Corporate Governance - An Indian Legal Format: a Critique

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Abstract. The purpose of this study is to study the role and responsibilities of Non executive directors as defined under Indian laws in imposing control and regulation on Public Ltd. Companies for ensuring good corporate governance and whether the boards have emerged from being ceremonial to progressive in future. The paper does a conceptual study of Indian statutory provisions under different acts for ensuring good corporate governance to find out the role and responsibilities of Non Executive Director. The paper also studies the effectiveness by which Non Executive Directors are able to dispose off the role and responsibilities they are entrusted with.

Keywords: Non Executive Directors, Companies Act 1956, Public listed companies, clause 49 listing agreement

1. Introduction

Separation of ownership and control is an inherent feature of public limited companies. These companies are owned by the shareholder's but the affairs are managed by employees with minimal interference from the shareholders. As a solution to the problem that arises from separation of ownership from control, the concept of corporate governance has evolved. The work of governing the affairs of the company is delegated to the board of directors who function as agents of the legal person i.e. the company. Corporate governance literature in UK and US describe the role of board as a bridge between board and management (Cadbury, 1992; Salmon, 1993). Most of corporate governance literature in India and related discussions are influenced from development in developed world in this regard and hence focuses on similar role of board (Jayanth Rama Verma, 1997). Defining board of directors in India - Section 252(3) of Indian Companies Act, 1956 states:

"*The directors of a company collectively are referred to in this Act as the "Board of directors" or "Board*".

As per the Companies Bill, 2009 Section 2(1)(j):

"*Board of Directors" or "Board", in relation to a company, means the collective body of the directors of the company"*.

Successful companies are those which have an effective board of director who execute their responsibility of shareholder's wealth maximization. Non executive directors are essential part of board of directors for public ltd. companies and they play pivotal role in the corporate governance framework put in place in most countries. Even amongst all different non executive directors it is the independent director on which the regulators and stakeholders depend most for protection of stakeholders' interest. However while in most well managed companies such directors are seen as resources bringing with them external know how, in some companies especially family owned and managed businesses they might be considered a burden enforced by statutory regulations. In any case non executive directors are there on the board of public limited companies and this study intends to study their role as defined in Indian legal system and also the effectiveness with which they are able to do justice to those roles.

2. Corporate Governance : Basic Principles

2.1. Background

Corporate governance was a hardly heard word prior to 1980s. However with increase in number of financial scandals the agency problem in case of public limited company came to the forefront and corporate governance became a buzz word. A number of committees were set up world over to look into difference aspects of corporate governance and lay out a foolproof structure for the same. The important ones amongst them were Sir Adrian Cadbury Committee on Financial Aspects of Corporate Governance (1992), Mervyn E King's Committee on Corporate Governance (1994), Jenkins Report, US (Sept, 1994), Toronto Stock Exchange Report, Canada (Dec.1994), Greenbury Committee on Directors Remuneration (1995), Hampel Report,UK (Dec,1997), Business Round Table(BRT) Statement on Corporate Governance (1997), Hampel Committee on Corporate Governance (1998), Blue Ribbon Committee on improving the Effectiveness of Audit Committee (1999), CACG Principles for Corporate Governance in Commonwealth (1999), Blue Ribbon Commission Report, US,2000. All these committees focussed on the role of Board of Directors (called 'the Board' hereafter) in adherence to corporate governance norms. Non- executive directors form an important part of the Board and they give share holders a better representation. Hence, their role becomes vital in protecting shareholders' interest.

The Evolution of Boards

Boards began to evolve in the post Corporate Governance regulations under three stages[1]

- The ceremonial boards
- The liberated boards
- The progressive boards

The ceremonial boards performed predominantly a compliance role (Charan Ram 2010). The work was scripted, CEO communicated very little with the board between meetings, other than with the one or two confidants the CEO trusted and worked. They were generally anonymous to the public. The liberated boards are creation of the corporate governance regime. These boards are expected to contribute, participate and embrace an active mindset[2]. The empowerment of directors under librated boards means a high functioning team but it can also mean each director singing a different tune and inadvertently can make the work in board meetings ineffective, slow and non productive. Each director may end up playing his own strength individually and not as collective body. The progressive boards as Andy Grove, founder Fortune magazine remarks[3] is "to ensure that the success of a company is longer lasting than the CEO's reign, than any market opportunity, than any product cycle". The directors on these boards are a coherent, effective and lead to consensus and closure of issues. Hence these boards are constructive and collaborative to company affairs (Charan Ram 2010). Thereby the endeavour of companies is to effectively evolve a board which is progressive.

2.2. Indian Non Executive Boards- Legal Perspective

Board of Directors:

A public limited company has separation of ownership and control. While the ownership resides with the shareholders, the company is controlled by the executives who are employees of the company. The link between shareholders and management is the board of directors who govern the management and are responsible for protection and enhancement of shareholder's wealth. 'Investopedia' defines board of directors as

"A group of individuals that are elected as, or elected to act as, representatives of the stockholders to establish corporate management related policies and to make decisions on major company issues."

The Indian Companies Act, 1956 Section 2(13) defines a director as-

"Any person occupying the position of director, by whatever name called."

Thus, the position of director in a company is not defined by the law but, by the functions he/she performs. These functions, responsibilities, rights and qualifications of a director have been further defined in chapter II, section 253- 323 of the Companies act, 1956.

As per the Companies Bill, 2009 Section 2(1)(zi):

"'director' means a director appointed to the Board of a company, and includes a deemed director".

[1] Charan Ram (2010), Boards that deliver, Wiley India

[2] In 1994, the General Motors advised by Ira Millstein, first published its "Guidelines for Corporate Governance also called as corporate Magna Carta

[3] Fortune magazine, August 23, 2004, pg 78

Board of directors is there for governance of the company and it performs the strategy making role. Hence, it should have a right mix of outsiders and people from the management so that people who execute the decisions have a say in decision making in parallel ensuring that the stakeholder's interests are protected.

2.3. The Non-Executive Director: Role & Responsibilities

Role in Public Limited Companies:

The major act governing functioning of a public limited company in India is the Indian Companies Act, 1956. This act details out the directors in a public limited company in Part II from section 253 to 323.

The provision for constitution of an audit committee from amongst the members of the board was inserted into the act by the Companies (Amendment) Act 2000. Thus, Section 292A (1) of the Indian Companies Act states-

"Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors."

Subsection 3 of the section further specifies that:

"The members of the Audit Committee shall elect a chairman from amongst themselves."

2.4. Role in public listed Companies:

Apart from being governed by the Companies Act the listed companies in India have to abide by the listing agreement of SEBI, the stock market regulator in India as part of corporate governance norms. Clause 49 of this listing agreement talks extensively of the composition of the board and other committees of the board of such companies. This listing agreement gives a lot of emphasis on non executive directors.

As per clause 49 of SEBI's listing agreement:

"The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors."

This list is quite exhaustive and makes sure that almost every thing that goes on in a company passes through the board of director's scrutiny. Non-executive directors form a majority on boards of public listed companies and hence the responsibility to look that all the decisions executed by the management are in the best interest of the stakeholders, falls on the non executive directors. However even non executive directors can have some connection with the company and hence have vested interest. Hence independence of scrutiny and control the concept of Independent director was introduced in clause 49.

3. Independent Directors

3.1. While laying down the composition of Board of Directors of a public listed company in India Clause 49 states that:

"Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors."

3.2. Non Executive Directors on the Board- Effectiveness of the Role Assigned

Several empirical studies have been carried out on impact of non- executive directors on company's performance. These studies mainly focus on if the high remuneration given to non-executive directors is a mere depletion from shareholder's wealth or it adds value by protecting their interests and secondly, does control of non executive directors over the Board bring added nuisances to the functioning of a company as ultimately the company is run by its executives who are in contract of service with the company. However, before looking into the studies we will look into the regulations Indian laws have made to ensure efficiency of non executive directors and their effectiveness.

Section 275 of Indian Companies Act, 1956 states:

"After the commencement of this Act, no person shall, save as otherwise provided in section 276, hold office at the same time as director in more than 1[fifteen] companies.

Clause 49 of SEBI's listing agreement states:

"A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place."

As an explanation to this provision Clause also states:

"For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered."

Furthermore regarding the meetings of Audit Committee clause 49 states:

"The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings."

Thus, if a non-executive director or independent director is member of 10 such committees he will have to attend at least 40 meetings in a year. Adding this up with the already scheduled 80 Board meetings makes it a total of 120 meetings i.e. 365/120= appx. one meeting every 3rd day. It seems practically impossible that a non-executive director can attend all of these meetings and even if he attends all of them he will not be able to give his concentration to matters discussed in all these meetings. Hence these directors cannot, even if they intend, actually evolve progressive boards. In spirit the corporate governance moves from being ceremonial to just being liberated not thereby not creating a competitive advantage for these companies.

Thus, the limit on directorship and membership of committees seems to be on a higher side. However, practically it is not a problem until and unless this limit is fully exercised by all directors. As per the Director's Database of Bombay Stock Exchange:[4] 16,179 individuals are on the boards of 2,743 companies of which only 868 (5.4%) are women. Out of these 16,179 individuals, profiles of 14,332 individuals have been filed. These 14,332 individuals occupy a total of 19,910 directorship positions in 3,231 companies listed at national-level stock exchanges and 422 companies listed at regional stock exchanges. Of these 14,332 individuals 11,338 hold only 1 directorship each 6,173 hold only independent directorship positions 339 hold 5 or more than 5 directorships in listed companies, with 2 persons holding 14 directorships. Thus, only 2.3% of the total number of directors whose profiles have been filed, hold directorship in more than 5 listed companies. This reduces the doubts over inefficiency of regulation by the non executive directors.

However, since Independent directors are the most important pillar of corporate governance in a public listed company's board we must also have a look at independent directorial positions in public listed company. As per the Director's Database of Bombay Stock Exchange:[5] There are 35 companies where the status of its directors is not known. 37 companies do not have even 1 independent director. 19 companies have only independent directors. A total of 7,282 individuals occupy a total of 9,447 independent directorship positions on 2,708 BSE-listed companies. Of these 7,282 individuals, 5,284 hold only 1 independent directorship each in any of the 2,708 BSE-listed companies. 6,173 hold only independent directorship positions in any of the 2,708 BSE-listed companies. 293 hold 5 or more than 5 directorships in listed companies (BSE and non-BSE), with 2 persons holding 14 directorships. Of these, 61 individuals hold more than 8 directorships in listed companies. Thus, of total 2708 BSE listed companies 1.7% have defaulted on the independent director norm. Of the 7282 independent directors 81% hold only independent directorial position. 4% of the independent directors hold directorship in more than 5 companies. Thus, the percentage of directors holding multiple directorship isn't very high. However if we compare it with total no. of directors; of the total 339 directors holding more than 5 directorship position 86% are independent directors. This suggests independent directors tend more to hold multiple directorships.

A KPMG poll conducted between late November 2008 and early January 2009 among 90 CEOs, CFOs, independent directors and other leaders from Indian corporate world suggests that 89% of the respondents believed that independent directors merely contribute towards fulfillment of statutory requirements. The poll

[4] DIRECTORS DATABASE, BSE http://www.directorsdatabase.com/
[5] DIRECTORS DATABASE, BSE http://www.directorsdatabase.com/

also showed that while majority believed that all committees other than audit committee are not effective even the audit committee require enhancement. The majority view in the poll was that the Indian boards do not get adequate time and information to discharge their duties (KPMG, 2009). Thus, the problem of multiple directorships should be seriously looked upon. There is no value addition or compliance oversight that these boards can be credited for.

The other question is that of the independence of independent directors. These directors are appointed on the board to eliminate the biased outlook which other connected directors may have while looking into company's functioning. However, on the subject of Independent Director one must remember that no one is invited to join a board to act as a nonexecutive director unless he/she is well known to the Promoters or the Chairman or the Managing Director. All non-executive directors, whether or not independent, need support of Promoter Group for their reelection. Hence, independence of director is more of a matter of attitude and training & updating knowledge of directors is required to ensure independence in his action (Dilip Kumar Sen, 2004)[6]. An empirical study of 499 publicly traded firms showed that directors with very high equity ownership worked in interest of firm as their interests converged with interests of the shareholders. However, given sufficient equity ownership, board members may become entrenched, whereby their interests do not reflect the interests of the shareholders and the board members have sufficient voting power to suppress sanctions on them or their removal. The study also showed that Independent directors show similar reactions to financial incentives as Independent directors. Hence, there is a requirement of stronger governance norms irrespective of type of director and corporate governance should not be left solely to independent directors (Teresa M. Pergola and Gilbert W. Joseph, 2009). However despite of the fact that there are differences of interest between non executive directors and shareholders the fact is that the non executive directors bring different set of skills to the company and they help in the process of executive learning. They also help in strategic decision making with bringing in independent opinion and fresh view point especially in case of small entrepreneurial firms (David Deckins, Eileen 'O' Neill and Patrick Mileham, 2000).

Non Executive directors on the company board have two fold roles of monitoring executive activity and contributing to the development strategy. These two roles have inherent tension between them and overemphasis on any of these roles undermines the effectiveness of any non executive director's performance. Hence, it is important to establish sense of partnership on the board and recognition of importance of role of non executive directors by the executives to promote effectiveness of non executive directors (Derek Higgs, 2003). Another piece of literature examining relationship between corporate governance practices and firm's performance through empirical study of a number of firms concluded that there is a positive correlation between firm's performance and stock ownership of board members. This clearly suggests that board members are more concerned if firm's performance when they have a stake in it (Sanjai Bhagat and Brian Bolton, 2008).

4. Conclusion

The above study leads us to the following conclusions:

Firstly, Board of directors are there to regulate the functioning of a company and Indian laws provide adequate powers and have devised useful mechanisms for free functioning of the Board. Secondly, corporate governance is more important for a public listed company as it has a more scattered and expanded shareholding. However, Indian Companies Act, 1956 treats all type of public ltd. companies at par in case of rules relating to directors. This anomaly of law has been taken care by SEBI's listing agreement which in its clause 49 make adequate provision of appointment of non-executive and independent directors on the board of a public listed company to ensure proper governance. Thirdly, as far as Board of directors is concerned Indian laws have made the Board quite powerful and its role is very clearly defined in the law. Clause 49 of SEBI's listing agreement emphasizes more on non executive directors, especially Independent directors, to have outsider's control over the regulation mechanism. However success of this model is not supported by different studies carried out for the purpose. Fourthly, proper financial functioning are the most important

[6] "Clause 49 of Listing Agreement on Corporate Governance", Dilip Kumar Sen, THE CHARTERED ACCOUNTANT, December 2004.

concern of corporate governance and this is taken care by the audit committee which has to be mandatorily constituted by all companies. Since Independent directors have a two third majority in audit committee of a public listed company their role is of utmost importance and it is their responsibility to closely scrutinize financial systems in a company to safeguard shareholder's wealth. Fifthly, a look into director's database reveals that Independent directors tend to hold multiple directorship positions which put a question mark on the amount of regulation they would undertake in one particular company. Indian laws in the matter seem lenient as the limits prescribed in them are very high. Thus, directors don't put enough effort behind one company and hence, the entire mechanism of having non executive directors for monitoring and regulation goes into vain. Sixthly, complete Independence of independent directors is not possible as they must be known by promoters or chairman or managers to be appointed on the Board. Different studies suggest that even Independent directors respond to financial incentives which put a question mark on their independence. Hence, proper training of all directors on the board is must to ensure they know their duties and responsibility. Seventhly, complete reliance on Non executive directors or Board of directors for that matter is not a good mechanism and there should be adequate checks and balances, reporting standards and other mandatory requirements to ensure proper corporate governance. Lastly, Boards need to be progressive in future. Hence as mentioned before the minimum number of directors should be reduced so that their participation can be more fair, accountable and transparent.

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