

Satyam's Nemesis

Are Independent Directors Truly Independent?

There are lessons to be learnt from Satyam's nemesis. Markets have begun to punish both greedy promoters & greedy financiers who turned the financial innovations on innocent investors as weapons of massive destruction. It should have been evident to Satyam promoters from the causes of market downturn. Ironically heads of five investment banks who ruined their shareholders and their long established brands lost \$2.2 billion of their personal wealth between them. The complete lack of trust in the market place despite government bailouts is further example of markets' nemesis on greed driven capitalism.

Satyam, India's fourth largest information technology outsourcing company by revenue is choking on its own vomit. None of the measures to bring back investor confidence such as share buyback, an increase in its dividend payout or other steps to try to reverse the fallout from the infamous deal is helping it to resuscitate itself.

Satyam first proposed to spend \$1.6bn on acquiring real estate and infrastructure companies Maytas Properties and Maytas Infra, but then abruptly cancelled the deal only seven hours later after an unprecedented revolt from India's normally subdued institutional investor community.

The deal outraged investors because Satyam, which is only 8.6 per cent owned by the family of Satyam chairman and founder B. Ramalinga Raju, (recent reports say promoters had used their equity as collateral) elected to buy out Maytas Properties and Maytas Infra without seeking independent shareholder approval.

In an unprecedented show of no-confidence, Citigroup, JP Morgan and Merrill Lynch downgraded Satyam over the proposed acquisition and slashed their share price estimates by up to half.

"While the deal cancellation is positive, investor confidence has been dented," Citigroup said in a client note. "We are respecting the views of all the investor community and we were very quick to ... call off the deal," Srinivas Vladamani, chief financial officer told the Financial Times late Wednesday. "Now we want to take investor confidence building measures like meeting investors, and taking some steps like a buyback, a higher dividend and those things."

As a consequence of the fallout, four independent directors have resigned. These include Mangalam Srinivasan, Vinod K Dham, Krishna G Palepu and M Rammohan Rao. This brings in to focus once again the role of the independent directors. Securities & Exchange Board of India (SEBI) in line with its counterparts worldwide has been moving to get listed companies to constitute 50% of the board as independent directors with a view to improving the standards of corporate governance. SEBI has specified principles of corporate governance and introduced a new clause 49 in the Listing agreement of India's Stock Exchanges. On 26 April 2003 SEBI advised all Stock Exchanges in India to ensure compliance of the revised clause 49 on or before March 31, 2004. The clause applied to all listed entities having a paid up share capital of Rs 3 crores (£400,000 approx) or net worth of Rs 25 crores (£3 million) at any time in the history of the company.

These requirements have created a lot of controversy because these required listed companies with share capital in excess of Rs 5 crores to have a majority of the minimum seven directors of listed companies to be independent. In a yet another move India's Ministry of Company affairs appointed a committee under J.R. Irani that has recommended at least a third of the directors to be independent.

Clause 49 of the listing agreement defines independent directors as follows:

- a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
- b. as not related to promoters or management at the board level or at one level below the board;
- c. has not been an executive of foe company in the immediately preceding three financial years;
- d. is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
- e. is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and
- f. is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

For the purpose of this clause the expression 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors.

The key difference between a non-executive & non-executive independent director is that the latter is forbidden to have any pecuniary relationship with the company apart from receiving a sitting fee which has been raised from Rs. 5000/- to Rs. 20,000/-. Can we truly justify a fee of \$450 for a few hours work in a country where the average wage is less than \$3 a day?

According to independent surveys independent directors are raking Rs 8-12 lacs a year per company in commissions alone. Add to this the sitting fees and the total can be Rs 12-16 lacs a year. At present you can be a director on the board of 15 listed companies. So you could be richer by almost 2 crores a year. What is then the difference between a non-executive and independent director?

Analysis of 2004 US compensation data shows that average remuneration of non-employee directors of the top 200 US companies rose by 13.4% to \$177000. These doubled in 2008. New compensation arrangements in Goldman Sachs meant directors were offered restricted stock worth \$280,000 a year plus a retainers of upto \$100,000. Would you expect an independent director who is dependent on the CEO on this kind of sum for barely a few days work in a year act more independently than an executive directors who earns the same amount for working throughout the year?

Independent directors are the cornerstone of good corporate governance. Theirs is the duty to provide an unbiased, independent, varied and experienced perspective to the board. Corporate scandals of ENRON & Worldcom have revealed how this independence has been compromised by a cosy relationship between the CEO even with the so called independent directors. The chairman of the audit committee of ENRON was no less a person than the Dean of Stanford Business School. Yet he could not spot the murky goings on in the company? Same has been true of auditors. Why auditors of the status of Arthur Andersen allowed the deception to continue for so long. In both cases the independence was compromised by expectation of excessive rewards. Should we not draw lessons? When a director has developed a stake in a company to the tune of Rs 10-15 lacs a year would he be able to risk it all by going against the current? This is a hard bat to knock.

We must not forget that we are talking of corporate India where a vast majority of listed companies have destroyed shareholder value. A survey by the Society for Capital Market Research & Development indicated that of the 6330 BSE listed companies only 21.5% had paid dividend in 2002-2003. Of all the 9644 listed companies only 16% are dividend paying. 83% of the listed companies in B2 Group, T Group and Z Group have destroyed shareholders value. Again we are talking of a corporate India where Companies (Amendment) Bill 2003 which sought some modest changes to the Companies Act specially with reference

to the composition of the board has been abandoned due to the hectic lobbying by corporates. Such changes have already been enacted in the USA & UK in the aftermath of high profile corporate collapses though not without opposition. Both Naresh Chandra and Derek Higgs were commissioned to look into the role of independent directors at the same time in early 2002. Both submitted their reports also about the same time. Both reports created minor storm. Indeed the one in UK was stronger. Chairmen of all FTSE 100 companies revolted against Derek Higgs recommendations.

Despite this almost all of these recommendations have become part of the UK's Combined Code on Corporate Governance and came into effect from 1st November 2003. We may have to wait another year for the redrafted companies bill.

The question we have to ask ourselves is "are independent directors truly independent?" All these companies Enron, WorldCom, and now Satyam had high profile independent directors. Henry Kissinger was a director in Hollinger which was used by Conrad Black to milch shareholders. In the celebrated case of Walt Disney where Delaware Judge Chandler has scolded Michael Eisner for being imperious and Machiavellian, it was shown that Eisner frequently used the Disney board as a rubber stamp even though it was packed with numerous non employee directors who by today's definition would be classified independent. These independent directors included Eisner's personal lawyer, his architect and the principal of elementary school attended by his children.

A solution to eliminate the cosy relationship between independent directors and their companies can be found by creating an independent body under the regulator such as Securities and Exchange Commission (SEBI in India). It is this organisation which will be charged with the role of screening and recruiting independent directors and placing them with listed companies. All fees and allowances to the independent directors are to be paid by the independent organisation. The organisation should be funded through a special levy charged by the regulator from each listed company based on the turnover of the company.

In the selection of independent directors we must not look simply for high profile names. The issue is not of lending name but having some one with an independent state of mind. An independent director without the ability to act independently can be worse than an executive director. Hollinger International, publisher of London's Daily Telegraph and the Chicago SunTimes, had people like Henry Kissinger on their board. Yet they could not stop the ousted Chief Executive Conrad Black from receiving \$32 million in unauthorized payments.

The corporate shenanigans leading to subprime crisis, destruction of shareholder values by investment giants like Goldman Sachs, Merrill Lynch, Morgan Stanley and dissolution of Bear Stearn and Lehman Brothers demonstrate that the institution of independent directors has sadly failed to make a dent. This has been largely due to two reasons. The inadequate time the independent directors spend in board meetings. Surveys conducted by the World Council for Corporate Governance showed that independent directors, unless they were part of a committee, spent barely 14 hours a year in board meetings. Secondly most lacked the communication skills to ask searching and uncomfortable questions.

Bill Brodsky, chief executive of the Chicago Board Options Exchange, said the Madoffs Ponzie scandal showed that SEC staff had not received enough training to enable them sufficiently to check for fraud. "The people doing the examinations have no clue what the right questions are to ask," he said in an interview with the Financial Times. "Going in and asking questions out of a manual doesn't help you understand how a business works."

Asking questions properly is the key to board effectiveness. Sadly there is little training & investment of companies in this direction.

In the case of Satyam, the scenario is different because two of the independents are distinguished academics, and one an acclaimed authority on corporate governance. Once again big names are no guarantee for good corporate governance. After all the chairman of the audit committee of ENRON was no less a person than a dean of the Stanford Business School.

Warren Buffet, the sage of American Capital Market in his annual letter to the shareholders of his Berkshire Hathaway investment company last year specially lamented about the failure of independent directors to protect the interest of shareholders. He focused on the failures of "Intelligent and decent directors" to sack mediocre managers or to stop greedy ones from dipping into shareholders' pockets.

He blamed the cosy "boardroom culture" with "well-mannered people" finding it almost impossible to suggest replacing the chief executive. He said that questioning their remuneration would be like "Belching at the dinner table". Independent directors are our only hope to instill some discipline in the murky world of corporate finance. They act as an insurance against short changing of investors. We have to make sure that then selection and training are carried out in a most professional & transparent manner even if it means "belching at the dinner table".

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