The Essence of Independent Directorship

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The older you get the more you tend to reflect on your experiences. Retirement from full-time activity provides the space for such reflection. This year I complete 20 years of independent directorship on various companies' boards of directors and, with the 75-year barrier, I have, in theory, another five to go. It is a good point at which to put my thoughts together so that the time remaining to me is more fruitful for both, me and the companies that still have me on their boards. I also hope that my distilled thoughts, few as they are, will be of some benefit to others. In these 20 years I have been on the boards of companies controlled by multinational corporations and traditional Indian businessmen, by a hoary Indian house considered "professionally managed", and by one of India's first IT entrepreneurs. These have been ?500 crore companies and ?50,000 crore companies. They have covered a spectrum of activity. The only gaps are those that I purposely chose to leave – to never sit on the boards of government-controlled companies or any in the financial services industry. After over three decades of auditing both these exceptions in my previous profession as an auditor, I concluded early that making a significant contribution in either is a task beyond me.

There are many lessons I have learned over the years but in this article I propose to talk only about the purpose of independent directors and what it takes for that purpose to be accomplished. I also wish to deal in the Indian context only and, as in any such article, I generalise. There are many outstanding exceptions to what I say in it.

Companies have had "outside" directors for many decades. It is only at the end of the 20th century that the concept of independent directorship was first introduced into the capital markets. They were, of course, looking to independent directors protecting the interests of minority shareholders from the egregious conduct of the controlling shareholder. Related party transactions, appointments of relatives to positions of power, skewed equity transactions such as preferential offers and other abuses were what these directors were created to thwart. But society has, over the years, had far greater concerns with the behaviour of business: monopolistic conduct, cartelisation, oppression of small vendors, manipulation of taxes, selling dangerous products and, most importantly, massive damage to the environment. These were not the concerns of the capital markets that invented independent directors; indeed, they were often beneficiaries of the asocial behaviour of companies. It is governments that have tried to control these abuses through legislation.

Business ingeniously tries to get around the spirit of laws intended to protect stakeholders in business and, often, violate even their letter. Society has begun to ask why independent directors permit this. Even the Companies Act exhorts independent directors to balance the conflicting interests of all stakeholders. Most remain ignorant of this; others have no idea how to go about it. Those pitifully few who attempt it are thwarted by controlling shareholders and managers who see the idea as a threat to their wealth. The 2013 act has several provisions obliging boards to address all stakeholders' interests with an even hand:

- S166(2) "A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and *in the best interests of the company, its employees, the shareholders, the community and for the protection of (the) environment.*"
- Schedule IV, part II
  "The independent directors shall –
  (5) Safeguard the interests of all stakeholders, particularly the minority shareholders;
  (6) *Balance the conflicting interests of the(sic) stakeholders*;"
- Schedule IV, part III(12) "assist in protecting the legitimate interests of the company, its shareholders and its employees;"

This article is a guide to how directors, who want to attempt fulfilling this obligation, can do so. To start with, it is necessary to accept that we lack the tools needed to achieve the letter of the law; namely, to balance conflicting interests of different stakeholders. Achievement of balance can only be proven if there exists a unitary measure in which disparate interests can be measured. There exists no such measure. Purely commercial interests can, perhaps, be reduced to rupees or dollars, often by huge leaps of logic. But many stakeholders and even more, many interests, might be intangible and will not submit to a monetary valuation. How does one measure the beauty of a fresh morning or the delight of a bird's song? What if in its attempt to earn still greater profits a cement kiln deprives a neighbouring community of either?

Consider the following situations.

1. A company is laying a railway to link a newly acquired coal mine to its power station. It can lay a direct route, which bisects a wild-life migration

corridor, or it can go around the jungle, adding to the cost of the power to be generated. In the former case the power would be amongst the cheapest on the market, in the bottom quartile, versus slightly above median cost in the latter option.

2. A property development company is bidding for land along the strand in a large city. At the prevailing prices the project could only be profitable if 25 storey towers are constructed. These would block the sea breeze that a large part of the town enjoys and kill migratory birds that would fly into the glass facades. If the company did not bid, there would be other competitors who would gladly execute the project.
3. A manufacturer of heavy machinery sources many of its components from small manufacturers. Many of these vendors were developed with assistance from the manufacturer and depend on it for almost all of their business. The manufacturer is very profitable. Should it subject them to cut-throat competitive pricing (new vendors have entered the market) or should it agree to a price in which they too share in some of the overall success? What percentage, from 0 to 100, should this be?
4. In open bidding, a power company has agreed to supply power to a city at a fixed price for 25 years. The unexpected rise in cost of fuel has made this agreement onerous and it could threaten the company's survival. Should the company renege on the agreement, banking on the legal system delaying a conclusion for about 15 years?

Take the first example. The beneficiaries of laying the railway track through the jungle would be the consumers of power across the country, the company's employees, its shareholders, the taxman and its lenders. On the other hand the losers would be the wild life (including the risk of eventual extinction of some species), local tribes dependent on forest produce, people living nearby who would lose a source of oxygen, the loss of visual beauty to current and future generations that could visit this jungle and the drying up of aquifers beneath the jungle leading to water shortages to farms and towns down-stream. How would the management be able to put a value to each of these gains and losses?

The same difficulty assails the hypothetical boards of directors confronted by the other three examples. This is one basic reason that virtually all independent directors and boards have refused to tackle this issue. But what if the company is challenged by a stakeholder with failure to meet this fundamental obligation? What conduct will let the management and the board off the hook?

Here are some ideas that enlightened boards may want to consider.

A. First, the vision and mission of the company should capture its obligation to all stakeholders. Currently, all these statements generally urge greater growth whilst paying mandatory lip-service to a greater good. There are also good examples. The oft quoted example of a good mission statement is that drafted under the former chairman of Unilever plc, Paul Polman in 2010, called "The Unilever Sustainable Living Plan." (Unilever plc, 2010)
B. The board and management then need to agree on who are their stakeholders. Most companies would have a broad list of seven or eight of them ranging from vendors to future generations (the environment). Because stakeholders are not only those who are impacted by what the company does but even those who can, in reverse, impact the company, some not-so-obvious parties such as NGO's or other businesses that have no contractual relationships will be added to the list.
C. After this list is nailed down begins the far more difficult task of identifying their interests. Most directors' and managers' first reaction to this requirement is to state that they always respect stakeholders' interests. On further reflection it will be apparent that what they are referring to is those stakeholders' rights as conferred by law or by contract. But interests go well beyond plain rights. The latter can be demanded in a court if not fulfilled. The former are on less firm ground. The interests of the nearly eight billion people on Earth in the invention of and fair access to vaccines and treatments for the Covid 19 virus is beyond all measure. But they have no rights to demand it. Under our Companies Act, Indian companies that invent the vaccine or the treatment are obliged to provide it equitably. This may not be obvious without a reference to the above quoted provisions.

   It might be necessary to have focus group discussions of different stakeholders for identifying interests. Other alternatives could include studies by schools of social sciences or business associations. Even those with a commercial relationship might have interests beyond mere contractual compliance. For example, vendors might seek to have long-term relationships, or they might want to share in the growth of the business. Even within the same class of stakeholders, interests might differ depending on size, legal constitution, location or stage of life cycle. A supplier of minerals in Africa would have interests quite different from those of a supplier of high precision components in Germany.
D. Having identified stakeholders, the next task is to decide thresholds of materiality. The first obvious question is materiality from whose perspective – that of each individual stakeholder or of the business? Generally, one would assume the latter. After all, what is material to a small canteen contractor to a project site, whose annual sales might be four lakh rupees would be below insignificance to the fifty thousand crore rupees company that operates that site. But a sensitive board would draw red lines. So, whilst the company might not invest in training that contractor to manage a site canteen better, it could require that when his contract is given or renewed the terms are equitable and he is not squeezed unduly

to reduce price. Most managers are rewarded for throttling vendors to a point just short of fatal in the never-ending search for cost cuts; they sometimes cut so close to the bone as to kill the unfortunate vendor. This is certainly not the way that vendor's interest is supposed to be recognised.

E. Having determined materiality thresholds, managers must devise systems to measure the impact of their decisions. Certain measures would be monetary – the amount of sales made (customers), the value of taxes paid (government), the investment in skills upgradation (employees or contractors), etc. Some would be in quantitative terms – the quantity of greenhouse gases generated (future generations), the number of trees cut down (present generation, assuming successful compensatory plantation), the numbers of children who grew into good citizens (community), etc. Some would not be measurable – the denial of fresh breezes or sunlight to homes obstructed by sky-scrapers, the loss of the beauty of a natural landscape blighted by wind turbines of fields of solar panels, the irritation caused in their neighbourhood by noisy factories, the extinction of a rare species by mindless destruction of their special habitat, etc. Boards and managers would need to decide on which side of their red line each such case would lie. Is the need for transmitting solar power cheaply from Rajasthan to Delhi justification enough for the extinction of the rare Great Indian Bustard? Would saving them justify charging its residents 1 extra per unit of power?

F. The company has to amend its processes and systems to incorporate consideration of stakeholder impact in all decisions. Management decisions have been designed to address the financial impact, in other words, the impact on shareholder value. Over the years many tools and techniques have been developed for this: inviting quotations to buy cheapest, net present value to equate different cash flows, various ratios, credit limits, there are hundreds of these. Now companies need to incorporate measures for impact on other stakeholders to provide decision makers with relevant information. Managers would need to judge if the gain to one or more stakeholders appears to outweigh the loss to others; if so, the decision can be made. Since there is no common unit of measurement, basic criteria would be needed. Taking the example given above, should the nearly extinct G.I. Bustard be sacrificed so that consumers of power in Delhi can save a few hundred rupees each month? Should a struggling vendor be supported even if the purchase from him is 10% more expensive than the cheapest equivalent material? This would require extensive training of managers that sensitised them to values other than saving money. It would need auditors to understand and appreciate decisions made in this fashion without a clear justification for them. Most importantly, it would require controlling shareholders, who still call all the shots, to really put their money where their vision and mission statements claim they put it.

G. More important than all others, company strategy would need to be designed to get into businesses and conduct them in a way that are stakeholder friendly, not only those that give the biggest NPV.

H. Directors might benefit from attending stakeholder meetings – employee town-halls, customer and vendor meets, meetings with local community leaders, with regulators, with major lenders, with NGO's, etc.

I. Companies would need to provide their stakeholders with information that measures their interests or enables them to judge if, overall, there is an increase in the returns each group of stakeholders earns in cash and kind. Not every individual stakeholder might be a beneficiary but as a group, each should feel that their interests have been recognised and given due weightage in the way business has been conducted.

J. In conclusion, this would require a total overhaul of culture in the organisation. The way people are evaluated and measured, the way they are rewarded, the knowledge and attributes they are required to possess, etc.

Very few controlling shareholders are likely to be so enlightened as to support this change. But change we must if humankind is to avoid eventual extinction brought on by the climate change it is causing. It would require companies to accept that business growth is the mantra that is the cause of the disaster that we are rushing headlong into. Young managers are today sensitive to this unless they have been indoctrinated in US style business schools. Independent directors need to be the champions, the torch bearers for this new corporation. This is not a trivial change. If it works, it will save the World from a massive calamity. If it does not, independent directors will be amongst the prime accused, witnesses to a disaster they could have prevented.