

ARE INDEPENDENT DIRECTORS REALLY INDEPENDENT? – A CROSS JURISDICTIONAL ANALYSIS

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ABSTRACT

The board of directors play a crucial role in a company's prosperity as they are responsible for managing the day-to-day affairs of the company. The board represents several interests. This paper looks at the effectiveness of the concept of independent director as a corporate tool in the Indian context. The concept of independent director originated in developed economies like US and UK as viable alternative to ensure that a company's interest is upheld above all other interests. Same concept has been adopted by India to safeguard the interest of the company. However, the economic backdrop in which the concept of independent director emerged in the developed countries is widely different from India and was ignored by the policy makers. As a result, the companies act not only fails to protect the company's interest but also the independent director himself. Analysis of various scandals in the Indian corporate world has revealed that independent director in India is not independent in the real sense, his appointment and dismissal is at the whims and fancies of the promoter. This paper also aims to analyze recent legislative developments around the concept and suggests amendment in legislative level to protect the companies' interest and minority shareholders' interest.

INTRODUCTION

A company is an association of persons, natural or legal, with a specific objective. This company is a juristic person which acts and conducts business through its board of directors. Consequently, the board forms an essential part of the company. They are responsible for managing the day-to-day affairs of the company while maintaining a fiduciary relationship to the company and its stakeholders. The board represents several interests including but not limited to the interests of the CEO, the promoters, the venture capitals, shareholders with significant holdings etc. Ideally, each director owes to protect the company over all these

interests. However, this may not always be the case. Therefore, an Independent Director is appointed to the board of directors, as he/she has no financial or material relationship with the company or anyone related to it, other than receiving a 'sitting fee'.¹ The rationale behind the appointment of an independent director to the board of directors of a company is to ensure that impartial and objective decisions will lead the company in a favorable direction. Their unique position allows them to act like a watchdog/conscious keeper of general corporate governance and maintain accountability within the internal affairs of the company.²

The concept of independent director was first conceptualized in US as a result of the sudden collapse of Penn Central in 1970. This concept was also discussed by Eisinger in his influential book '*The structure of corporation*' in 1976.³ Post Enron and other corporate scandals, the Sarbanes-Oxley Act and NYSE listing rules mandated that independent directors must hold board majority in domestic and listed companies.⁴ Similarly, the Maxwell communication scandal in UK led to the publication of the Cadbury Report which highlighted the importance of independent directors in improving corporate governance.⁵ The economic liberalization of 1991 relaxed stringent foreign investments policies in India and as a result, Indian companies were able to issue securities to not just domestic but also foreign investors to meet its capital needs. Since most of the foreign investors came from US and UK, the companies voluntarily took up standards of corporate governance prevalent in these countries.⁶ Indian companies also started overseas listing to improve its valuation and build reputation in international market. As a result, the corporate practices of US and UK infiltrated into the standards of corporate governance in India.

This article aims to analyze the current legislation pertaining to independent directors in India and compare their position with the independent directors in the UK and US. This article argues that the concept of independent director, though successful in UK and US, has failed

¹ Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U. L. REV. 898, 899-900 (1996)

² Dr. G. K. KAPOOR & Dr. SANJAY DHAMIJA, COMPANY LAW AND PRACTICE, TAXMAN, at 449, (23rd ed., 2018)

³ Donald C. Clark, Three Concepts of the Independent Director, GW Law Faculty Publications 32 Del. J. Corp. L. 73 (2007)

<https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=1045&context=faculty_publications>

⁴ Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Vol 6, No. 2 Hastings Business Law Journal (2010)

⁵ Jay Dahya & John J. McConnell, Board Composition, Corporate Performance, and the Cadbury Committee Recommendation I (2005), available at <<http://ssrn.com/abstract=687429>>

⁶ Umakanth Varottil, A Cautionary Tale of the Transplant Effect on Indian Corporate Governance, National Law School of India Review, Vol. 21 No. 1, p.1 (2010)

<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1331581>

to bring in the desired effect in India. Further, the analysis of recent corporate scandals in India unveils that the adoption of this concept of independent director as a tool for corporate governance is ineffective, emphasizing the reality that simply categorizing a director as 'independent' does not guarantee that he is actually independent.

POLICY AND LEGISLATIVE ANALYSIS

Post the infamous Satyam scandal, the Indian government tried to revamp the Indian corporate world by enacting the companies Act, 2013. The standing committee in 2009 observed that ineffectiveness of the independent directors was one of the main reasons behind the Satyam fiasco.⁷ Subsequently, the uncertainty regarding the functions, liabilities and the duties of the independent director was put to an end by the 2013 amendment to the companies act. Where the chairperson of the board of directors of a public listed company is a non-executive director, the statute now mandates that at least one-third of the board to comprise of independent directors.⁸ In the absence of a non-executive chairperson, the statute mandates at least one-half of the board to comprise of independent directors.⁹

Section 149(6) of the act further provides conditions for appointment of an independent director.¹⁰ A candidate can be appointment as an independent director only if he is a person of 'integrity' and holds experience in the field of law, marketing, administration etc.¹¹ He should not have any pecuniary relationship with the company apart from receiving remuneration for his services which includes not having a pecuniary relationship with the company, its holdings, subsidiary or associate company.¹² Section 149(6) also lays down restriction on the professional relationship and voting power of the independent directors. The idea is to have individuals on the board of directors who are not blinded by specific interests while taking objective decisions. An independent director this way is intended to keep the interest of the company and that of the minority shareholders above the interests of other powerful stakeholders. The code for independent directors imposes liability on the

⁷21st Report, Standing Committee of Finance, The Companies Bill, 2009

⁸The Companies Act, 2013, §149(4)

⁹The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Rule 4

¹⁰The Companies Act, 2013, § 149(6)

¹¹The Companies (Appointment and Qualifications of Directors) Rules, 2014, Rule 5

¹²The Companies Act, 2013, §149(6)(c)

independent director to be versed with the functioning of the company, detect and avoid any possible fraud and any other unethical behavior.¹³

Recent events of the Indian corporate world demonstrate that the companies act, 2013 has failed to fulfill its objectives. The recent Jet Airways and IL&FS scams have brought the role of independent directors in a company's board to the public eye. After the internal concerns in Jet Airways were brought to light,¹⁴ several independent directors served their resignation letter, stepping down from the board. A similar trend was noticed in IL&FS when the company failed to fulfill its payment obligation.¹⁵ A study by NSE reported that nearly 2000 independent directors resigned from their posts recently.¹⁶ An overzealous interpretation of Section 149(12) could be a contributing factor to this increasing resignation rates, as an independent director is held liable only when the wrongful act occurred with his knowledge. Such data pose serious questions regarding the concept of independent director as a tool for corporate governance, as these directors seem to often run away from their responsibilities instead of protecting the minority interest and disclosing any failure of standards of corporate governance within a company.

The shady removal of Nusli Wadia as an independent director from the board of Tata Chemicals, Tata Motors and Tata Steel for rebelling against the promoter and disclosing corporate governance grievances highlights the other part of the issue regarding the concept of independent director.¹⁷ The unjust removal of Mr. Wadia suggests that even in cases where the independent director performs his duties religiously, his tenure will be still at mercy of the promoters, thereby raising concerns about the independence of Independent directors.

¹³Code of Conduct for Independent Directors, Schedule IV, The Companies Act, 2013

¹⁴Asish K Bhattacharyya, Grounding of Jet Airways: Misgovernance of Family Business, Business Standard, (2019)

<https://www.independentdirectorsdatabank.in/pdf/partners/imt/Grounding_of_Jet_Airways_Misgovernance_of_family_business-A_case_study.pdf>

¹⁵Meena Bhatia, IL&FS Fallout: Is it a Business Failure or Corporate Governance Failure?, South Asian Journal of Business and Management Cases (2020)

<https://www.researchgate.net/publication/339643162_ILFS_Fallout_Is_it_a_Business_Failure_or_Corporate_Governance_Failure>

¹⁶Subrata Sarkar, Strengthening the Institution of Independent Directors, Chapter 15, 10 NSE Corporate Governance (2019)

¹⁷Dhameja, Nand L., and Vijay Agarwal, Corporate Governance Structure: Issues & Challenges – Cases of Tata Sons & Infosys, Indian Journal of Industrial Relations, vol. 53, no. 1, (2017), pp. 72–85

<www.jstor.org/stable/26536438> Accessed 5 June 2021

COMPARATIVE ANALYSIS OF OWNERSHIP PATTERN: US, UK AND INDIA

Before analyzing the 'independence' of an independent director, it is important to understand the ownership structure that distinguishes Indian corporations from their UK and US counterparts. Thompson and Nestor bifurcated the system of corporate governance into outsider and insider model based on the ownership structure of the corporation. An outsider model is where the ownership is scattered in the corporate system. In such a system, the shareholder takes up a passive role and does not show any interest or maintain any relation in the day to day activities of the corporation except for their financial contribution.¹⁸ There is a clear-cut separation of ownership and control.¹⁹ The corporate system of UK and US follow this outsider model.

Unlike US and UK, the ownership structure of Indian corporations follows the insider model of corporate governance where shareholders take up an active role, having direct interest and relation with the corporation. The significant part of the shareholding is under the possession of the controlling group (the insiders) while the rest of the shareholding is scattered amongst the public. The Indian economy was subjected to several phases of structural reforms since independence.²⁰ Between 1950 and 1970, The new Indian government intervened through system of license raj and economic production quotas which ensured that only few business families and industrial groups thrived. These groups often held significant chunks of ownership in public companies and exert influence over the corporation at the expense of the minority shareholders, thus making insider model the norm in India.²¹

A corporate governance system is effective only if it addresses and corrects the agency problem that companies face.²² As discussed above, owing to liberalization, cross listing and with an aim to increase foreign investment; India adopted the corporate governance system similar to US and UK without paying heed to the nature of corporation that exists here. Each model has an agency problem specific to it. The agency problem in an outsider system is the one between the manager and the shareholder whereas in an insider model it is between the

¹⁸ Erik Berglof, Ernst-Ludwig von Thadden, The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries, (1999) <<https://ssrn.com/abstract=183708>>

¹⁹ Brian R. Cheffins, Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom in JOSEPH A. MCCAHERY, PIET MOERLAND, THEO RAAIJMAKERS & LUC RENNEBOOG (EDS.), CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 151 (2002)

²⁰ RANDALL K MORCK, A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, University of Chicago Press (2005)

²¹ Id

²² Pranav Mittal, The Role of Independent Directors in Corporate Governance, NUJS Law Review, 4 NUJS L.Rev. 285 (2011)

minority and majority shareholder. By transcribing the corporate governance system aimed to tackle the agency problem in an outsider system, India not only failed to address the underlying issues faced by the corporations, but this blind transplantation has exacerbated the corporate scandals.

CORPORATE SCAMS AND HOW INDIA HAS HANDLED ITS AFTERMATH

The appointment and removal of the independent directors are core elements that endanger the independence of an independent director. Up until this point, under the SEBI regulations and Company law provisions, an independent director is appointed to the board of directors by the shareholders, by passing an ordinary resolution in the general meeting. Section 152(2) which deals with appointment of director does not distinguish an independent director from other forms of directors.²³ However, in a bid to change the board dynamics the Security Exchange Board of India has passed new amendments to the Listing Obligations and Disclosure Requirements (LODR) concerning listed companies in India. These amendments are set to come to effect from 1st January 2022. Through these amendments, the appointment and removal of independent directors will now be possible only through a special resolution that is passed by the shareholders. Shareholder approval for appointment of all directors including Independent directors shall be taken at the next general meeting, or within three months of the appointment on the Board, whichever is earlier.

The nomination and Remuneration committee simply 'recommend' candidates for the post of an independent director, the ultimate power to appoint the candidates as independent directors lies with the majority shareholder. With the newly passed amendment by SEBI in June 2021, the process to be followed by Nomination and Remuneration Committee (NRC), while selecting candidates for appointment as independent directors, has been elaborated and made more transparent including enhanced disclosures regarding the skills required for appointment as an independent director and how the proposed candidate fits into that skillset. These amendments provide greater voice to independent directors in the NRC and Audit Committee, mandating two-thirds of these committees to comprise independent directors. Although this might have a positive effect, one has to note that the proposal to have only those directors not related to the promoters to be on the Audit Committee has not been duly approved as of now. With these amendments, SEBI has essentially mandated a structured

²³The Companies Act, 2013, §152(2)

process to be run by the Nomination and Remuneration Committee and has enhanced its role and transparency to ensure that the right person is appointed as independent director (rather than someone merely recommended by the promoter). In a country like India, where promoters hold majority stakes in nearly 66.66% of all public listed companies, the outcome of the election process can be easily influenced by the majority in the general meeting.²⁴ The appointed independent director may feel a sense of loyalty towards the promoters of the company for this reason. Similarly, section 169 which deals with removal of directors does not distinguish independent director and other directors; independent director can be removed as per the whims and fancies of the promoter by passing an ordinary resolution at the general meeting.²⁵

Discussion of the Satyam scam, one of the biggest corporate frauds in the Indian corporate world, is crucial while discussing the effectiveness of concept of independent directors. The company was alleged to have seriously duped and falsified its accounts thereby exaggerating its profit.²⁶ This company was not only listed in NYSE but also complied with Clause 49 and the SOX Act.²⁷ The company had appointed highly skilled independent directors to its board. The independent director was supposed to oversee and identify fraud taking place within the company. Ramalinga Raju, the promoter of the company held only 5% of the shareholding but continued to hold significant control over the affairs of the company. The Satyam Scandal therefore demonstrates that the promoter can exert control over the independent directors even with minimal shareholding.²⁸ Similar case is seen with the corporate giant Infosys, where a whistle-blower complaint has alleged the top executives of the company to be involved in unethical practices and financial irregularities.²⁹ There are also allegations of “haphazard” working of the audit committee which highlights the lack of independence of the directors as the stewardship code was not being followed. SEBI has now gotten involved and has ordered for a thorough investigation on this matter.

²⁴ Ownership Structure of Listed Companies in India, OECD, (2020)

<<https://www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf>> at pp. 10

²⁵ The Companies Act, 2013, §169

²⁶ Dr. Kotishwar Aarugonda, The Role of Independent Directors in Corporate Governance- A Critical Evaluation, International Journal of Research in Computer Application Commerce and Management, 1.27-34 (2011)

²⁷ Indian Stock Exchange Listing Agreement, Clause 49; The Sarbanes-Oxley Act, 2002, § 302&404

²⁸ Supra note 6

²⁹ Jayshree P. Upadhyay, SEBI Plans to Get Tough of Infosys, Orders Forensic Probe of Allegations, LiveMint (2020) <<https://www.livemint.com/companies/news/infosys-probe-sebi-gets-tough-on-infosys-to-order-a-forensic-probe-11579791521994.html>>

One way of redressal adopted by our judiciary to avoid such embarrassing corporate conduct is by going ahead and incorporating ‘independent directors’ under the definition of “officer in default”. This way, an independent director will be held liable for financial and criminal penalty for any misconduct that takes place within the internal affairs of the company.³⁰ However, when such situations arise, these directors have often used the defence of misconduct happening without their consent and outside their knowledge. This way, the directors face no real consequence for the kind of reputation damage that India suffers in the international market due to these corporate scandals.

Due to these mounting failures of the current corporate governance system, SEBI has recently published some recommendations to improve the functioning of these independent directors.³¹ Two main proposals in this regard concern the appointment and removal of these independent directors. SEBI is proposed a dual approval method to be adopted where the appointment of directors must not only be based on the passing of an ordinary resolution but should also require approval from the minority shareholders. In terms of resignation, SEBI proposed that these directors must unveil their resignation to all the shareholders so that there is more open communication and clarity as there have been several questionable instances involving resignation of independent directors. This recommendation is once again synonymous to how independent directors get appointed in a listed company in UK.³² The listing rules mandates a two-step process of approval before an independent director can get appointed thereby giving the non-promoter or public shareholders more control over such appointments.

In addition to this, the ministry of corporate affairs has established a new ‘test’ which applicants have to pass with at least 60% to be eligible for appointment as an independent director. The aim of this test is to test their knowledge and proficiency in corporate affairs and management. The applicants also have to enrol into a databank of the government through which the companies will be choosing the director. While having such a test can be seen prudent as it establishes the candidate’s ‘eligibility’ it cannot be a guarantee for their overall conduct in the board. Even after passing this test, someone having a profit motive can

³⁰ N.K. Wahi v. Sekhar Singh and others, (2007) 9 SCC 481

³¹ Consultation Paper on Review of Regulatory Provisions Related to Independent Directors, SEBI, (2021)

³² U.K. Sinha, Saumya Sahai, Redefining the Process of Appointment of Independent Directors, Prime Data Base, (2020), <<https://www.primedatabase.com/article/2020/Article-U.K.Sinha%20&%20Saumya%20Sahai.pdf>>

be a defective director. Amendments in law therefore cannot be the answer for such matters as it is a behaviour issue rather than a legal one.

CONCLUSION

Through this discourse, it has become evident that independence of directors has evolved into a common governance feature all over the world. However, the outcome of having independent directors seems to not be universal as it largely depends on the type of industry structure and agency problems that different jurisdictions face. While the recent SEBI recommendation of involving public investors in the voting process of appointing independent directors in India has largely been welcomed, this paper argues that even this change might not bring a desirous change in the Indian corporate climate that is dominated by controlled companies. This is because, while many scholars in this field believe that the involvement of minority investors could help in creating a more transparent process, in a country like India which has a misguided and naïve general public, it is very much possible that these minority shareholders might not be having the required knowledge to take these decisions which are of such high stakes. This is why, the better alternative to make independent directors more responsive and effective is through the involvement of non-activist institutional investors.³³ Having non-profit associations that represents the interests of such minority investors will create an environment where appointment and removal of independent directors is neither at the whims of the promoter nor with the scattered minority shareholders but with trusted institution which is aware of minority interests and possess market knowledge. Lastly, it is crucial for India to stop merely adopting a governance strategy from first world countries without customizing it to match the requirements of our domestic market as these restrictive provisions can create an environment which coerces efficient independent directors to resign to avoid liability as they are at present underpaid, underpowered yet over-obligated.

³³Giovanni Strampelli, How to Enhance Directors' Independence at Controlled Companies. Oxford Business Law Blog, (2018) <<https://www.law.ox.ac.uk/business-law-blog/blog/2018/11/how-enhance-directors-independence-controlled-companies>>