee of the Board. This Committee should consist of 3 or more Non-Executive Directors. Out of

this at least 50% should be Independent Directors.

7. A listed company or other specified company has to appoint a Corporate Social Responsibility (CSR) Committee of Board. This committee should consist of 3 or more Directors, out of which at least one Director shall be an Independent Director.
8. The Board Report to Members should give a statement of declaration given by Independent Directors u/s. 149(6).
9. Section 169 lays down that an independent director can be removed by way of an ordinary resolution requiring a simple majority (at least 50%).
10. Regulation 17 of SEBI (Listing Obligations and Disclosure Requirements) Regulations states that the Board of a listed entity shall have an optimum combination of executive and non-executive directors with at least one woman director and 50% of Board shall comprise of non-executive directors. In case the chairperson of Board of Directors is a non-executive director, then 1/3rd of Board shall comprise of independent directors and where the Chairperson is an executive director, 1/2 of Board shall comprise of independent directors. In case the nonexecutive chairperson is a promoter or related to the promoter or any other person occupying management position in the Board of Directors or at one level below the Board of Directors, at least 1/2 of the Board of Directors shall comprise of independent directors.

IV. CONCEPT OF RAISING RED FLAG DURING COMPANY'S MISMANAGEMENT

Independent Directors play a pivotal role in maintaining a transparent working environment in the corporate regime. Independent Directors constitute such category of Directors who are expected to have impartial and objective judgment for the proper functioning of the company. The appointment of Independent Directors ensures an effective and balanced composition of the Boards. Independent Directors play a pivotal role in building a strong foothold of Corporate Governance in an organization. They bring accountability and credibility to the Board process and also strengthen sound practices. While they need not take part in the company's day-to-day affairs or decision making, they should ask the right questions at the right time regarding the board's decisions. Raising the appropriate red flags at the right time would help them in avoiding the occurrence of unwanted situations and their consequences to a great extent. However, an Independent Director may not be able to play an effective role in isolation despite his commitment to ethical practices. He may not be able to stop a decision that is detrimental to the members individually, but if the Independent Directors act collectively, then they can together make a difference. Independent Directors may not be in a position to stop fraud at the highest level, but with a high level of commitment and due-diligence, they may be well placed to identify signals that indicate that everything is not as it should be.

Globally, with the evolving regulatory landscape, which makes them responsible for the prevention and detection of fraud,

directors have begun exercising adequate oversight on the management of the risk of fraud. Non-compliance with these regulations or guidelines can have serious repercussions for directors, including their reputational loss and personal liabilities.

For directors of organizations with operations spread across multiple countries, the risk of non-compliance increases significantly. The role of IDs in fraud prevention and detection has come under the direct scanner of regulators, members and other stakeholders due to the recent exposure of high-profile instances of fraud in India. In the last few months, we can clearly see IDs taking direct interest in reviewing the fraud risk management framework put in place by their organizations to mitigate the risk of fraud.

Recently, when an instance of fraud was reported in a large IT company, IDs on the boards of other companies insisted on conducting a forensic review of corresponding processes and transactions in their companies to ensure that similar issues do not exist in their company. Several multinational companies have started conducting a "Fraud Risk Diagnostic Review" at their Indian subsidiaries to understand the current state of fraud risk management at these entities. The trend is clearly a positive one by IDs, choosing to be proactive rather than assuming that no fraud can happen in the company.

The IDs can play the crucial role of bringing objectivity to the decisions made by the board of directors by playing a supervisory role. While they need not take part in the company's day-to-day affairs or decision making, they should ask the right questions at the right time regarding the board's decisions. Raising the appropriate red flags at the right time would help them in avoiding the occurrence of unwanted situations and their consequences to a great extent.

To avoid such concerns and mitigate risks in general, IDs should ensure that their potential liability is insured. The vulnerability of independent directors is a real concern as they are being arrested for actions that are a result of no fault of theirs. However, in the Indian context, it may be argued that liability arises only on account of conduct or act or omission on part of the ID to fulfill certain obligations, and not by the mere fact of holding an officer responsible for actions taken by the company.

V. ROLE OF I.D- FROM SATYAM SCAM (2008) TO TATA SON-CYRUS MISTRY SPAT

The concept of the institution of IDs is simple. They are expected to be independent from the management and act as the trustees of shareholders. This implies that they are obligated to be fully aware of and question the conduct of organizations on relevant issues. After the break out of some of the largest corporate scams in the country in recent times and the subsequent increase in the number of resignations by IDs, there is a heightened focus on their role and responsibilities as custodians of stakeholders' interests.

The recent Satyam scandal has put the role of independent directors in the spotlight. It is not only in Satyam that independent directors showed lack of commitment; earlier in the case of Enron, WorldCom and other companies in which corporate governance as well as independent directors failed to

perform effectively. The conjecture is based on the fact that the accounting fraud was perpetrated over a long period of five to seven years and that DSP Merrill Lynch, who were hired to identify some partners for the company could within a week smell accounting fraud. Moreover, as reported in many newspapers, some customers, including the World Bank, were complaining of fraudulent and unethical practices by the company. This leads to the conjecture that independent directors lacked commitment, at least collectively. It is seen that after the satyam incident, the independent directors of the company and other such companies have relinquished their respective posts thereby jeopardizing the position of the independent directors in the company.

The Satyam board including its five independent directors, had approved the acquisition of Maytas Infra and Maytas Properties, owned by the Raju family. Without taking shareholders into confidence, the directors went along with the management's decision. The fact that the company was spending money on a totally unrelated business at a time when its core business of SAP needed to be consolidated (after competitor HCL Technologies bought Axon which is strong in SAP) did not deter the board. This was curious, particularly which is keeping in mind the luminaries who sat on the board. The independent directors were acting as mere stamps for the decisions taken by the executive board.

If independent directors are held liable for corporate fraud and severe penalties are imposed on them, it will be difficult to induct right people as independent directors in the board and companies will be deprived of the collective wisdom of people who can make a difference in the performance of companies.

TATA vs. MISTRY: BAD GOVERNANCE PRACTICE

The sacking of Cyrus Mistry as the chairman of Tata Sons, and the intrigues and machinations that followed, show us that good governance cannot be ensured with mere legislation and that the independence of directors in listed companies is a myth. In the first week of 2017, Tata Sons would have all but won. A few defamation cases will drag on in courts. Tata Sons has already issued a victorious advertisement thanking shareholders of Tata companies for helping it throw out NusliWadia and Cyrus Mistry from key group companies. The reason for NusliWadia's removal is even flimsier. His decision to support Cyrus Mistry seems to have enraged Ratan Tata who ensured that Tata Sons requisitioned extraordinary general meetings (EGMs) in quick succession to ensure his exit from the group. This raises serious questions about the true 'independence' of directors who have onerous responsibilities cast on them by the law.

Ironically, the Tata group has had issues with truly independent directors even earlier. In the 1990s, the late SS Tinaikar, a firebrand former municipal commissioner who was on the board of Voltas Limited, had dared to question some shady decisions of its then chairman AH Tobaccowala. When he did not get proper support from Ratan Tata (even though Mr Tata wanted MrTobaccowala ousted too), he went public about the goings-on at Voltas at a press conference. Soon enough, the powerful MrTobaccowala isolated him on the board and he was forced to resign. No company ever invited him to be a director again.

There have been extensive changes since the 1990s, at least on paper. Today, the Companies Act 2013 and regulations of the Securities and Exchange Board of India (SEBI) have made independent directors responsible for ensuring good governance. They have also cut the benefits and remuneration they can earn from companies, in order to preserve their 'independence'. But MrWadia's example shows that the law provides no protection to independent directors against recalcitrant or vindictive management. Mr. Wadia has correctly said, *"What is at stake is not whether I am removed or not, but the fate of the very institution of independent director that has been created in law and by SEBI to safeguard the interests of all stakeholders. If independent directors can be removed at the whim and fancy of a promoter, then their role will be reduced to that of 'yes men'."* He goes on to say that the ability of a promoter to remove an independent director through the brute force of its shareholding, by an ordinary resolution on which it can vote, is a serious and major dichotomy and the contradiction needs to be, and must be addressed, urgently.

VI. CONCLUSION

The collapse of international financial markets, commitment breaches by directors, governance failure, corporate frauds, witnessed in the last decade mandated appointment of independent directors in companies to prevent shareholders and stakeholders interest, however, the provisions have been followed just in paper, not complying with adequate qualification and experience required to ensure good governance practices. It is strongly accepted that Board has not been succeeded in their monitoring role to the top management of company and are unable to develop alternative strategies after serious deliberations with the CEO as has been witnessed in high profile corporate disasters. It is here, that independent directors perform as an advisor to the top board rather than monitoring the board. The Companies Act, 2013 imposes a high level of responsibility on independent directors and makes them liable in cases of failure. Further, independent directors are expected to be independent of the management and act as the trustees of minority shareholders. This essentially requires independent directors to be fully aware of the decisions taken by the company management and raise red flags wherever any mismanagement is detected. But the scheme of the Act fails to protect independent directors if they fall out of favours with the majority shareholders.

At present the concept of Independent Directors exists under SEBI Regulations. Therefore, it is obligatory for listed Companies to have specified number of Independent Directors. This concept does not exist under the existing Act. However, the New Act defines the term "Independent Director" and provides for specific duties and responsibilities of Independent Directors. The Duties and Functions of Independent Directors are explained in Schedule IV. These provisions tells that the Independent Director will have to acquire knowledge of the technical, financial, managerial as well H.R. functions of the Company and report to the Board about deficiencies in the functioning of the staff in each of these fields. He will have to suggest remedial steps to be taken and also see that they are promptly implemented. In other words, the role of an Independent Director under the new Act will be that of a "SUPER WATCHDOG" who has to ensure that those in the

day-to-day management (including all Directors on the Board) are functioning in the best interest of the stakeholders, minority shareholders, regulators, workers, customers and public at large.

The IDs can play the crucial role of bringing objectivity to the decisions made by the board of directors by playing a supervisory role. While they need not take part in the company's day-to-day affairs or decision making, they should ask the right questions at the right time regarding the board's decisions.

Raising the appropriate red flags at the right time would help them in avoiding the occurrence of unwanted situations and their consequences to a great extent. The Act empowers independent directors with proper checks and balances, so that such extensive powers are not exercised in an unbridled manner, but in a rational and accountable way. The changes are a step in the right direction. They should enhance corporate governance and ensure the management and affairs of the companies are conducted in the interest of stakeholders. It is expected that these changes will thwart corporate scandals in future and insulate shareholders interest. However, since the provisions are not yet in force, the actual effectiveness and practical defects can be determined only in the time to come.

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