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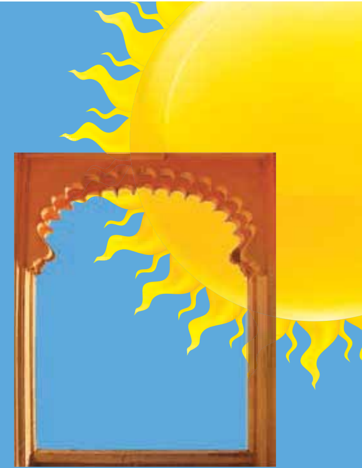

Issues in Board and Director Independence

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Executive Summary

- Worldwide, corporate governance best practices and regulations recognise the need for boards and directors to be independent and objective.
- In a country such as India, where concentrated ownership dominates the corporate landscape, the main rationale for board and director independence is to protect the minority shareholders from possible exploitation by the promoter or controlling shareholder (CS), who may also act as the CEO.
- Despite a number of regulatory initiatives to preserve it, 'board independence' continues to be undermined in India.
- Factors that inhibit board and director independence include the prevailing sense of gratitude in the minds of independent directors (IDs) for CEOs and controlling shareholders; IDs' fear of losing board seat if they challenge the CEOs; and deliberate attempts by CEOs to create competency deficits in the boards.
- Some (additional) legal measures have been suggested; significantly, mandates for: (a) approval of election and compensation of IDs by a majority of non-controlling shareholders, (b) presence of majority of IDs for quorum of board meetings and for approving key resolutions; and (c) IDs resigning mid-tenure to explain the reasons for resignation to non-controlling shareholders.
- Deficiency in the area of board independence cannot be entirely addressed by regulations alone; CS and IDs need to walk the extra mile to address the issues.

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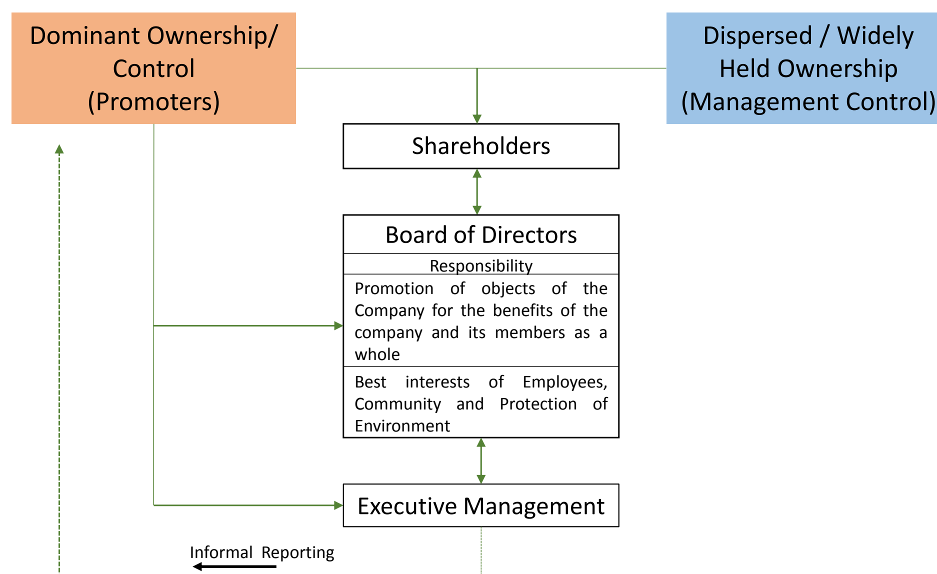
I. Introduction

Corporate governance best practices and regulations around the world recognise the need for boards and directors to be independent and objective, so as to promote and protect the interests of the company, its shareholders and other stakeholders. In practice, though, most boards and directors face impediments in living up to these expectations. This Briefing reviews the underlying justification for independence, identifies some factors that militate against exercising such independence, and offers a set of measures that might help promote and preserve independence, while recognizing that there can be no one-size-fits-all prescription that will address all potential assaults on independence.

II. A framework for analysing Board and Director Independence

What drives the regulatory quest for independence of directors worldwide? Who are they to be independent of? What does 'independence' mean in the context of boards and their directors? Exhibit I sets out the present day hierarchy, with the shareholders at the top; executive management at the bottom, operating level; and the board of directors in between providing strategic guidance and counsel besides exercising appropriate control over the affairs of the corporation.

Exhibit 1: Corporate Ownership and Control Hierarchy



Principal-agent problem

As can be seen in Exhibit I, shareholders and executive management are in two separate boxes. This was not always so. In the commercial capitalism that prevailed earlier, owners of a firm were also its managers. In the second half of the 19th century, corporations in the US and elsewhere started raising capital from the market while their founding entrepreneurs gradually began delegating management to hired professionals. This separation of ownership from management led to an important problem, which is generally labelled as the Principal-Agent problem. In this setting, the principal (i.e., shareholder) provides capital to the agent (i.e., the Management), who on behalf of the principal takes decisions which can and do impact the principal. The principal-agent problem, or simply the agency problem, arises when the agent is motivated to act in his own best interests, which may be contrary to those of the principal, and the principal, having delegated day to day management to the agent, cannot directly ensure that the agent was always acting in his (the principal's) best interest, mainly because the principal (shareholder) has far less information about the company than the agent (management). This is the rationale for having in the governance structure a board of directors, who are required to act as fiduciaries of the company and all its shareholders--promoting and protecting their interest. To do this task effectively, the board needs to be independent, that is, it has to have some directors who need to be independent of the executive management; this is the underlying rationale for the regulators demanding 'director independence' on company boards.

The ownership impact

While the rationale for board and director independence is rooted in the principal-agent problem, the nature of the problem differs depending upon the shareholding pattern of the corporates. In widely held corporations that are typical of US and UK, the role of IDs is to minimize managerial opportunism (such as self-dealing and empire-building). In countries where corporate ownership is heavily concentrated, such as India, the need to have independent board is further heightened, as there is an additional dimension to the problem. Here, promoters of corporations--often holding substantial equity--tend to position themselves as the executives as well as board members (see Exhibit -1). In that role, they are in a position to exercise operational control and enrich themselves at the cost of other absentee shareholders.[2] The additional role of the IDs here is to protect the absentee shareholders from expropriation by the promoters, who generally are families or multinational parents or the State. The unique feature of these shareholders is that they exercise operational control over the corporation, and should be distinguished from other block holders like institutional shareholders.

Meaning of 'board independence' - a regulatory perspective

From a regulatory perspective, a board is said to be independent when it has a sufficient number of IDs. Who then qualifies as IDs? Generally speaking, to qualify as an ID, a director must not have any (a) social or family relationship with the management and (b) financial relations with the company or the management. (This is so, because such relationships may create a 'conflict of interest' and thereby stifle the 'independent voice' of the directors.) In the context of India, which is characterised by concentrated ownership, IDs are further required not to have similar relationships with the controlling shareholders as well.

III. What is expected of IDs?

Mankind is predominantly driven by self-interest and greed. Promoters, executives or even IDs are no exception. According to Frederick Bastiat (1850), a French economist and statesman, "Self-preservation and self-development are common aspirations among all people.... When they can, they wish to live and prosper at the expense of others." While one is unlikely to control one's personal avarice, it appears more feasible for one to recognise this trait in others and act to contain its impact. IDs on company boards are required to perform this function.

Accordingly, the board and the directors, in addition to their contributing and counselling roles, are also obligated to exercise appropriate surveillance and control to ensure that wealth is created by the company and is duly transmitted to the shareholders. Leakages during such transmission, however, can and do occur when controlling shareholders (and managers) appropriate part of the wealth created by the company either overtly (by obtaining board and shareholder approvals such as in case of executive pay) or covertly (through clandestine mechanisms such as tunnelling which involves opaquely diverting company resources to themselves or to firms where their interests are better served). As fiduciaries of all stakeholders, and especially of the absentee shareholders, directors need to have an independent mind to arrest any such tendencies and ensure fair play so that the non-controlling shareholders are not short-changed.

The task of the IDs to identify and frustrate such moves is easier said than achieved, since such outside directors largely depend on the executive for information; and further, they may not have the time or even basic forensic skills that such surveillance may require. But fortunately no one expects IDs to be super humans; all that is required of them is informed and unbiased application of mind to the issues at hand, and action similar to that of any rational person with similar expertise and experience in similar circumstances. Some relief is also afforded by law to the IDs, limiting their liability to acts of omission or commission done with their knowledge or connivance or negligence. [3] To deal with the potentially confrontational situation vis-à-vis the controlling shareholders, in addition to legal protection, IDs need to have high standards of tact, negotiation skills, and persuasive communication, besides a fair and objective mental orientation.

Best practices and regulations around the world have sought to give expression to these basic tenets by requiring IDs to constitute a certain minimum percentage of board and board committee membership. Further, as stated earlier, any relationship that involves economic, filial or emotional linkages with the managers or promoters are mandated as disqualifiers. Other regulatory instruments used for ensuring 'independence' relate to (a) nomination, election, and

[2]This term denotes the shareholders who have nothing to do with the management of the affairs of a corporation.
[3]Section 149 (12) of Companies Act 2013

removal of IDs; (b) mandate for exclusive meetings for IDs, (c) director compensation and so on. Over the years, these measures have been strengthened.

IV. Factors inhibiting board and director independence

Despite progressively tougher regulations relating to board independence, there is a widely held impression both in India and elsewhere that IDs have often not lived up to expectations. Following are some of the factors that have inhibited director and board independence:

'Hands that feed' Syndrome

Outside directors are generally "invited" to join company's boards. Powerful CEOs and CS are largely seen as influencing such invitations, which usually are also conveyed by them. This practice tends to give rise to a sense of indebtedness and gratitude in the minds of the IDs for the CEO and CS. The recently mandated 'Nomination and Remuneration Committee' in India may not have helped much, as the board chair, who is not necessarily independent, can also be the committee's member. [4] Opportunities to get extended tenure on company boards and even introductions to other boards are a form of patronage that obligates the IDs and likely erodes their independence.

While gratitude is one side of the 'hands that feed' coin, the other side is the threat of losing board seat, which has been historically demonstrated as a credible threat. So, it is only human that an ID, who holds the board seat "at the pleasure" of someone else, should consider adverse consequences (such as losing board seat) before opposing the benefactor's proposals, even if they are patently unjust to the company and absentee shareholders. Further, loss of seat in one board may result in uncertainty of continuance in other boards.

'Golden shackles' impact

Exorbitant compensation and perks are the most obvious golden shackles that help erode independence. Admittedly, directors deserve befitting remuneration considering their increasingly onerous responsibilities and the wealth of expertise and wisdom most of them bring to the table. But many times, this is overdone. The downside of overdoing this is to undermine independence and fair judgement. In addition to transparently approved pay, directors are often offered many other facilities in the name of courtesy and hospitality. Illustratively, during 2008 to 2014, some 4,300 US non-executive directors had a median pay of $ 255,000 per annum; not surprisingly, just a handful among them each earned as much as five times that median number! Similar examples in the Indian context are not difficult to find.

Deliberate competency deficit

Some CEOs and CS *deliberately* pack the board with chosen members whose skill sets do not match company requirements. This rather insidious initiative renders the directors incapable of objectively critiquing management proposals; and in order not to expose their inadequacies, such directors typically prefer to be silent abstainers and supporters of the executive.

Shortfall in supply of competent IDs

Over the years, regulations have been mandating larger presence of IDs in boards and board committees on one hand and making the definition of 'independence' increasingly more strict on the other. Some argue that this has resulted in an increasing shortage of competent IDs. This can be overcome through widespread and effective training, which unfortunately has not yet happened to the extent required.

V. Some suggestions to contain erosion of independence

Following are some suggested measures to be taken by the directors themselves or by the regulators, that may help address the threats to director and board independence.

[4]Section 178 (2) of Companies Act 2013

How can directors protect their independence?

As we have seen, independence--an invaluable asset--is constantly assailed by vested interests. This asset needs to be protected and preserved by the concerned directors themselves by measures such as:

- Not taking on more positions than can be done justice to; never underestimating time and effort requirements;
- Being cautious if offered compensation that appears way above comparable norms; never expecting or accepting any 'hospitality' or facilities beyond what is formally approved;
- Meeting retiring and replaced directors and board chair / CEO to assess expectations, before accepting an offer to join a board;
- Understanding any covenants, agreements or other mandates that constrain freedom of the board and directors;
- Improving communication and negotiating skills to better carry conviction in board discussions;
- Never being overwhelmed by more senior or domineering colleagues, notwithstanding their personal status or reputation.

What can inside directors do?

CEOs and controlling shareholders need to voluntarily revisit the benefits of an independent board for the company as a whole--in terms of market capitalisation and reputational advantage that good governance brings. In a competitive market place, these might spell the difference between a successful firm and a failed firm.

Some regulatory initiatives

While several countries have succeeded in getting more IDs on boards, much less has been achieved in bringing forth the required voice to independence on key corporate issues. A small but significant advance has been made in India with law now requiring the presence of at least one ID at meetings called at short notice, for resolutions to be approved.[5] Similar initiatives such as mandating a majority of IDs' presence or participation to constitute a quorum, or even to approve key resolutions would help to make their voice count. Again, exclusive independent oversight of key corporate events such as mergers and acquisitions, leveraged buyouts, auditors' appointment and so on will strengthen the voice of independence in the board. These and some other measures are set out in the box below.

Suggested regulatory measures to promote board and director independence

- Key matters to require majority support of IDs;
- Key specified matters including M&A, LBO, Appointment of Auditors, and major RPTs to be approved and overseen exclusively by IDs;
- Quorum requirements to specify presence of majority of IDs;
- Executive sessions before every board meeting;
- Board report to shareholders to disclose (for ratification by non-CS) all monetary and non-monetary facilities extended to IDs, over and above shareholder approved compensation;
- IDs to be elected by a majority of non-CS;
- IDs resigning mid-term to personally explain the reasons for resignation to non-CS and address any question that the latter may have.

[5]Section 173 (3), Companies Act 2013

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About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavoured to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.