Enabling Corporate Boards to Effectively Perform

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Abstract
In the corporate format of business organizations, the position of the board as a company's supreme body, subject only to the laws of the land has long been well established. It is vested with every power required to achieve on behalf of its shareholders optimal wealth on an ongoing basis and in return is held accountable only to its shareholders who theoretically appoint or elect them. The only constraints on board authority are those imposed by law and the company's own charter documents such as the Articles of Association in terms of processes and the Memorandum of Association in terms of business objectives it can engage in. Why then is it that a large number of boards do not succeed in fulfilling this trusteeship assignment and yet continue sanguinely in their insulated and exalted retreats? This paper seeks to ascertain some of the key issues that permit and encourage this self-perpetuating institution of corporate boards and ventures to suggest some enablers to shake them out of their indolence and get effective in the discharge of their onerous responsibilities.

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The discussion is organized as follows; Section I recapitulates the context and primary roles of boards and their composition and structures in terms of best practices (not necessarily laid down by law); Section II describes some of the impediments to board performance and effectiveness; and Section III concludes with a set of recommended enablers that may help in overcoming these hurdles so that the effectiveness of boards could be improved.

I : Rationale and Roles of Corporate Boards

Why are boards of directors required? After all, the corporation itself is a fiction of law by which a group of people get together and form themselves in to a collective entity (quite distinct from themselves) for stated and agree purposes. Theoretically, like in case of partnerships, all signatories to the agreement may decide to run themselves the business or other operations on a day to day basis, each contributing to the management depending upon their expertise. Many small private limited companies still run on this basis. In practice though, especially when the number of members of the entity gets larger, it is impractical to expect everyone to be associated with the business operations. The board of directors in that case becomes a kind of buffer between those shareholders who have nothing to do with day to day management (who may be best labeled as *Absentee Shareholders*) and those shareholders and others who have an active role in executive management.

This separation between ownership and operational control creates its own set of potential problems. Adam Smith (1776) famously wrote that directors, "being the managers rather of other people's money than their own," cannot be expected to watch over it "with the same vigilance with which the partners in a private copartnery frequently watch over their own." While this observation appeared, somewhat tolerantly, to rationalize the inherent weakness of the system, in actual practice there was potentially more to this separation than this simple indifference; those in operational management, because of their position and access, could actively expropriate some of the gains made in the business to themselves rather than truthfully accounting for it and distributing it to the rightful owners including the absentee shareholders. Not all managers and operating shareholders would necessarily resort to this subterfuge but the potential for abuse in varying degrees did (and does) exist in common with any situation where work is delegated to another, giving rise to what is referred to in literature as the *Agent-Principal* problem. It was necessary therefore for an objective set of people to act as referees and (for want of a better expression)

policemen to protect the *absentee shareholders'* interests.

To do this surveillance job with objectivity and impartiality, the board obviously had to be populated with directors with no unmanageable obligations towards the executive or controlling shareholders. While theoretically it is conceivable that managers and controlling shareholders sitting on the boards could well discharge this responsibility (and surely there would be some exemplary instances of such people but regrettably their tribe would be small and diminishing), following the admirable dictum that justice should not only be done but also *seen* to be done, an exclusive band of directors who could discharge and be seen as capable of discharging this responsibility came to be inducted on to company boards either by choice or (mostly) by regulatory mandate. Thus was born this Institution of "independent" directors, essentially those whose objectivity and reputation were not in doubt. They were termed i*ndependent* because they were expected not to be obligated to the controlling shareholders or executive management in any pecuniary or filial sense or with other vested interests which may interfere in their exercise of independent judgement on matters coming up for decision.

It is only fair to add that every director on the board is uniformly charged with a *fiduciary* or trusteeship responsibility that they owed their company and its shareholders.[1] Experience however has shown though that executives and controlling shareholders sitting on boards have an apparent conflict of interest between optimizing their personal gains and meeting equitable shareholder interests.

The other important point to be noted is that the board's role is not one of just policing alone but also of contributing and counseling that would help companies to maximize wealth creation. Especially in case of independent directors, the surveillance function of the board gets overly emphasized almost to the exclusion of the other two roles such directors could and should assume and play for the benefit of the company and all its shareholders.

II : Some Impediments to Board Effectiveness

These can be considered under three headings: structural impediments which arise from the manner in which boards and their subset, board committees are constituted; process impediments that originate in the way boards and board committees are asked to function; and legal impediments where it is the law of the land that comes in the way of boards effectively discharging their responsibilities.

Structural Impediments

In countries like India, corporate ownership tends to be predominantly concentrated in the hands of controlling shareholders, such as family or domestic groups, multinational groups, or the State in case of public sector enterprises. Boards of companies are generally constituted in a manner that provides a majority of seats to the controlling owners or executive management; even the stock exchange requirements on independent directors seek only a third of the board in case the company has a non-executive chair and one half if otherwise. Granting that some independent directors may not always be able to attend meetings (while a three line whip can always be used to ensure executive and non-executive directors attend critical meetings), coupled with the fact that directors each have only a single vote (barring the chair who can generally exercise a casting vote), this means that the non-aligned or objective component of the board can never muster a majority to frustrate any resolution blatantly not in the interests of the absentee shareholders. Similar considerations apply in case of committees: even though the listing requirements mandate (for audit committees) a majority of non-executive directors with only the chair having to meet the independence criteria, objective majority is not easy to come by.

The second structural issue relates to the election format governing both appointments to and separations from the board. Who screens and selects candidates for appointment as independent directors? Theoretically the board itself is expected to consider prospective candidates and recommend to the members at the general meetings for approval. Nomination committees are not mandated as yet in India and even in the rare instances where they are in place their independence and objectivity in terms of membership are not assured. In practice, it is the controlling shareholders or executive managements that propose candidates for induction on to their boards. And the same shareholders will also vote their dominant proportion of shares at general meetings that elect the directors. Without casting any aspersions and with due respect to all directors so selected, it is not too difficult to infer a latent sense of loyalty or obligation that in most such cases would be inevitable, thus eroding the candidates' independence of judgement on matters coming up for board discussion and approval.

Third, once the required number of "independent" directors have been appointed and the relevant check-box in the compliance list had been ticked, there is no follow up requirements mandating such independent directors' (of a majority of their) approval even for the most important resolutions that impact absentee shareholders negatively to any degree. Not even the presence of independent directors or at least a majority of them, is required at meetings scheduled to discuss key matters affecting the interests of absentee shareholders ; the very purpose of their association with the company is thus negated, leaving the executive and non-executive-non-independent directors to approve such resolutions entirely in their discretion.

The fourth structural impediment arises from the independent directors themselves, having to do with the time they can humanly devote to the affairs of the company. Many independent directors are full time employees or busy professionals in practice that leaves

them with limited time to devote to other matters. Many others who are not in that category may suffer from over-boarding problems arising from their being on too many boards and other organizations, spreading their valuable resources too thin. Board work is not limited to attending meetings alone. To be effective, independent directors have to keep abreast of developments relating to their domain expertise as well as the industry segments their companies operate in. Arthur Levitt, a former chairman of the US Securities and Exchange Commission once estimated around twenty two working days as the average requirement of a director in large US corporations. The National Association of Corporate Directors in the US had recommended that directors should budget for at least four full 40-hour weeks of service for every board on which they serve (1996). Since then, the time allocation requirements would only have gone up, not come down, given the increasing public scrutiny of failed companies and escalating litigation. Indian companies may be less complex but any conscientious independent director would confirm a requirement (having regard to preparation, participation, follow-up and travel time) of at least two weeks of work for each directorship in a large company, counting a minimum each of four board and committee meetings annually. Consideration of these requirements while offering or accepting a directorship is generally conspicuous by its absence. This leads to poor preparation, attendance and contribution all of which impair the effectiveness of board functioning.

Process Impediments

Among the key impediments that can be attributed to board and committee processes are those concerning information flows, time allocation, agenda calendar, executive sessions, presentations, table items, accurate minutes and follow up actions taken, and so on (Bala 2010, pp 147-157).

Non-executive directors (and in several instances even some of the whole time directors) depend upon executive management to provide adequate and appropriate information on matters coming up for board consideration. While non-executive interactions with operating management (with the knowledge of the chief executive) is considered a good practice to help directors keep themselves abreast of developments and also to get routine clarifications without consuming boards' time or taking the executive by surprise at meetings) this rarely happens in practice and is often seen as encroaching upon executive domain. The result is that the outside directors have to depend upon what is provided to them by the management; some conscientious directors may try to ascertain additional information on their own or based on their domain expertise but this will be more of an exception then the rule.

Compounding this dependence is usually the lack of time for preparation even if the outside directors wish to do justice to their task, since the material would generally arrive just a few days before the meeting, or even tabled at the meeting, or is offered as a presentation at the meeting itself. None of this is conducive to a meaningful or informed discussion of the matter before the board. Presentations in particular, while being trendy and particularly useful to directors who may not have had the time to study the papers, usually leave little time for informed discussion.[2] Procedural and compliance issues, important though they are, tend to take disproportionately long leading to discussions on substantive issues of strategy, operations, risk and internal control, and so on being rushed through.

Another process issue that impairs board effectiveness is the scheduling of committee and board meetings in quick succession, ostensibly to minimize inconvenience to visiting directors having to stay overnight or having to arrive the previous day. The unintended result is that meeting durations are not dictated by the time legitimately required by the members but often cut short to fit in with some fixed minute-to-minute programmed schedule.

A major lacuna in Indian practice (with some illustrious exceptions) is the absence of any face-to-face interaction among independent directors exclusively without executive management and directors being present. Such sessions are very useful vehicles for frank exchange of views without being inhibited by the (usually) intimidating presence of the chief executive or promoting patriarch. Bereft of this opportunity, and usually having had little advance notice of the items under discussion, outside directors tend to keep their views to themselves during the formal board meetings. There is very little value-add by this kind of inflicted withdrawal on the part of directors.

Legal Impediments

It is strange but true that some of the legal and regulatory provisions (or their absence) contribute to lower the boards' effectiveness. There are two broad categories of such issues: those that concern board and committee meetings and those that pertain to members general meetings.

Let us consider board meetings first. A key objective of getting non-aligned outside directors on to the board in some proportion is to ensure that they objectively review and decide upon matters that may negatively impact absentee shareholders. In that one respect, their brief is somewhat different from that of other non-independent directors, even while not overlooking the distinct possibility that some or even most in the latter category of directors may, and do, also take similar objective decisions. But the law does not distinguish this salutary utility and purpose of independent directors and treats them with the same brush as it does the others. Surprisingly, the presence of such independent directors or at least a majority of them is not mandated for even when the board is scheduled to discuss matters that may adversely impact absentee shareholders. There is no quorum requirement or any majority voting requirement on such resolutions that insists that their

objectivity and independence – the very traits that qualified them for their election to the board – must be applied on such contentious matters.

The second legal impediment is partly psychological. As already noted, outside directors appointment offers are first made by the controlling shareholders or the CEO as their representative; approval by the shareholders is seen as a formality, since the controlling shareholders would vote in their favour, and in any case the other shareholders are either passive or insignificant in terms of voting strength. The overriding impression that it is the promoter or the CEO who is responsible for the appointment likely puts the appointees under some moral pressure to be mindful of not to biting the hand that feeds.

The third legal anomaly is that even though the members in general meeting are the electing or appointing authority, the elected director need not face them if he or she chooses to resign from the board for whatever reason. It is the board to whom the resignation is normally addressed and by whom it is accepted. Apart from a ceremonial mention in the directors' report to the shareholder at the end of the year, members are not in the picture at all. What more can one ask for to distance the outside directors from the very shareholders whose interests they are expected to protect and to whom they are accountable as part of the board. The message that most non-aligned directors subconsciously register in their mind is that it is the controlling shareholders and CEOs and 'their' boards that matter in all issues concerning their appointment, remuneration or separation, not that faceless body of outside shareholders.

The legal impediments to board effectiveness at the level of members meetings stem essentially from the failure of law to recognize and act upon a simple equitable principle that voting at members meetings on resolutions by those who stand to benefit from the decision must not take into account the votes of such interested shareholders themselves (Bala 2010, pp. 305-309). Thus the controlling shareholders can push their agenda through a largely emasculated board (as noted earlier) and equally steamroller approvals at members meetings because they can vote their dominant holdings in their own favour! As a Hong Kong Report (2000, p. 108) concludes citing a judicial observation: "..It becomes a pointless formality, inevitably producing the same result as the original board decision."[3]

That the concept of disallowing interested shareholders' votes on resolutions at members meetings is well grounded in equity and entirely wholesome in its conceptual basis admits of no doubt. The Irani Committee (2005, para 35) to whom this was represented noted that this concept "was an aspect of good Corporate Governance which may be adopted by companies on voluntary basis by making a provision in the Articles of Association of the company" but stopped short of recommending legislation, "in view of the issues related with enforcing compliance of such requirements." It should not, of course, surprise anyone that there has been no great rush since then on the part of companies to adopt this restraint in their articles on their own in pursuance of the committee's wise counsel.

III : Some Prescriptions for Overcoming Impediments

How can the bar be raised to help boards enhance their effectiveness? Three sets of recommendations are ventured in the hope at least some of these would be acted upon by leadership companies and their directors and the legislative and regulatory agencies

What Companies Can Do

- Constitute nominations committees consisting wholly of independent directors to scan, screen and select candidates for independent board positions, based on their integrity, reputation, domain and/or functional expertise, and value-adding potential in one or more of the three arenas of contributing, counseling and controlling capabilities
- Enhance the proportion of such independent directors on the board without limiting themselves to the minimum prescribed by regulations. Leadership companies aim at maximizing their capabilities, not adhering to the lowest common denominator
- Adopt changes in their Articles of Association to:
  - o ensure a minimum proportion of independent directors are required to constitute an acceptable quorum for their board and committee meetings, that resolutions potentially impacting absentee shareholders negatively are approved by a majority of independent directors on the board (and not just those attending)
  - o ensure that acceptance of separations/ resignations of independent directors (just as their initial appointments) are approved by the members in general meeting, the concerned directors are present to answer any questions from members, and the controlling shareholders do not vote on resolutions accepting resignations of such directors
  - o ensure all material related party transactions are put up to the members in general meeting for their approval, having regard to the comments especially of the independent directors on the board
  - o ensure that independent directors invariably meet in executive session before each meeting and a chair or nominated representative of the group briefs the full board of any view expressed on matters before the board
  - o ensure that all directors (other than those who are in executive positions and contractually have a longer time horizon) retire and offer themselves for re-election at every annual general meeting; that each such director are present (unless prevented by extraordinary personal circumstances) to personally seek election, outlining his or her track record and future objectives

What Individual Outside Directors Can Do

- Before accepting an offer of directorship or deciding to seek reelection, evaluate what they can bring to the table in terms of value addition in the three domains of contributing, counseling and controlling, assess the time requirements of the directorship and the feasibility of doing justice to the assignment, and explore conflicts of interest in terms of other directorships or substantive engagements
- Be present at the general meeting of members and seek their approval with an account of what has been done and what he or she proposes to achieve if elected
- Diligently discharge their fiduciary duties to the company and in particular to the absentee shareholders, ensure their views and dissent if any are properly recorded in the minutes, and add value to the company depending upon one's expertise and capacity
- If resigning or otherwise stepping down, attend the members meeting following, share reasons for the separation and seek approval for acceptance of the resignation. Especially, avoid the standard explanation of *personal reasons* in support of the resignation or not-seeking-reelection request

What Legislation and Regulation Can Do

- To the extent feasible, incorporate all the articles changes enumerated above in the law/ regulations either as a mandate or with a comply -or explain requirement
- Mandate material related party transactions including mergers, acquisitions and divestments to be approved by shareholders with the controlling or interested shareholders not being eligible to vote on such resolutions.
- In all cases of interested shareholder resolutions, mandate institutional shareholders with specified minimum thresholds of holdings to disclose on their web sites and on the concerned company web sites the reasons for their voting position, for or against.

Would these measures help in improving the standards of governance? The answer would certainly have to be in the affirmative. Would they completely eliminate frauds and corporate abuse of power? No, there can be no one hundred percent solution to prevent calculated schemes of deception and crime but there can be a reasonable assurance that such frauds would be more difficult to perpetrate and escape timely detection. Would these impair companies' entrepreneurial management and competitive capabilities? If these are defined to exclude expropriation of other peoples' monies through subterfuge and tunneling, these measures are unlikely to interfere with the normal business potential of the corporations. On the other hand, with governance risk being minimized, their market values and reputation should go up and benefit all the stakeholders including shareholders.

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[1] It must be pointed out that while the *fiduciary* responsibility is to the company and its shareholders (based on a legal concept known as *residual claimants*, there are strong schools of thought arguing justifiably that board accountability should extend to all relevant stakeholders besides shareholders alone

[2] Ram Charan (1998), the noted American consultant, observed: "Presentations by management can be (and often are) stultifying, or in the words of one director, "mind-numbing," The point of longer meetings is to allow more time for open questioning and intellectual give-and-take on key issues." This being an American example, it does seem that the problems of outside directors are pretty standard universally!

[3] This is extracted from a longer quotation from *Corporate Power and Responsibility* (1993), see Bala (2010)