Caution: Independent Directors – Hairpin Turns Ahead!

Chief Contributor: Bala N Balasubramanian [1]

EXECUTIVE SUMMARY

- Proposed amendments to Company Law promise to render the responsibilities of Independent Directors more onerous.
- Disgorgement of inappropriate earnings mandated; applicability to IDs unclear but not unlikely.
- Permitted non-directorial pecuniary receipts being increased and linked to individual director's personal income; besides any potential impairment to independence, this may lead to discord among directors if remuneration differences are significant.
- Onerous oversight of compliance responsibility in respect of undisclosed significant beneficial ownership issues.
- Academic certification required to qualify as ID except where exempted.

1 Author can be reached at bala4391@gmail.com; Insightful comments and suggestions from Messrs Sharad Abhyankar, Nawshir Mirza, Nirmal Mohanty, Deepak Satwalekar and Umakanth Varottil are gratefully acknowledged.

I. Introduction

The institution of Independent Directors (ID), heralded as a virtual *panacea* for all governance ills, nearly three decades ago in the UK's Cadbury prescriptions, is now almost universally under attack for non-performance, criticising voices getting shriller with every corporate scam uncovered and publicised. And the near-precarious situation of IDs, already struggling to cope with the conventional "devil and the deep sea" syndrome of meeting expectations of company controllers on the one hand and the regulatory mandates on the other, seems set to be further exacerbated, by some of the proposed legislative amendments to Company legislation. [2] Some of these are clearly reactive measures to address issues thrown up by corporate frauds and misdemeanours of the recent past but their impact will, as usual, be suffered by the many for the misdeeds of a few.

II. Key Proposals and their Likely Impact

a. Remuneration as Marker of Independence

Proposed Amendment to Section 149 (6) (c):

"Provided that the total pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters or directors, shall not exceed twenty-five percent of his total income, of which, professional or any services rendered by him, …, shall not account for more than ten percent of his total income:

Provided further that the remuneration received under sub-section (5) of section 197 and expenses incurred for participation in the Board and other meetings shall not be accounted for determining the total pecuniary relationship."

Assessment:

A few rare exceptions aside, financial independence is admittedly a major contributor to one's overall independence of thought and action; consequently, remuneration is a potent weapon in any effort to "capture" the board or individual directors. Hence the general principle that independent directors' remuneration ought to be high enough to attract talent and compensate for risks but not so high as to likely impair their independence of judgement.

The present limit for such pecuniary relationships (excluding income from serving as a director) that directors may have without breaching their independent status is ten percent of their total personal income. While this in itself is a departure from the original prescription of "no pecuniary relationship" at all, this relaxation is now proposed to be increased to 25 percent (with a sub-ceiling of ten percent for professional services (see the proposed Amendment mentioned above). This is a substantial increase in the overall cash flows to such directors. To what extent this relaxation would likely compromise such directors' independence can only be speculated upon at this time, but in an environment of world-wide disaffection on the effectiveness of the institution of independent directors, this proposal would seem somewhat ill-advised.

2 Ministry of Corporate Affairs Notice of 5 November, 2018, http://www.mca.gov.in/Ministry/pdf/NoticeAmendmentsCA2013_05112018.pdf

In addition, since different ID's personal income could vary significantly, this relaxation may also lead to material variations in the total take-home cash flows of different directors; this is a potential source of discord among the IDs that is best avoided in the interests of board cohesion and collegiality.

The only case for some linking of independent directors' remuneration to their personal incomes or wealth would be in the area of limiting the IDs' compensation as a director from a company to a reasonable proportion [3] of the individual's total income averaged over two or three years, so that dependence on such income (and likely consequent impairment of independence) could be mitigated to some extent. There would, otherwise, seem to be no rationale for relating director compensation and other receipts to one's personal total income.

b. Disgorgement of Fraudulent Earnings

Proposed addition of Section 212 (14A):

"(14A) Where the report under sub-section (14), states that fraud has taken place in a company and due to such fraud any director, key managerial personnel, other officer of the company or any other person or entity, has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the Central Government may file an application before the Tribunal for appropriate orders with regard to disgorgement of such asset, property or cash, as the case may be, and also for holding such director, key managerial personnel, officer or other person liable personally without any limitation of liability."

Assessment:

It is an established principle of equity (flowing from the concept of restitution) that perpetrators of fraud, when detected and convicted, ought to forfeit their right to any earnings or wealth appropriated by them as a result of such fraud; in most jurisdictions, such offenders are required to disgorge their ill-gotten earnings and wealth back to the rightful claimants. Many countries have legislated this measure to public corporations and have sought to claw back unjust enrichment of corporate directors and officers who had benefitted from fraudulent practices. This punitive measure, however, is generally applied to executive directors and top managers (largely in the area unjust remuneration) but rarely to non-executive directors.

The proposed addition of Section 212 (14A) in the Companies Act is a pioneering step in this direction. Whether non-executive independent directors would also be subject to such this retributive action is unclear, but the wording in the proposal, *any director*, would seem to suggest that such independent directors may not be beyond the purview of this measure if their involvement, by active collusion or passive indifference, is proved. Disconcertingly, some of the judicial pronouncements bearing upon independent directors' responsibility and liability seem to portend more onerous standards of expectation than ever before. [4]

3 Suggested indicative limits range between 20% - 33% in case of individual companies, and 40%-66% in case of all group companies together, of the total personal income of the directors.

4 Illustratively, see https://indiacorplaw.in/2019/02/actions-independent-directors-dishonour-cheques.html for a discussion on a SEBI Order in an unrelated matter, commenting up on the role and responsibilities of independent directors; Umakanth Varottil, March 13, 2011.

Independent directors may have to be on their guard to avoid getting entangled in such situations, but what extra precautions they ought to consider is an open question. Clearly, one cannot suspect potential fraud as a general rule as such an approach might be inimical to constructive board functioning. Dependence upon statutory auditors' assurances may not be a fool-proof option; in extreme cases (as in Satyam Computers) auditor collusion may not be ruled out either. Independent directors would likely have to rely on their wisdom based on their experience and business acumen!

c. Significant Beneficial Ownership

Proposed Addition of Section 90 (4A):

"Every company shall take all necessary steps to find out if there is any individual who is a beneficial owner in relation to the company and if so, to identify him and require him to comply with the provisions of this section".

Assessment:

Shareholders and in fact most other stakeholders (for their own different reasons) have always been curious to identify the ultimate controllers of their corporations. Published information has been generally been economical on detail limited to disclosure of details of holding companies, if any, in the Balance Sheet.

The proposed [5] insertion of the new section 90 (4A) seeks a paradigm shift in the onus of identifying any undisclosed significant beneficial owners on to the company and obtaining due compliance. So far, disclosure was the responsibility of the incumbent shareholder on record without beneficial ownership, or the government to investigate and identify if it had reasons to believe that there were undisclosed instances of such beneficial holdings.

While the proposed new responsibility is sited in the ubiquitous "company", it would be fair to assume that the board (and especially its independent directors) would have to oversee compliance with this requirement as part of their compliance review exercise periodically, at least to show on record this matter had been considered and reported compliance was satisfactory.

What steps would meet be statutory requirement of "necessary" (as opposed to say, reasonable") steps is a matter of subjective interpretation. One hopes the board's guidance on this matter would have the benefit of something like the *Business Judgement Rule* widely followed in the US where courts do not attempt to second-guess the decisions of the directors unless *prima facie* there were reasons to suspect some foul play. Independent directors can only hope their judgement meets the rigours of the judicial scrutiny in case of any litigation. Perhaps, the judiciary may, in some future litigation, lay down some criteria in this regard.

5 No longer a proposal, this has since been implemented through a notified Rule by the Ministry.

d. Debarring "Fit and Proper" Status

Summary of Proposed Section 241 (3):

Government may apply to the Tribunal in appropriate cases seeking an order to declare a person found guilty of oppression and mismanagement of a company as not "fit and proper" person to hold office as a director or any other office connected with the conduct and management of any company for a period of five years, on the following grounds:

- The person is guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations under the law, or breach of trust;
- The person has not conducted and managed the business of the company in accordance with sound business principles or prudent commercial practices;
- The person has conducted and managed the company in a manner likely to cause serious injury or damage to the interest of the trade, industry or business pertaining to it;
- The person has conducted and managed the company's business with intent to defraud its creditors, members or any other person or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

Assessment:

Under the broad theme of Oppression and Mismanagement and their prevention, Companies Act has always had provisions for redress to the complainants (typically holding ten percent of the equity capital, or lower of ten percent of the total number of shareholders or one hundred) in justified cases. The proposed insertions in Section 241 of the Act seek to challenge the "fit and proper" status of any person found guilty of the charges of oppression and mismanagement such that the person is debarred from holding office of director or any other office connected with the conduct and management of any company, for a period of five years.

There may be two dimensions to the actual impact: first, in case of executive directors and others in management convicted under these provisions, they may suffer disqualification for appointments (and even continuance) as independent directors in other companies for five years; second, opportunities of appointment as managing or wholetime directors in other companies will be denied to them during this five-year period. Harsh as these provisions are (in that they shut down sources of livelihood for the convicted persons), they seem to be rationalised on the basis that their proven unacceptable conduct should not be allowed to impair the interests of shareholders and other stakeholders of other companies for the prescribed five years (or less if so decided by the government) during which hopefully the person may be reformed to eschew such behaviour in future.

The moot question, however, is whether these provisions will at all apply to incumbent independent directors of companies. The wording of the proposed section is clearly wide enough not to exclude them, should their involvement, by commission or omission, be proved in the perpetration of the fraud. While chances of such charges being proven are likely remote, independent directors would nevertheless have to be conscious of the Damocles' sword over their heads and order their conduct and behaviour in a manner to keep them out of harm's way!

e. Academic Certification of Independent Directors

Proposed Amendment to Section 149 (6) (ea):

An independent director "who completes such assessment, conducted by such body or institute, as may be prescribed:

Provided that the Central Government may, by order, exempt an individual or any class of individuals from the requirement of completing such assessment."

Assessment:

Among the criteria to qualify as Independent Directors is a proposed (section 149(6)(ea)) additional requirement (except where exempted) that they undergo a measure of academic instruction and certification that would help them in the discharge of their obligations to the company and its stakeholders including all shareholders. The need for appropriate and continuing training for independent directors (besides the usual on-board induction inputs received from the company) has long been recognised. This has so far been met by generic and specific training courses offered by business schools and directors institutes around the world but the idea of certification as a "qualifying requirement" envisaged by the proposal is arguably a first among countries. While the measure is a welcome step (and may even be a forerunner to the formal recognition of a profession of independent directors with a body overseeing certification, continuing education, and disciplinary oversight), the efficacy of its mandatory prescription is open to debate. Although there exists a provision for exempting certain IDs (presumably on the basis of some criteria relating to their experience and stature as IDs, or pre-existing educational background as in the case of academics in related disciplines and so on), this measure is likely to further compound the oft-repeated problem of paucity of suitable candidates for ID positions. Some alternative mechanisms such as a requirement to go through Continuing Professional Education (of some stated hours) by voluntarily attending "approved" short courses or seminars on relevant topics conducted by institutions of scholarship and eminence may well be the answer.

f. Resignation of Independent Directors

Proposed Amendments to Section 168 (1):

Two additional measures are introduced by a proposed modification/ insertion of provisos in section 168 (1).

- The first imposes an obligation on the independent director to forward a copy of his resignation to the Registrar of Companies, together with detailed reasons for the resignation.
- The second, possibly the more important, defers the effective date of resignation to thirty days from the date of receipt by the company of the notice of resignation, or a later date if voluntarily so specified in the resignation notice.

Assessment:

The first measure offers the IDs an authoritative forum to explain the reasons that led to their resignation, and pre-empt any contrarian communication the company may put out for public consumption. [6] The apparent implication of the second provision would be to extend the directorial liability of the person by thirty days, should the resignation have been triggered by the imminent possibility of some event or cause that could potentially inflict some liability upon the individual, or involve him in avoidable litigation processes.

How should the resigning directors protect themselves from any undesirable fallouts? One effective precaution would be extra diligence and care in attending to communications from the company and any board decisions during the period; and recording their dissent in case of any disagreement.

III. Takeaways for Independent Directors

- Both directly and peripherally, the proposed amendments, if implemented, are likely to render the job of independent directors more onerous than before. They would call for more rigorous surveillance of management conduct and performance; an approach of constructive scepticism and due diligence on information inputs for board consideration may be called for. Of course, in the Indian context of dominant controlling share ownership in the corporate sector, this might be more easily prescribed than achieved.
- On the other hand, such legislative provisions may help in strengthening the hands of independent directors in their pursuit of credible information inputs from management. It is of course necessary to strengthen their controlling role in board functioning even while avoiding dysfunctional discord or confrontation.

6 For a recent example, see https://bloombergquint.com/markets/dhfl-independent-directors-resignation-letter-contradics-company-disclosure#gs.04rp0v

- Overall, the watchword would be to proceed with utmost caution and well-informed conviction while addressing issues that (ought to) come up for board discussion and decision.
- Before accepting any offer of independent directorship, appropriate diligence and agreed understanding of the role cannot be gainsaid.