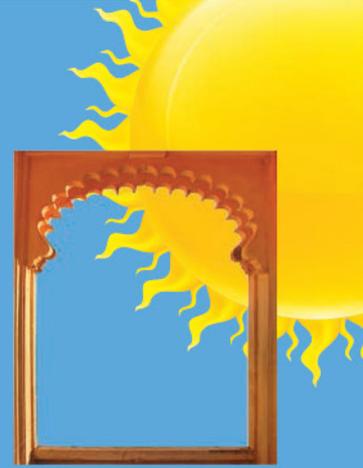


Board and Director Independence in Controlled Companies

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Executive Summary

- “Controlled companies” constitute a vast majority of Indian listed companies with promoters having dominant ownership and management control.
- The concept of board and director independence to monitor executive management emerged in regimes such as the US, where corporate ownership is widely dispersed, but has been transplanted in concentrated ownership regimes in India and elsewhere in the world, without adequate measures to adapt.
- The potential for erosion of board and director independence in controlled companies is high, which is likely to impair the protection of absentee shareholder interests.²
- The current regulations need review and change. Among the proposals are:
 - (a) election of independent directors by a majority of non-controlling shareholders, with safeguards to prevent any abuse of this power by vested interests
 - (b) provision for mid-term separation of independent directors to be approved by non-controlling shareholders.

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² The expression ‘absentee shareholders’ refers to non-controlling shareholders with no role in management of their companies.

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I. Introduction

More than 90% of listed companies in India are “Controlled Companies.” The main distinguishing feature of the controlled companies is that the share ownership in these companies is concentrated in the hands of an individual, family or other investor group, domestic or foreign parent, or the State which enables them to assume directly or indirectly management control of the business. It is also useful to remember that roughly 20% of the voting equity is generally adequate to control companies since it is virtually impossible for anyone to coordinate and get together higher number of votes from out of the remaining 80% to challenge the controllers. Among the main reasons contributing to this predicament are the geographical dispersion of small shareholders and their insignificant size of holding, high costs of monitoring corporate developments, and even plain indifference of shareholders. Many promoters in India have been taking advantage of this situation to gain and retain control of their companies with significantly smaller than majority shareholding.

What are Controlled Companies?

“Controlled Corporation” means a corporation controlled by a Controlling Shareholder or group of shareholders who together (directly or indirectly) control a sufficient number of common shares of the corporation to be able to elect the board of directors or to direct the management or policies of the corporation.

“Controlling Shareholder” means a person or company that directly or indirectly controls a sufficient number of common shares of a corporation to be able to elect the board of directors or to direct the management or policies of the corporation.

- Canadian Coalition for Good Governance, Policies: Governance Differences for Equity Controlled Corporations (2011)

What is “Control”?

“... the right to appoint majority of directors or to control the management or policy decisions exercisable by a person or persons individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.”

- Companies Act, 2013 - Section 2 (27)

Who is a Promoter (or Controller)?

A person:

“(b) Who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise;

(c) In accordance with whose advice, directions or instructions the Board of directors of the company is accustomed to act.”

- Companies Act, 2013 - Section 2 (69)

On the other hand, present day corporate ownership in major markets such as the US and the UK indicate largely widespread dispersal of shares among numerous individual and institutional shareholders, each with relatively small holdings. There is thus no large scale concentration of ownership (as for example in India) in the hands of individual shareholders sufficient enough to acquire control of corporations. Actual management of the business in such circumstances is passed on to hired managers whose expertise and experience are necessary to cope with increasing size and complexities of modern business. The net result is that a vast majority of corporations experience separation of management from ownership, which in turn leads to powerful executives advancing their own agenda and a dispersed body of shareowners with miniscule equity holdings, which was not adequate to successfully challenge management. This brings in its wake its own problems. The executives, who act as agents of shareholders, are now in a position to enrich themselves at the cost of the shareholders who are distanced from day to day managerial control of the business--a problem referred to as 'agency cost.' Clearly, the absentee shareholders need some trustworthy representatives to monitor the executive and minimise any such expropriation. Outside directors independent of the company's management emerged and evolved as the solution. Monitoring the executive increasingly became a key preoccupation of the board and its independent directors. Regulatory criteria of independence became progressively stringent even as judicial evaluations of independence began digging deeper and wider, as for example in the case of Oracle Corporation at the turn of this century.

Director Independence in Oracle Corporation

In a derivative litigation, four directors of Oracle Corporation - Lawrence Ellison (Chairman and CEO), Jeffrey Henley (CFO), Donald Lucas (Outside Director), and Michael Boskin (Outside Director) - were accused of insider trading in January 2001. The Oracle board constituted a Special Litigation Committee (SLC)--as permitted by Delaware Law in such cases--with two other outside directors, Hector Garcia-Molina and Joseph Grundfest, both tenured professors at Stanford University. The SLC after extensive investigation and discussions with independent legal counsel, found no case for Oracle to pursue the plaintiff's claim against the four directors.

The question at issue before the court was the independence of the two investigating directors on the SLC which was of critical importance for accepting their finding. The court noted that they were both tenured Stanford Professors and were investigating four other directors on their board (one of them another Stanford Professor who had taught one of the investigating directors; another a student of Stanford who had donated substantially and had a facility named after him at Stanford; and the third, Board Chair and CEO of Oracle, who had made substantial donations to Stanford both personally and from Oracle Corporation, and was tentatively proposing a further donation from the company around the time the two investigating directors were inducted on to the Oracle board).

Taking all these attendant factors together, and noting the extensive linkages between Stanford University, Oracle Corporation, and the directors, the court held that the two SLC directors' independence had not been proved.

Source: Delaware Court of Chancery In Re Oracle Corporation Derivative Litigation, 824 A.2d 917 (Del.Ch.2003)

II. Board Monitoring of the Executive

Given the separation of management from ownership and the resultant agency issues noted earlier, monitoring the executive had become an inherent responsibility of the board and its non-management directors. In practice though, it may not have been pursued by directors with all the seriousness it required, as reflected in periodical exposure of mismanagement and malpractices. But the collapse of Penn Central Transportation Company in the US in 1970, “amidst personality clashes, mismanagement, and lax board oversight,” triggered a movement for more stringent monitoring of the executive by boards.³ This was further exacerbated by the exposure of illegal payments and scandals at several corporations unleashed by the infamous Watergate probes around that time. Almost overnight, imperatives of board monitoring moved up centre-stage and the role of independent directors on corporate boards became synonymous with good, tight corporate governance. In order that independent directors could be seen as effective monitors of the executive, independence criteria were prescribed with increasing rigor. The practice was widely accepted and readily adopted over time by virtually all countries around the world, including India.

III. Company ownership and board independence

As the concept of independent monitoring of the corporate executive took hold and became more popular beyond the originating country, corporate ownership pattern--a key contextual difference--did not receive adequate attention. As noted earlier, in the US, where the concept of board and director independence originated, ownership was (and is) largely dispersed among a large number of shareholders. But in most other countries (barring the UK and Australia) including India, corporate ownership is concentrated in the hands of promoters or sponsors of the companies who also generally act as the executive. Not recognising this key difference in the ownership pattern can neutralise to a large extent the true monitoring potential of the board and effective independence of its directors.

IV. Improbability of Independence in Controlled Companies

All over the world--dispersed ownership regimes or otherwise--it is clear that independence of the board and its directors is imperative for effective monitoring of the executive. The question is how to achieve and maintain the quality of independence at a level where directors--and collectively the board--could make truly independent and objective decisions to protect and promote the interests of shareholders and other stakeholders. In dispersed ownership regimes this is achieved by routing selection of directors through an independent or largely independent nominations committee of the board followed by approval by the shareholders. In controlled companies, while the selection process may apparently be similar, in effect it will be the controlling shareholders who will be influencing the selection by the nominations committee and subsequent election at the members' meeting, voting for their selected candidates. This is the key difference: while undoubtedly, in the dispersed ownership scenario, the all-powerful executive and their representation on boards would tend to dominate the director selection process, in controlled companies the controllers will have the added power of voting their shares in favour of their candidates at members' meetings. This distinctive advantage enjoyed by the controlling shareholders is available to all controlling companies, whether they are in India or in the US. This helps the controllers to have their independent directors beholden to them, thus striking at the very roots of the institution of independent directors. If they

³ Brian Cheffins (2010), Did Corporate Governance ‘Fail’ During the 2008 Stock Market Meltdown? The Case of the S&P 500

do not toe the line, their jobs may be at risk; if they do, they may be better off, but the downside is that they will not be able to do justice to their job of looking after the interests of absentee shareholders. That is why Warren Buffett (himself a controlling shareholder!) had commented that director independence was the weakest in controlled companies where the controller held all the cards opposite independent directors! Some of the recent high profile involuntary separations from very reputed company boards in India are indicative of the vulnerability of independent directors that drives most of them either towards abject complicity or frustrating exit from the scene. Of course, this need not necessarily be so.

V. What Should Controlled Companies Do?

Enlightened controllers who perceive their interests being better served by the decisions of a truly independent board do recognise the possible value addition and benefit from such independent voices. Thus, while there are good chances that invited independence may work well for the company and its shareholders including controlling shareholders, similar optimism in case of regulation imposed independence may have to be tempered.

Outside directors, independent or otherwise, do bring to the table different perspectives and inputs of value to the company. The insightful statement of Francis Bacon, the seventeenth century English statesman and philosopher, “The light that a man receiveth by counsel from another is drier and purer than that which cometh from his own understanding and judgment, which is ever infused and drenched in his affections and customs,” is nowhere more appropriate than in the board rooms of corporations.

Controlling shareholders need to appreciate this. How companies would benefit from outside directors is a question often raised when considering induction of outside directors. Having brought them in, it makes no business sense not to benefit from what they bring to the discussions.

VI. How can Regulators Help?

Controlled companies exist in all countries: they are a minority in some (US, UK, Australia) and the majority in others, India included. Where they are in a minority, certain special regulations are applied to them as exceptions. The question is how such controlled companies should be regulated in a market where they are the main stream, not the exceptions.

The imperatives of director independence even in the context of our concentrated ownership regime cannot be gainsaid. One step regulators can take to make it work for the concentrated ownership regimes is to neutralise the huge voting advantage controlling shareholders enjoy.

This would mean independent directors’ appointment, remuneration, removal, and other related matters will be approved by a majority of non-controlling shareholders, with controlling shareholders barred from voting on such resolutions. Since one of the main roles of the independent directors is to objectively oversee management to procure protection of absentee shareholder interests, it will be unfair to let the monitored (controlling shareholders in their executive role) have a say in electing the monitors (independent directors) or deciding on their remuneration, removal and other related matters. This should substantially help independent directors to do their job without fear or favour, largely freed from any sense of loyalty to the controllers.⁴

Regulators can also consider boosting the independence of statutory auditors, on whom independent directors rely for much of their oversight work especially on financials. Again, on the same principle that the audited (controlling shareholders preparing financials and reports in their executive capacity) should not have a say in choosing who will audit them, regulation could stipulate that independent auditors’ appointment, remuneration, termination

⁴QB No. 15, Issues in Board and Director Independence has more recommendations on process improvements to strengthen exercise of director independence

and other related matters will have to be approved by a majority of non-controlling shareholders, with controlling shareholders not being permitted to vote.

Lest a small minority or other vested interest potentially abuses the new-found power of the non-controlling shareholders, regulation could also prescribe that the majority vote of the non-controlling shareholders can be effective, only if it is no less than, say one-half of the total non-controlling votes of the company.

VII. What Should Independent Directors Do?

Conscientious independent directors would do well to get some due diligence done on the company's governance practices especially if they are invited to join controlled companies. Prominent among the topics to investigate would be the volume of related party transactions, presence of promoter's family members in senior executive positions, abridgement of board powers through private shareholders' agreements, other independent directors' profiles, longevity of their tenure, and profile of the first line management below the board level.

A second area for careful scrutiny is the compensation offered. While compensation should be commensurate with the time, effort and expertise that directors commit to the company and the risks they undertake, offers of very high compensation out of line with industry norms should raise a red alert. Equally, prospective directors may also wish to assess the offered compensation as a proportion of their respective personal earnings. If it is too high, say over 20% from a single company or 33% from all companies in a group, one should take a personal call as to whether its potential loss would interfere with his or her independence of judgement.

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