

## Yes, Governance Matters.

August 14, 2023

### INDEPENDENT DIRECTORS: STEERING THE GOVERNANCE WHEEL

Corporate governance is crucial for the smooth and efficient functioning of a business, and the driving force behind this governance is the board of directors (referred to as “the Board”). However, the Board faces numerous challenges when making executive decisions, particularly when it comes to balancing the interests of various stakeholders in the company.

To address this issue and, amongst other things, represent the interests of various stakeholders including the minority shareholders, the Companies Act, 2013 (“the Act”) introduced the concept of independent directors and the requirement that at least one-third of the total directors in every public listed company are independent directors and it also laid down requirements for their appointment and code of conduct to be adhered to by the independent directors.<sup>1</sup> Further, it also mandated that every unlisted public company crossing certain thresholds in terms of paid up capital, turnover or outstanding loan shall appoint at least two independent directors.<sup>2</sup> While unlisted companies are mandated to comply with the requirements under section 149 of the Act, listed companies, as well as those intending to be listed, are obligated to adhere to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“LODR Regulations”) as well.

#### WHY HAVING INDEPENDENT DIRECTORS ON THE BOARD OF A COMPANY IS ESSENTIAL?

The notion of Independent Directors emerged as a solution to the need for a diverse and unbiased perspective in the decision-making process of companies. By having individuals who are independent of the company’s management and major stakeholders, the interests of all shareholders, including minority and small shareholders, can be better protected and represented. An independent director is a member of the board of a company, who does not have any direct or indirect relationship with the company or its promoters and is not involved in active day to day management.<sup>3</sup>

Independent Directors act as a vital link between the company’s management, board, and other stakeholders, ensuring a healthy balance of power and interests. The composition of the Board with proper proportion of executive and independent non-executive directors is of great importance for a sound and smooth governance system in a company. The key role of independent directors is to bring a fresh perspective, provide technical business expertise, and offer unbiased judgment during the Board’s discussions on a wide range of issues, including strategy, risk management, and board performance evaluation.

In accordance with the Code of Conduct, Independent Directors are required to focus specifically on maintaining the integrity of financial information and overseeing related party transactions, while also protecting the interests of minority shareholders.<sup>4</sup> To fulfil this responsibility, the Audit Committee of the board, which is accountable for approving related party transactions and overseeing the financial reporting process and accuracy of financial information, must consist of at least two-thirds of Independent Directors<sup>5</sup>.

The major role that independent directors play in a company broadly includes improving the overall corporate governance framework and risk management processes of the company. They serve as trustees of good corporate governance. However, the true meaning of Independence can only be practiced as Independence is a state of mind and depends upon the individual’s ability to challenge the powers that be and ask the relevant questions. Thus, it becomes important to create an environment and culture where Independent Directors can essentially practice the independence.

#### POWERS AND DUTIES OF INDEPENDENT DIRECTORS IN CORPORATE BOARDS:



### NDA Introduction



### Want to work with us?

*We aspire to build the next generation of socially-conscious lawyers who strive to make the world a better place.*

At NDA, there is always room for the right people! A platform for self-driven intrapreneurs solving complex problems through research, academics, thought leadership and innovation, we are a community of non-hierarchical, non-siloed professionals doing extraordinary work for the world’s best clients.

We welcome the industry’s best talent - inspired, competent, proactive and research minded- with credentials in Corporate Law (in particular M&A/PE Fund Formation), International Tax, TMT and cross-border dispute resolution.

Write to [happiness@nishithdesai.com](mailto:happiness@nishithdesai.com)

To learn more about us [Click here](#).

### Research Papers

#### Compendium of Research Papers

May 2023

#### Time for Evolution of Sport Adjudication in India

June 2023

An independent director is an integral part of the Board and, like other members, actively contributes to formulating both long-term and short-term strategies for the company. The professional qualities possessed by independent directors play a vital role in guiding the Board towards making accurate and efficient decisions to achieve its objectives. Typically, independent directors are selected from a pool of highly capable individuals with extensive knowledge and experience in commerce, industry, and related domains. The company can leverage their expertise to enhance its business strategies and overall performance.

An independent director possesses powers both as a collective member of the Board and in their capacity as an independent director. The Board of a company has the right to exercise all such powers and perform all necessary acts and actions as authorized by the provisions of the Act, the Memorandum of Association, the Articles of Association, or any applicable regulations, as long as they do not contradict these governing documents. However, certain powers can only be exercised either under the Act or by the company in a general meeting, as stated in the memorandum or articles.

The duties of an independent director as enlisted in the Act<sup>6</sup> encompass a wide range of responsibilities to uphold the principles of corporate governance and safeguard the interests of the company and its stakeholders. They should continuously update their skills and knowledge, seeking professional advice when needed. Active participation in board and committee meetings is essential, and they should attend general meetings too.

Further as per the Act, Independent directors must address concerns about the company's operations, ensure proper deliberations before approving related party transactions, and ensure the existence of a functional vigil mechanism. Reporting unethical behaviour, fraud, or violations of the company's code of conduct is part of their responsibility. They must act within their authority, protecting the company's legitimate interests and not disclose confidential information without proper approval or legal requirement. Overall, their role is to contribute constructively to the company's growth while maintaining ethical standards and transparency.<sup>7</sup>

#### STRATEGIC ROLE OF INDEPENDENT DIRECTORS:

The presence of an adequate number of Independent Directors on the board serves several purposes. Firstly, their past experiences and distinguished expertise enable them to contribute valuable wisdom and professional domain knowledge. Being external to the company's payroll, they can adopt an impartial perspective solely focused on enhancing stakeholder value, free from any conflicts of interest. Consequently, they possess the authority to challenge management decisions that they perceive as detrimental to the company and/or its stakeholders.

Independent Directors maintain their independence and are not subordinate to the Chairman, who heads the board, or to the Managing Director & CEO, who lead the management. Their role does not involve any reporting relationship with anyone, allowing them to freely exercise their influence in board decisions. They have the option to abstain from voting on an agenda or express dissent if needed.

Despite the significance of their role, certain companies have observed a breach in implementing corporate governance norms, leading to repeated corporate fiascos as Independent Directors fail to uphold the integrity of their positions. In the below paras, we highlight the strategic role expected from an Independent Directors:

- 1. Impartiality and Unbiased Judgment:** Independent directors are entrusted with providing objective and unbiased insights into the company's operations, strategies, and financial matters. Their impartiality is crucial in ensuring that decisions are made in the best interest of all stakeholders.
- 2. Corporate Governance:** Independent directors act as custodians of corporate governance, overseeing that the company adheres to the highest standards of transparency, accountability, and compliance with relevant laws and regulations.
- 3. Strategic Decision-making:** Drawing on their expertise and experience, independent directors actively participate in board discussions and contribute to strategic decision-making. They offer valuable perspectives on critical issues faced by the company.
- 4. Safeguarding Minority Shareholders:** Independent directors must fulfil their duties and strive to enhance transparency in the company's operations. As shareholders, particularly minority shareholders, are often not equipped to scrutinize the company's affairs, they rely on independent directors to offer them the desired transparency and safeguard their interests by ensuring that their rights are protected, and they are treated fairly.
- 5. Oversight and Risk Management:** They oversee the management's performance, ensuring effective risk management practices and identifying potential risks to the company's sustainability.
- 6. Nomination and Remuneration Committees:** Independent directors also form part of the nomination and remuneration committees, which are responsible for identifying and appointing suitable candidates for key positions and setting executive compensation.

#### Sovereign Wealth Funds & Pension Funds-Investments into India

June 2023

#### NDA Connect

Connect with us at events, conferences and seminars.

#### NDA Hotline

Click here to view Hotline archives.

#### Video

##### Webinar: Angel tax – impact on PE/ VC investments

June 09, 2023

##### Webinar : Generative Artificial Intelligence: Legal, Ethical and Policy Implications.

June 01, 2023

#### Mobile App



Click here for  
Apple IOS

Android

#### Proud Moments

##### Chambers and Partners Asia Pacific

**2023:** Top Tier for Tax, TMT, Employment, Life Sciences, Dispute Resolution, FinTech Legal

##### Legal 500 Asia Pacific 2023:

Top Tier for Tax, TMT, Labour & Employment, Life Sciences & Healthcare, Dispute Resolution

##### Benchmark Litigation Asia Pacific

**2023:** Top Tier for Tax, Labour & Employment, International Arbitration

**IFLR1000 2022:** Top Tier for M&A and Private Equity

##### AsiaLaw Asia-Pacific 2022:

Top Tier for Tax, TMT, Investment Funds, Private Equity, Labour and Employment, Dispute Resolution

##### FT Innovative Lawyers Asia Pacific

**2019 Awards:** NDA ranked 2nd in the Most Innovative Law Firm category (Asia-Pacific Headquartered)

7. **Audit Committee:** As majority of the members of the Audit Committee are independent directors, they play a very important role in ensuring good corporate governance in the company. Being independent, they can expressly review and monitor critical audit and financial transactions including related party transactions aspects for the benefits of the company

### FACTORS CHALLENGING INDEPENDENCE OF INDEPENDENT DIRECTORS:

Independent directors face significant challenges in terms of governance and maintaining their independence. To be effective in their role, an independent director must possess a deep understanding of the specific industry in which the company operates. Each industry has its unique features, statutory requirements, and risk factors that demand specialized knowledge. Additionally, being aware of the performance parameters of other market players within the same industry is crucial.

Furthermore, certain industries are subject to specific economic statutes, and an independent director must have a fair understanding of these provisions, in addition to the fundamental corporate laws. However, there are concerns that the current framework places excessive reliance on the executive management for information, making it difficult for independent directors to fulfil their responsibilities adequately.

While the Act intended to promote the importance and contribution of independent directors, we can argue that it may have overreached itself, creating complexities that hinder their effective functioning. Certain provisions of the Act tend to impose rigid do's and don'ts, potentially limiting the decision-making autonomy of independent directors.

There is a need for improvements to raise governance standards. After several years of the Act's implementation, there remains ample scope to understand and address these challenges. Identifying the obstacles faced by independent directors and corporates in complying with the law is essential. Moreover, exploring the incentives available to independent directors to ensure adherence to the Act's intent will be valuable in enhancing corporate governance to higher standards.

1. **Ties with Promoters or Management:** Despite the prescribed independence criteria, some Independent Directors may have past or even ongoing associations with the company's promoters or management. While these relationships may not be classified as "material" under the legal definition, they could still impact the director's judgment and decision-making. Even seemingly innocuous ties can impact an independent director's decision-making process. Subconscious biases, loyalties, or undue familiarity might inadvertently sway judgment, potentially diluting the rigor and neutrality expected of their role. The director might find it challenging to raise tough questions or challenge management when necessary, fearing strained relationships or perceived conflicts.
2. **Multiple Directorships:** Independent Directors often serve on the boards of several companies, which raises concerns about their ability to devote enough time and attention to each company. In some cases, this could even lead to a conflict of interest, particularly when issues arise involving two or more companies in which they hold directorships.
3. **Fee Dependency:** Independent Directors are compensated for their services, and this remuneration could influence their decisions. The fear of losing lucrative directorship fees might deter them from taking strong or inconvenient stands on critical matters that might displease the management or promoters.
4. **Lack of Expertise:** Appointing Independent Directors who lack domain expertise or relevant industry experience may hinder their ability to comprehend complex business decisions fully. This can limit their effectiveness in offering valuable insights and contributing to crucial discussions.
5. **Insider Information:** In some instances, Independent Directors may inadvertently receive sensitive or confidential information that could compromise their independence. The potential for such information leaks raises questions about how well companies can safeguard such data.

### HOW CAN WE ENHANCE THE STRENGTH OF INDEPENDENT DIRECTORS?

As businesses face mounting challenges and complex issues, it becomes paramount to explore ways to bolster the strength and effectiveness of independent directors. In There are various strategies and initiatives that can empower independent directors, equipping them to play a more impactful role in shaping the trajectory of modern corporations. From refining selection processes to enhancing training and accountability measures, we explore the path towards a robust and resilient system of corporate oversight.

1. **Enhance Independence and corresponding Authority:** Policymakers and regulators should establish robust criteria for determining the independence of directors. Independent Directors bear significant responsibility, yet the authority bestowed upon them is comparatively limited. Consequently, there arises a necessity to augment the authority granted to these Independent Directors. The same can be achieved by appointing independent directors with a diverse range

**RSG-Financial Times:** India's Most Innovative Law Firm 2019, 2017, 2016, 2015, 2014

### NishithTV



June 22, 2023

**Webinar: Angel tax – impact on PE/ VC investments**

of expertise and professional backgrounds and establishing a comprehensive board charter that outlines the roles, responsibilities, and authority of independent directors. Further, the company needs to ensure that independent directors have timely access to accurate and relevant information about the company's operations, financials, risks, and performance. Access to information empowers them to make informed judgments and actively participate in discussions.

2. **Improvement in selection process:** While there is an online data bank of the independent directors and the requirement to clear online proficiency test, most are hand-picked by promoters. An inference consequently arises that an independent director cannot be as independent as they are expected to be.
3. **Regular Assessment:** Regular evaluations of Independent Directors' performance, both individually and collectively, can help identify any potential conflicts of interest or shortcomings in fulfilling their responsibilities.
4. **Continuous Education:** Companies should invest in continuous training and development programs for Independent Directors to keep them updated on industry trends, best practices, and changing regulatory landscapes. These programs should cover corporate governance best practices, legal and regulatory requirements, risk management, ethics, and sustainability.
5. **Encourage Diversity:** Promoting diversity among Independent Directors, including gender, age, and professional backgrounds, can bring a broader range of perspectives to the boardroom and reduce groupthink.
6. **Empower Whistle-blower Mechanisms:** Establishing robust and confidential whistle-blower mechanisms can encourage employees and stakeholders to report concerns about the company's practices without fear of retaliation.

## CONCLUSION:

As the business landscape evolves, the role of Independent Directors will become significantly more instrumental in shaping the corporate world's ethical and responsible future. There is a need for increased rigor in the screening process to ensure the suitability of Independent Directors for board positions. Comprehensive training and grooming should be provided to them to ensure the proper implementation of Corporate Governance principles in both letter and spirit

While the concept of Independent Directors is a step in the right direction to strengthen corporate governance, ensuring their true independence remains a practical challenge. Striking the right balance between independence and expertise is crucial to harness their full potential as watchdogs of corporate integrity. By addressing the factors that challenge independence and implementing measures to strengthen their autonomy, companies can uphold the credibility of Independent Directors, bolster transparency, and enhance stakeholders' trust in the corporate system.

The role of Independent Directors should be redefined and utilized as an effective mechanism to protect the long-term sustainability of organizations. By doing so, the corporate sector can prevent governance issues that tarnish the image of the entire business ecosystem and instead ensure a stronger foundation for a transparent and accountable corporate environment.

The objectives of corporate governance cannot be effectively met without the inclusion of independent directors in the larger scheme of things. This becomes even more convincing in the context of an escalating Indian economy with unprecedented amounts of funds flowing into companies from within and outside the country.

As start-ups aspire to disrupt industries and redefine norms, the strategic appointment of independent directors can be the catalyst that propels them toward sustainable success. While start-ups may not be bound by regulatory mandates to appoint independent directors, the voluntary inclusion of such seasoned professionals can catalyze a transformative journey. These directors infuse start-ups with expertise, drive a culture of governance, and send compelling signals of commitment to stakeholders.

Further, the decision to appoint independent directors sends powerful signals that reverberate through the start-up ecosystem. It communicates a start-up's maturity and readiness to embrace external counsel, demonstrating a willingness to learn, adapt, and thrive. This move resonates with potential investors, who often seek evidence of a robust governance structure as a sign of prudent management. Additionally, the presence of independent directors can enhance a start-up's credibility in negotiations, partnerships, and regulatory interactions, positioning the company as a reliable and credible player in the market.

You can direct your queries or comments to the authors





**MAULIN SALVI**



**SAHIL KANUGA**

---

<sup>1</sup>Section 149(4), Companies Act, 2013.

<sup>2</sup>Section 149(4), Companies Act, 2013 read with Rule 4 of the Companies (Appointment and Qualification of Directors) Rules, 2014

<sup>3</sup>Section 149(6) of the Companies Act, 2013

<sup>4</sup>Section 149(8), Companies Act, 2013 read with Schedule IV.

<sup>5</sup>Regulation 18, LODR Regulations.

<sup>6</sup>Part III of Schedule IV, Companies Act, 2013.

<sup>7</sup>Ibid

---

**DISCLAIMER**

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.