

EXPLORING THE DUE DILIGENCE PROCESS FOR INDEPENDENT DIRECTORS IN INDIA



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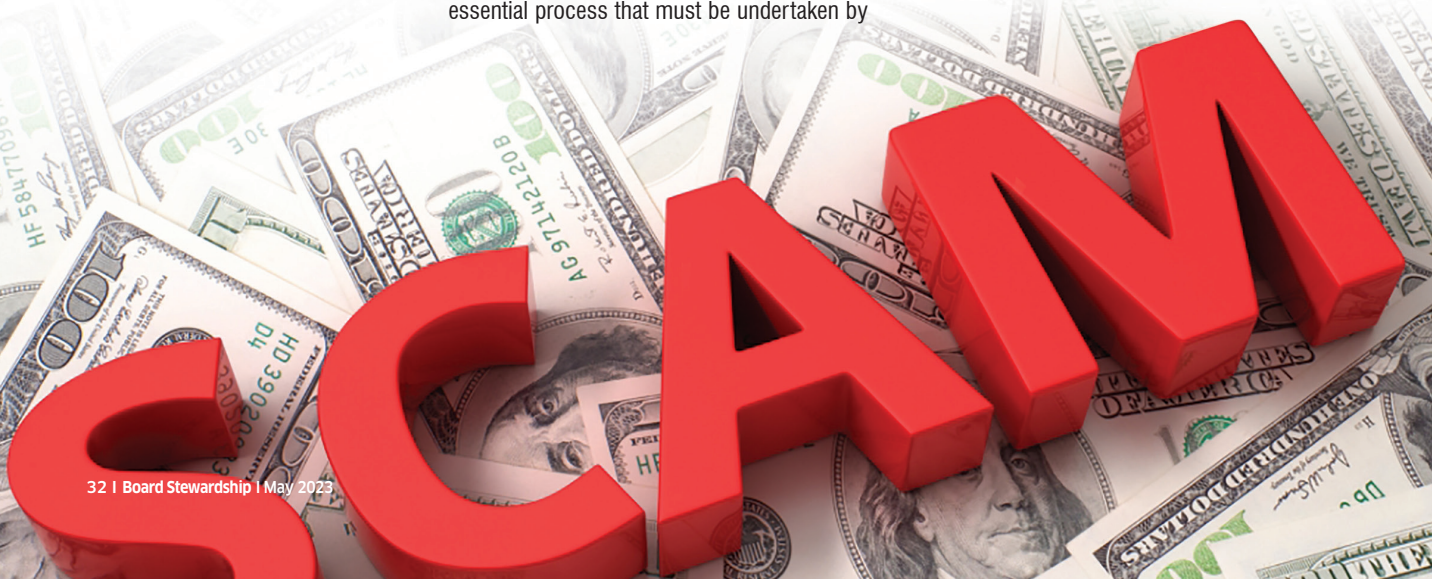
In India, Independent Directors, and their roles evolved as a response to several corporate scandals and frauds in the country in the early 2000s. The introduction of Independent Directors was aimed to improve Corporate Governance and increase transparency in the management of companies.

One of India's most significant corporate scandals was the Satyam Computer Services scandal in 2009, wherein the Indian IT company was caught in a massive accounting fraud worth \$1.5 billion. The scandal highlighted the lack of transparency and accountability in the company's management, and it became clear that the existing Corporate Governance mechanisms were ineffective in preventing such fraudulent events. In response to this scandal, the Indian government made it mandatory for all listed companies to have at least one-third of their board members as Independent Directors if the chairperson of the board is a Non-Executive Member. In other cases, Independent Directors should constitute at least 50 percent of the board. Due diligence is an essential process that must be undertaken by

Independent Directors when selecting companies to join. The Companies Act, 2013 the primary legislation governing the operation of companies in India, outlines the responsibilities and obligations of Independent Directors. This article will explore the due diligence process that Independent Directors must follow while selecting companies to join.

1 Section 149(12) of Companies Act, 2013

An Independent or Non-Executive Director can only be held accountable for company actions that occurred with the director's knowledge, were traceable to board procedures, with his consent or connivance, or where he failed to act diligently.





2 Lacunae in Indian Legislative Statutes

Statutes lack an attribution of liability provisions that distinguish between Executive and Non-Executive Directors. (Both civil and criminal). The Contract Labour (Regulation and Abolition) Act, 1970, the Environment (Protection) Act, 1986, and the Prevention of Money Laundering Act, 2002 are a few such laws.

3 Due Diligence: Company's Operations

Independent Directors must ensure that the company's operations, vision, mission and values align with their own values, beliefs, and principles. Independent Directors must be comfortable with the company's business model, operating procedures, and policies. Understanding the company's financial health and reputation in the market is also essential.

4 Due Diligence: Company's Corporate Governance Policy

The Act requires every listed company to comply with various Corporate Governance norms. These include the appointment of Independent Directors, the composition of the Board of Directors, the establishment of an audit committee, and the disclosure of financial and non-financial information. They must review the company's compliance with these norms and ensure the active pursuance of effective Corporate Governance practices. This review should also include the company's compliance with environmental, social, and governance standards, which have become increasingly relevant in recent years.

5 Due Diligence: Company's Corporate Risk Profile

Independent Directors must understand the company's risk profile; this includes identifying the key risks that the company faces, evaluating the effectiveness of existing risk management strategies, and identifying areas where improvements can be made. Independent Directors must also ensure the company has appropriate insurance coverage to mitigate potential risks.

6 Due Diligence: Company's Financial Statements

Independent Directors must evaluate the accuracy and completeness of the financial statements and ensure that they comply with the relevant accounting standards. They must also review the auditor's report and other relevant reports, such as the management discussion and analysis report. Independent Directors must ensure that the financial statements provide a true and fair view of the company's financial position, performance, and cash flows.

7 Due Diligence: Company's Regulatory Compliance

Independent Directors must review the company's legal and regulatory compliance. They must ensure that the company complies with all applicable laws and regulations, including labour, environmental, and tax laws. They must also review any legal or regulatory proceedings that the company is involved in and assess their potential impact on the company's financial and operational performance.

8 Due Diligence: Company's Related-Party Transactions

Independent Directors must assess the nature and extent of related party transactions and evaluate their fairness to the company and its shareholders. They must also review the company's policy on related party transactions and make sure it complies with the relevant laws and regulations.

9 Due Diligence: Company's Stakeholder Engagement

Independent Directors must assess the company's stakeholder engagement and management practices. They must review the company's policies and practices concerning stakeholder engagement, including employee engagement, customer satisfaction, and community engagement. They must also assess the company's management practices, including its leadership, culture, and talent management.

10 Cases In India Where Independent Directors Have Legal Action Because The Companies They Were Associated With Committed Fraud Or Engaged In Misconduct

IL&FS: In 2019, the Serious Fraud Investigation Office (the "SFIO") filed a charge sheet against nine individuals, including five Independent Directors, concerning the fraud at Infrastructure Leasing and Financial Services (the "IL&FS"). The Independent Directors were accused of failing to exercise due diligence and acting negligently, which led to losses for the company and its investors.

In the Satyam scandal, all the Independent Directors were held accountable and fined. One of the Directors, Harvard University Professor Krishna Palepu was fined Rs. 2.66 crore by a Hyderabad court in 2018. Other luminaries on the board were fined Rs. 20,000 each.

Due diligence is a crucial process that Independent Directors must undertake while selecting companies to join. Independent Directors must review the company's operations, Corporate Governance practices, risk profile, financial statements, legal and regulatory compliance, related party transactions, and stakeholder engagement and management practices. By conducting thorough due diligence, Independent Directors can ensure that they make an informed choice and don't fall into any legal trouble.



Mr. Krrishan Singhania, Founder and Managing Partner at K Singhania & Co is a seasoned professional with comprehensive experience of over 30 years. His legal expertise in corporate & commercial law, arbitration, foreign direct investments is highly respected in the industry and his ideas and opinions can be found in popular legal newsletters and international journals. He is also an empanelled arbitrator with the Bombay High Court.

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