



Independent Directors : ‘Gatekeepers’ anxiety and Board’s response

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The perspective

Corporate Governance is a globally relevant theme. Jurisdictions all across the world are grappling with the ever-increasing challenges being posed in this domain. As a concept, it has been evolving for more than two decades now and has been debated, learnt, re-learned and revisited. In an environment in which fluidity and uncertainty seem to dominate the board agenda, corporate leadership will continue to be called upon to devote significant time and attention to addressing the emerging legitimate individual accountability concerns of Independent Directors termed as the corporate gatekeepers. An emerging governance challenge is the need to address the tension between the pursuit of legitimate corporate strategic goals, and the concerns of “gatekeepers” who perceive themselves at increasing personal legal risk for corporate wrongdoing.

Independent Directors as watch dog of companies

Section 2(47) of the Companies Act, 2013 defines Independent director in conjunction with section 149(6) which provides an exhaustive list of qualifications to decide that who can be an independent director and who cannot be. Schedule IV notified by the Ministry of Corporate Affairs provides for code of conduct of Independent directors and exhaustive guidelines regarding duties, manner of appointment, meetings, etc. and requires every Independent director to abide by it.

An Independent Director (“ID”) is a director other than a managing director or a whole-time director or a nominee director, who, in the opinion of the board, is a person of integrity and possesses relevant expertise and experience, not being a promoter of such company of its affiliates, not being a relative of promoters or directors of the company or its affiliates, is an independent director. Such individual cannot have any pecuniary relationship with that company, its promoters, senior management or affiliate companies, during the past two years or the current year. Moreover, the independent director cannot be related to promoters or the senior management and should not have been an executive with the company, partner or executive director of the auditors, lawyers, consultants of the company in preceding three years. It has been witnessed that IDs are rarely chosen based on qualification and/or experience of the candidate, but mostly through close associates or nomination basis.

Such a Non-executive director plays the role of a watchdog in companies as they are responsible for handling affairs of the Company to boost up ethics of corporate governance and to ensure transparency in the Company. It can be said that the general duty of such directors is to strive for benefit of the company by utilizing its experience in corporate governance and to ensure transparency in the functioning of the company to avoid the commission of frauds and wrongdoings by the officers of the company.

The importance of having outside directors is being increasingly viewed as essential to protecting public investors, especially in

controlled companies, all over the world. Accordingly, several countries have adopted one or more of the following arrangements: (i) public company boards are expected to include some fraction of independent directors; (ii) independent directors must serve on committees that play an active role in monitoring management and controlling shareholders; The importance of the institution of independent directors has been aptly captured by the SEBI report on corporate governance chaired by Mr. Uday Kotak (2017) as: “The institution of independent directors forms the backbone of the corporate governance framework worldwide and in India. Independent directors are expected to bring objectivity into the functioning of the board and improve its effectiveness. Independent directors are required to safeguard the interests of all stakeholders, particularly minority shareholders, balance the conflicting interest of the stakeholders and bring an objective view to the evaluation of the performance of the board and management.”

Gatekeepers are the Key to Good Governance

The term “gatekeeper” refers to those who have direct, formal governance authority, and others who perform key roles in promoting corporate responsibility. Regulators often use the term “gatekeepers” to refer to those within the organizational hierarchy who have fiduciary or professional obligations to spot and prevent potential misconduct, and respond to any problems that do occur. One of the most important roles gatekeepers must play is as a check on management’s tendency to focus on short-term profits at the expense of long-term shareholder value.

Independent Directors : Liabilities and risk factors

Once considered a dream position, the post of Independent Director has lost its sheen, as it is not the case of the private sector but even the public sector undertakings are not finding suitable candidates to fill the positions lying vacant for some time. There are multiple reasons why the position of an Independent Director has become a less sought option in today’s era. Strict compliance requirements and failure in distinguishing their liabilities have made it tedious for Independent Directors to deliver their roles. Independent Directors are required to improve the functioning and effectiveness of the board and to safeguard the interests of all stakeholders. Every listed public company is complied to have at least one-third of the total number of directors to maintain checks and balances and to question the decisions of the board as an independent authority in an impartial manner. The role of the independent directors has not changed but expectations have increased in recent times.

Independent Directors have limited authority in making a meaningful contribution to the firm, while facing the risk of being summoned, investigated, arrested and harassed by investigators and adjudicating authorities have prompted independent directors to resign their posts in recent years. The situation has discouraged many potentially well-qualified candidates from joining boards of companies. The number of independent directors who resigned

from board positions doubled in 2019, compared with total exits in the previous two years, as greater liability, rising number of corporate governance cases, increasing fear of fraud risk and chances of personal reputation being on stake led to the exodus.

The Board's challenge

The challenge for the governing board is multifold. On the one hand, it is expected to exercise informed risk taking with its strategic initiatives, while continuing to promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law. How, then, can board members do their jobs and implement appropriate corporate strategy in the face of roadblocks raised by self-protective conduct? Indeed, some individual board members may feel the same concern regarding issues of their own personal liability, and thus may become more inclined to say "no." How do leaders make difficult and important decisions for the company when they feel pressured to prioritize concerns with their personal liability profile over concerns with the legitimate interests of the company? The primary board concern is that for certain potentially controversial initiatives, some gatekeepers may become "gun-shy," i.e., may engage in self-protective conduct that frustrates valid board strategic initiatives and other appropriate efforts. This, despite the fiduciary or employment risks a gatekeeper may assume by acting in what may be perceived as his/her own interests, as opposed to the legitimate business interests of the company.

The Board's Response

Recently, there have been considerable exits of independent directors ('IDs') from listed companies due to apprehensions about their potential liability on account of the wrong doings of the companies. It is in this context that the Ministry of Corporate Affairs ('MCA') issued a much required clarification on March 2, 2020 that prosecution proceedings will not be initiated against independent and non-executive directors ('NEDs') unless there are sufficient evidences to prove that such default or violation had been committed with his knowledge or consent or he was guilty of gross and wilful negligence or fraud.

MCA has therefore clarified that another provision of the Act [Sec. 149(12)] expressly provides that an ID and NED can only be held liable in respect of such defaults which occur with his knowledge and consent attributable through board processes, and that they should not be held liable for any criminal or civil proceedings under the Act unless the said criteria is met. As per the Circular, monitoring the day to day compliances of the Company is not the responsibility of the IDs and NEDs and hence an ID or NED cannot be held liable for acts which are beyond their control like failure on the part of the Company to maintain and update statutory registers, minutes of meetings, filing of returns etc.

Boards will be continually called upon to deftly balance the need to preserve and enhance the loyalty and confidence of corporate gatekeepers; the obligation to promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

While the most effective action plan depends upon the unique circumstances of an individual company, a successful board response might include elements of the following:

- An internal board-to-gatekeepers acknowledgement that this new tension exists; why it exists; why it is more the function of human nature than it is of bad faith; and of the risks that can arise from this conduct.
- Assure gatekeepers that corporate strategic plans are consistent with the board-approved risk profile for the

corporation, and that all major corporate strategy decisions have been carefully vetted by experienced legal counsel.

- Provide gatekeepers with clear legal advice on the proper implementation of approved corporate strategies.
- Enhance gatekeeper confidence in the effectiveness and rigor of existing corporate compliance and risk management programs, and of conduits through which gatekeepers and others can express—without fear of retribution—to the highest organizational authorities their concerns about individual strategic initiatives.

Conclusion

People are getting more and more selective about joining boards of companies, while basing their decision on several qualitative factors. The concern is that these developments may cause some gatekeepers and other corporate officials to be much more self-protective in performing their corporate and fiduciary responsibilities, to the possible detriment of strategic implementation. The attentive and forward looking boards should acknowledge the potential for this conflict and take a series of pro-active steps to reduce the understandable concerns of gatekeepers. Such steps should be consistent with a top-down organizational "culture of compliance" that the board is responsible for maintaining.

References

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OBITUARY



CMA M.N. Bapat (M/2491) Sr. Member of Institute passed away on 22nd November 2020. May the departed soul rest in peace.