ROLE OF INDEPENDENT DIRECTORS

SOMASEKHAR SUNDARESAN
Counsel

If there is one institution that has been seen as a panacea for all ills in corporate India, it is that of independent directors. The role of the independent directors has come to mean different things to different people. Like the story of the *blind men and the elephant*, it has come to mean different things to different people. Some believe the independent director to be a strategic guide; others want her to be a conscience-keeper; while yet others believe she is a policewoman, who some believe is a watchdog and others believe must be a bloodhound.

First, a word on what exactly a director, or for that matter, the Board of Directors is meant to do. Directors are those who direct the running of the company. The Board of Directors comprises the individuals who direct the course of operations. The management conducts the affairs of the company under the overall superintendence, oversight and control by the Board of Directors. The management of a company holds office at the pleasure of the Board of Directors. Directors of a company hold office at the pleasure of the shareholders of the company.

Once the Board of Directors is appointed, the shareholders move out of the picture in relation to the day-to-day oversight of the company. It is for the directors to govern the company in terms of the Articles of Association. It is the directors who are meant to provide strategic direction and guidance to the management of a company. That is their main role. An attendant consequence is the role of being policemen keeping vigil over the conduct of affairs by the management.

In this context, sits the office of independent directors, which is now firmly codified into the law. Making its debut in the Listing Agreement – a statutory agreement between listed companies and stock exchanges – the concept has moved firmly into Parliament-made company law, and indeed in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (**"LODR Regulations"**) governing listing obligations that has replaced the listing agreement. With each move in this regulatory waltz, the expectation, role and scope of what is expected from an independent director has kept changing. Add to this rulings by courts that have at the least laid down what cannot be ruled out from the role of these directors.

INDEPENDENCE FROM?

Yet, to begin with, one has to necessarily understand what the law expects from independent directors in terms of independence – are they meant to be independent of ownership or are they meant to be independent from management? As defined, the independence is expected from both ownership and management. The definition rules out independence of a director on both counts. An equity ownership interest of two percent or more would result in a director being regarded as non-independent. Likewise, senior executives of a company who become directors would not be considered independent unless three years have passed since their association with the company.

However, the facet that skews the picture in any case is that all independent directors would in any case rely on the vote of all shareholders to be appointed to the Board of Directors – just as any other director would have to be voted into office. In other words, every director, including the independent director, holds office at the pleasure of the majority vote of the shareholders.

How independent can the director therefore be, purely as a matter of political science, from the shareholder? The answer perhaps does not lie in making the majority owners, or controlling owners (under Indian law, "promoters") ineligible to vote for independent director appointments. The answer in fact lies in recognising that independent directors cannot be totally independent of ownership and can indeed lose their office by being voted out for being unpopular. Therefore, strengthening the institution of the independent director, granting an independent director protection of tenure, and providing conceptual clarity on real role expectations is the way to go.

The very concept of independent director is one that has developed as a matter of best practice elsewhere in the world, but has been codified into the law here. Best practices that evolved with the aim of minimising the risk of litigation

against those involved in governance of companies as a shield against litigation, have become swords that directors need to defend themselves against.

ROLE OF INDEPENDENT DIRECTORS

The question of whether a director is meant to represent the interests of the shareholders has been well settled in case law. Company law is quite clear that the role of every director on the Board of Directors, whether independent or not, is to apply her mind to serving the best interests of the company, and not of the shareholder who nominated her to be appointed. Indian company law has been codified for long. However, what standards a director must bring to bear, how she is supposed to conduct herself in decision-making, and what is a realistic expectation from her was left substantially to the sphere of judge-made law, laid down when dealing with controversies and proceedings presented to them for resolution. India is a common-law jurisdiction – gaps in the statute are filled in by judges, providing meaning to ambiguities and inconsistencies based on the principles of justice, equity and good conscience.

Some of these principles are now codified into the Companies Act, 2013 ("the Act"), with section 166[1] , which contains motherhood statements in the expectations from directors in general, leaving the burden of establishing the tests and standards to be applied when ruling on alleged violation of the provision, to the courts – but more about that later. Once appointed, a director has a fiduciary duty to discharge to the company and she is not a servant of the shareholders who appoint her. The shareholders cannot impinge upon the exercise of rights by a director in discharge of the fiduciary duties of the director. Shareholders cannot dictate terms to directors except by amendment of Articles of Association or by sacking the directors[2].

In the words of the court, in the first-cited judgement in the footnote to the foregoing paragraph:-

"The shareholder….. is entitled to consider his own interests, without regard to interests of other shareholders. However, Directors are fiduciaries of the Company and the shareholders. It is their duty to do what they consider best in the interests of the Company. They cannot abdicate their independent judgment by entering into pooling agreements."

"In our view, the curtailment of the powers of Director by enforcement of such a clause would not be permissible. Clause 8 would result in curtailment of the fiduciary rights and duties of the Directors. ***The shareholders cannot infringe upon the Directors' fiduciary rights and duties.*** *Even Directors cannot enter into an agreement, thereby agreeing not to increase the number of Directors when there is no such restriction in the Articles of Association. The shareholders cannot dictate the terms to the Directors, except by amendment of Articles of Association or by removal of Directors."*
[Emphasis Supplied]

In the second judgement referred to in the footnote to the foregoing paragraph, the court rejected the attempt to cite the aforesaid judgment to support arguments relating to the facts of the case before the court, but well reiterated the same principle thus: -

"Or ***take a nominee director****, that is, a director of a company who is* ***nominated by a large shareholder to represent his interests.*** *There is* ***nothing wrong*** *in it. It is done every day.* ***Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves.*** *But* ***if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawfu****l, or* ***if he agrees to subordinate the interests of the company to the interests of his patron, it is conduct oppressive to the other shareholders*** *for which the patron can be brought to book ."*
[Emphasis Supplied]

The codification of directors' responsibilities in section 166, is a game-changer in what company law means for directors. For independent directors, the Code of Conduct stipulated u/s. 149 read with Schedule IV, is another game changer. These are now explicit provisions of the law that require directors to be mindful that their constituents are way beyond shareholders alone. For all directors, the term used is "stakeholders" u/s. 166 while for independent directors, there are specific obligations imposed to be mindful of the interests of minority shareholders.

1 *References to Sections by number are references to provisions of the Companies Act, 2013 while references to Regulations by number are references to provisions of the SEBI (Disclosure Obligations and Listing Requirements) Regulations, 2015.*

2 *All these principles are well stated by a Division Bench of the Hon'ble Bombay High Court in the case of Rolta India Ltd. & Another Vs. Venire Industries Ltd. & Others 2000 (100) Comp. Cas. 19 (Bom) and has been well analysed in other decisions applying the principles found in this judgement, including Mrs. Madhu Ashok Kapur & 3 Others Vs. Mr. Rana Kapoor & 8 Others – decision by Justice Gautam Patel of the same court on June 4, 2015*

Therefore, many of the past practices and comfort zones reached by corporate Boards of Directors, are up for disruption. The impunity that has been demonstrated in the past is no longer a light matter – indeed, companies are now actively considering becoming private limited companies so that they are not bound by the statutory obligation of maintaining the institution of independent directors. A case in point is Tata Sons Ltd., which is a "systemically important core investment company" and has sought to convert itself into a private limited company amidst litigation over governance standards applied in that company[3].

What is clear is that independent directors can now be litigated against as a matter of codified legal standard, with principles-based law that forms part of statutory obligations set out in Schedule IV of the Act.

LIMITATION OF LIABILITY

Now, one facet of the law that is not fully appreciated among Indian corporate boards yet, is that while the limitation of liability for shareholders is limited, increasingly, the limitation of liability for directors seems to not be so. The Act has codified the obligation to have independent directors[4]; the qualifications of an independent director[5]; the duties of independent directors[6], with a specially stipulated Code of Conduct for independent directors[7]. A fully codified robust statutory framework for governance of companies in India is now formally in place.

It is settled law that every director of any company (including directors nominated by specific shareholders) are meant to address and look after the interests of the company and not the interests of the shareholders nominating them.

A director indeed holds office at the pleasure of the shareholders, who can appoint, remove or replace a director in compliance with other applicable law, by passing an ordinary resolution. This is in fact the reason for the Takeover Regulations to provide that a right to appoint a majority of the Board of Directors constitutes "control" and it is the shareholder holding the majority of a company who is deemed to be acquiring the voting rights in any listed company, held by the company being acquired.

3 *Disclosure: The author is involved as an advocate in the litigation and is interested in the intervention against Tata Sons Ltd.*
4 *Section 149(4)*
5 *Section 149(6)*
6 *Section 149(8) read with Schedule IV*
7 *Schedule IV to the Act*

A ruling by the Hon'ble Supreme Court just before the onset of the Act and the LODR Regulations is instructive in appreciating this growing trend in this area of jurisprudence. Upholding monetary penalty imposed against directors of a company for a finding of market abuse by a company, in the case of *N. Narayanan vs. Adjudicating Officer, SEBI*[8] the Court actually ruled that the role of directors in listed companies is meant to be a "particularly onerous" one, stating that "the Board of Directors makes itself accountable for the performance of the company to shareholders and also for the production of its accounts and financial statements especially when the company is a listed company."

In the court's own words (paraphrasing would not do justice to the content): -

Responsibility is cast on the Directors to prepare the annual records and reports and those accounts should reflect 'a true and fair view'. The over-riding obligation of the Directors is to approve the accounts only if they are satisfied that they give true and fair view of the profits or loss for the relevant period and the correct financial position of the company. Company though a legal entity cannot act by itself, it can act only through its Directors. ***They are expected to exercise their power on behalf of the company with utmost care, skill and diligence.*** *This Court while describing what is the duty of a Director of a company held in* ***Official Liquidator vs. P.A. Tendolkar (1973) 1 SCC 602*** *that a* ***Director may be shown to be placed and to have been so closely and so long associated personally with the management of the company that he will be deemed to be not merely cognizant of but liable for fraud in the conduct of business of the company even though no specific act of dishonesty is proved against him personally.*** *He cannot shut his eyes to what must be obvious to everyone who examines the affairs of the company even superficially.*

The facts in this case clearly reveal that the Directors of the company in question had failed in their duty to exercise due care and diligence and allowed the company to fabricate the figures and make false disclosures. Facts indicate that they have overlooked the numerous red flags in the revenues, profits, receivables, deposits etc. which should not have escaped the attention of a prudent person. For instance, profit as on quarter ending June 2007 was three times more than the preceding quarter, it doubled in the quarter ending December 2007 over the

8 *Civil Appeals no. 4112 – 4113 of 2013 – available at: http://judis.nic.in/supremecourt/imgs1.aspx?filename=40338*

preceding quarter. Further, there was disproportionate increase in the security deposits i.e. Rs. 36.05 crore in September 2007 to Rs. 270.38 crore in December 2007 as compared to increase in the number of theatres during the same period. ***They have participated in the board meetings and were privy to those commissions and omissions.***
[Emphasis Supplied]

All the judgements and precedents cited above involved the law governing directors and their role prior to the Act and the LODR Regulations coming into force. Now, the codified law stipulates the standards to be followed and expectations from directors. To take just the role of independent directors, summarising and paraphrasing just some of their obligations under Schedule IV, such directors must: -

a) act objectively, constructively and exercise responsibilities in the interest of the company;
b) not allow extraneous considerations to vitiate objective independent judgment in the paramount interest of the company as a whole;
c) bring independent judgment to bear on the Board's deliberations especially on issues of strategy, performance, risk management and resources;
d) safeguard the interests of all stakeholders, particularly the minority shareholders;
e) balance conflicting interests of the stakeholders;
f) moderate and arbitrate in the interest of the company as a whole;
g) seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice and opinion of outside experts at the expense of the company;
h) ensure that concerns about any proposed action are addressed and, to the extent that they are not resolved, insist that their concerns are recorded;
i) ensure adequate deliberations before approving related party transactions and assure themselves that the same are in the interest of the company; and
j) hold meetings of just the independent directors at least once in a year, without the attendance of non-independent directors and members of management.

Each of these standards would necessarily entail mixed questions of fact and law in disputes involving interpretation of Schedule IV. Section 166 is but a synopsis of these tests and is made applicable to all directors, whether or not independent. The LODR Regulations, which follow more of a check-the-box framework for composition of the Board of Directors and of sub-committees of the Board of Directors or listed companies, too have to be read with Section 166. It must be remembered that the provisions of the SEBI Act, in particular, sections 11 and 11B, entitle SEBI to issue directions "in the interests of the securities market". Such directions may be issued by SEBI of its own accord without having to convince any independent judicial mind about the appropriateness of its intervention. The only check and balance is a post-facto statutory appeal to the Securities Appellate Tribunal.

This poses multiple nuanced threats to directors. Actions may be taken *suo motu* by SEBI where it is convinced that a director must be taught a lesson. These may take the form of restraint not to deal in securities or not to join the board of directors of other listed companies or capital market intermediaries for specified periods. Action by SEBI could be triggered by a complaint by other regulatory agencies and tax authorities. There is precedent of regulatory action triggered in such a manner. It is only a matter of time for the gravity and creativity in the application of the law to reach the doorstep of independent directors of companies that SEBI acts against.

Some independent directors are also prone to getting carried away and get involved in the day-to-day functioning of the company – at times with direct access to the employees whose line of reporting is to the CEO. Whether a director has been truly in charge of day-to-day operations or only relied on Board processes for oversight of the company, will always be a mixed question of fact and law, requiring tedious evidence.

Given the scope for intervention by the securities regulator and indeed other regulators who may be regulating the company in question, one must be very clear and have very specific and formal processes for an independent director's engagement with the company.

Whether every director has then acted in the interests of the company would become the question to ask. Derivative suits by shareholders in any civil court present a serious threat to directors having to answer allegations about their conduct. To summarise, if the general standard for directors of listed companies as laid down by the Supreme Court in the Narayanan case (*supra*) is to be followed under the newly-legislated framework set out in the Act and the LODR Regulations, being a director, and more so, an independent director at that, would not be an easy call. ■