

OP Jindal Global University

Jindal Global Law School

Title - **“Independent” director a myth**

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Research Question - Are Independent Directors really independent?

Research methodology - The Research Methodology used for this paper is legal research. This research entails analysing various secondary sources like Journals, articles, websites and various statutes and case studies.

Justification for the Topic - The independence of Independent directors is an important factor to be considered when it comes to the corporate governance and especially when we have a concentrated shareholding pattern. The rights of the minority shareholders, maintaining transparency in the management of the company and policy decisions which are very much central part of running of any company. But in order to fulfil all these duties it is important that the independent director is independent free from any constraints of the Board of Directors or promoters.

Interest of the Legal community - I think that the topic of independent directors have been an interest of legal community because of its role of independent director in the corporate governance. The legal community had talked in detail about how independent directors are becoming target of the scandals by the promoters and majority shareholders. And one of the reason why we are having huge frauds in the corporate sector, as no independence is given to the independent directors.

“Independent” director a myth

Corporate Governance as per Sir Adrian Cadbury “Corporate governance is the system by which companies are directed and controlled”¹. As per M. Damodaran corporate governance is a continuing process which is beyond the scope of a legislation². Having ensure that corporate governance will captivate capital and ensuring transparency in the system will thereby attract more investors. Therefore in order to maintain this transparency it is important that independent directors are part of the system, “both the willingness and ability to sustain...rigor and sceptical objectivity when its sponsored by or especially beneficial to the (controlling shareholder)”³.

The Indian corporate sector is dominated by concentrated shareholding pattern or family dominated business. In this corporate set up major stake holdings are in the hands of concentrated people and it becomes difficult to extract information by the independent directors in this setup⁴. This kind of controlling nature of the firms leads to expropriating of the assets of the minority shareholders and lack of transparency⁵. This is where the role of independent directors in a company is of vital importance in order to have transparency in the management of the company and prevent the exploitation of the minority shareholders and prevention of corporate fraud.

The present legislation regulating the corporate sector in India is The Companies Act, 2013 who’s predecessor is The Companies Act, 1956. The 1956 act caused uncertainty as it did not have proper provisions regarding the role of independent director, their duties,

¹ Developing Corporate Governance Codes of Best Practice. (n.d.). Retrieved October 06, 2020, from <http://documents1.worldbank.org/curated/en/194571468330288811/pdf/346690v20Corporate0governance0Rationale.pdf>

² THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE. (n.d.). Retrieved October 06, 2020, from <http://docs.manupatra.in/newsline/articles/Upload/54EB39FB-D867-4B4A-ADE3-0CDD27749B0F.pdf>

³ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

⁴ Supranote 1

⁵ Supranote 3

functions and appointments. Nor the Securities and Exchange Board of India (SEBI) had any such provisions regarding independent directors. But post Satyam there were major changes in the role of independent directors and was given importance. But we notice there has been immense backlash to the independent directors of Satyam for not being able to detect the fraud. This led to a reputational injury and made several Indian independent directors to worry, that the independent directors will be held responsible for the misconduct taken on by the Promoters. So the question which arises is that are independent directors really independent and are they responsible for the corporate frauds?

B. Ramalinga Raju who was the founder and chairman of Satyam Computer Services. Satyam was crowned as the IT jewel of India and won many awards in the corporate world. But Ramalingam Raju fabricated approximately \$1 Billion in the balance sheet⁶. This fraud was kept hidden from the employees, board, and the auditors of the company for years. And Raju finally confessed in the year 2009 regarding this mismanagement. This gave rise to one of the biggest corporate frauds in the country⁷. This raised the question of the independence of directors and the status of corporate governance in our country. Why were the independent directors not able to predict such fraud and raise alarm against it. We see that by 2010 out of 935 of Indian Independent Directors present, 619 have resigned. This was the mass resignation of independent directors which created a huge problem for the corporate sector in India⁸. This act of the independent directors shows that they are not able to fulfil their duties, and are hesitant to take any kind of legal liability as they would be held liable if any wrong occurs in the company. This era showed the horrible side of corporate governance. But later we have

⁶ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

⁷ Gupta, M. (n.d.). 'Independency of Independent Directors in Corporate Governance'. Retrieved October 06, 2020, from <https://www.icsi.edu/media/portals/86/Independent%20Directors.pdf>

⁸ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

the Companies Act, 2013 very descriptively laid down the role and the duties of independent director.

The parliament enacted new legislation, The Companies Act, 2013, keeping in mind the objective to have better corporate governance in India and the prevention of huge scandals like Satyam. This act laid down in more detail about the role of independent directors play, unlinking their functions duties, and roles⁹. SEBI, the Securities and Exchanges Board of India, in the year 2019, by added that at least one woman independent director must be there in the listed companies and half of the members of the board must be independent directors.

The role played by the independent director is the role of the “watchdog” of the public shareholders¹⁰. Here the directors work as a watchdog and keep a check on the management and controlled shareholders if there has been misuse of any assets of the firm as they responsibility to bring out if any wrongdoings happen in the company to the public. These directors work as the vigilant officers in the firms to protect the minority shareholders from being exploited by the majority shareholders. Another role is of Strategic advisor to the controlling shareholder. Here the directors provide expert advice in any business decisions made by the company for its benefit¹¹. The JJ Irani Committee, which was constituted to provide advice for the matters related to Company law. The Committee observed that directors only represent specific interests to the table, but independent directors bring the overall interest of the company to the table.¹²

⁹ Supranote 4

¹⁰ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

¹¹ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

¹² Why removal of independent directors is not an ordinary affair. (2017, July 8). *The Economic Times*. Retrieved October 6, 2020, from <https://economictimes.indiatimes.com/small-biz/legal/why-removal-of-independent-directors-is-not-an-ordinary-affair/articleshow/59502056.cms>

We see that another main functions of the Independent director is to ensure that the minority shareholders' demands are not undermined by the majority shareholder. The role of the independent directors in reviewing the policies taken up by the management is of importance for the long-term sustaining of the company. So the independent director's independence will help in matching the interests of the shareholders and this would eventually lead to improving the quality of decision making in the company¹³. SEBI's Chairman Ajay Tyagi stated that "the concerns of independent directors not being truly independent, especially in promoter-dominant companies continue and for the right reasons. While such directors meet regulatory requirements on paper, their independence in conduct and decisions is often under the cloud"¹⁴. Also stated that maintaining this balance has been difficult to keep. The JJ Irani report stated that the independence of directors must not only be seen from the view of the Promoter's interest but also from the point of the weak shareholders who don't have much say in the working of the company¹⁵.

If looked from outside the process of selection of the independent directors might not look independent¹⁶. Any monetary and collegial relationships or any business dealings with the firm is not considered to be independent, so there might be a conflict of interest. The definition of independent by Delaware Chancery Court stated "independence is not limited to financial independence, but also involves an inquiry into other measures of independence, such as social

¹³ Supranote 4

¹⁴ Uphadhyay, J. P. (2019, November 29). Sebi: Independence of independent directors remains a key concern. *Livemint*. Retrieved October 6, 2020, from

¹⁵Report of the Expert Committee on Company law 2005. (n.d.). Retrieved October 06, 2020, from <http://reports.mca.gov.in/Reports/23-Irani%20committee%20report%20of%20the%20expert%20committee%20on%20Company%20law,2005.pdf>

¹⁶ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

ties and connections”¹⁷. If there is anyone who has prior experience in the firm would lead to a lack of separation between the management of the firm and the independent director, due to the common colleagues and friend circle within the firm¹⁸. Any of this kind of relationship would lead to leniency in the company towards any kind of mismanagement. This is termed as “compromised monitor”¹⁹. So in order to prevent any of this kind of act the Companies Act, 2013 under section 149 (6) (d) (e) restricts the appointment of any such person, which compromises with the independent working of the independent directors. Prithvi Haldea, chairman of Prime Database stated that “It is a very fine line as promoters will not like to have total strangers on board while known persons might not act independently”²⁰. Due to the concentrated shareholding pattern in the firms can lead to questioning of the selection of the independent director. As the majority shareholder has a major control, voting control, has the power to remove or suggest the appointment of a board of director or an independent director.

The dispute between TATA Sons. Pvt. Ltd and Cyrus Mistry the former chairman who was removed from his position which created chaos and leads to questioning the appointment and removal of the independent directors. It was stated that in the case of Satyam the independent directors were criticized for not standing up against the wrongdoings of the directors, but when the independent directors are giving their view and standing up for what they believe to be right for the company they are being removed²¹. Independent director Nulsi Wadia was removed in the last Extraordinary general meeting when called upon. If directors are removed just because they are contending what the company supports then, “ What is at stake right now is not an independent director. What is at stake is the independence of

¹⁷ Khanna, V., & Mathew, S. J. (2010). The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer. *Jstore*, 22(1), 33-66. Retrieved October 6, 2020, from <https://www.jstor.org/stable/44283713>

¹⁸ Wang, C., Xie, F., & Zhu, M. (2015). Industry Expertise of Independent Directors and Board Monitoring. *Jstore*, 50(5), 929-962. Retrieved October 6, 2020, from <https://www.jstor.org/stable/43862282>

¹⁹ Supranote 18

²⁰ Rukhaiyar, A. (2016, December 18). To be, or not to be, an independent director. *The Hindu*. Retrieved October 6, 2020, from <https://www.thehindu.com/business/To-be-or-not-to-be-an-independent-director/article16900272.ece>

²¹ Supranote 10

independent directors”²². If such conditions continue to prevail it would be difficult for the independent directors to perform their duties, and uphold corporate governance.

Usually, for the removal of an independent director, no special resolution is required, just a simple majority passed in the general shareholder meeting of the company. But recently due to arising controversy to strengthen the process of the removal of the independent directors, SEBI (Securities Exchange Board of India) proposed an amendment for the removal of the independent directors. Whereby for the removal of the independent directors should not be done through an ordinary resolution but through special resolution, same done for the re-appointment of the independent directors.

Under the Companies Act 2013, under section 149 (6) (a) it is always important that independent directors are experts in various aspects of the working of the company in order to have effective monitoring over the company and reduce the risks of any faults. As per the Companies Act, 2013 under section 149 (1) (a), it lays down the proportion of independent directors in the board of directors, that in every listed company, at least one-third of the total number of directors must be independent directors. It is really important that there is enough representation of independent directors on the board in order to have their voices raised among others. It has been noticed that the Board of Directors is unable to perform their duty to the poor transparency, disclosure of the board practices. When it comes to the examination of the board in matter related disclosures like financial reporting, if there is the poor quality of management of the financial information and the disclosure of information then this kind of financial misconduct can lead to loss of the shareholders when information is revealed. And the blame if finally put on the independent directors for the damages. The performance of the company and the independence of the board is always related as independent directors, the board having proper disclosure practices improves the interest of the investors in the company, enhancing their face value and the value of the company shareholders²³. The regulatory bodies can't point out each and every problem, the burden is on the companies and the board members to take pragmatic decisions based on the issues arising.

²² Roy, A., & Rocha, E. (2016, December 23). Tata-Mistry spat shows independent company directors vulnerable in India. *Livemint*. Retrieved October 6, 2020, from <https://www.livemint.com/Companies/M1HMKGMfrN6SAkVj9lrxwL/TataMistry-spat-shows-independent-company-directors-vulnera.html>

²³ Supranote 4

In the case of Yes Bank, the independent Directors Uttam Prakash Agarwal has resigned from his post stating the reason that it was an “it is a totally management driven and not board-driven bank and if things go wrong, the independent directors are blamed”. It was the failure of the corporate governance which led him to resign him from his post.²⁴ This leaves the independent directors with two options, they either resign from their post or have to face removal or to defend themselves before the shareholders. This brings the independent director at a tough spot.

The source of information for independent directors is vital and is what the company provides by its internal auditors who are chosen by the board of directors. The fact that the independent directors have fiduciary responsibilities but there is a lack of resources to perform their jobs. We expect independent directors to be and be vigilant but no resources are provided to them for the same and they end up being the “sacrificial lambs” in the hands of the majority shareholders and promoters²⁵. For effective corporate governance, the burden does not only lie on the independent director but also the independent behaviour of the board. There is not only a need to have independence for a particular subject but as an institution as a whole, it is a collective effort²⁶.

The regulators are working towards strengthening the position of Independent directors. In 2019, the Ministry of Corporate Affairs, Government of India notified under rule 6 (1) of the Companies (Appointment and Qualification of Directors) Fifth amendment rules, having

²⁴ I resigned from YES Bank as independent director because of corporate governance failure: Uttam Prakash Agarwal Read more at: https://economictimes.indiatimes.com/markets/expert-view/i-resigned-from-yes-bank-as-independent-director-because-of-corporate-governance-failure-uttam-prakash-agarwal/articleshow/73188045.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst. (2020, January 10). *The Economic Times*. Retrieved October 6, 2020, from <https://economictimes.indiatimes.com/markets/expert-view/i-resigned-from-yes-bank-as-independent-director-because-of-corporate-governance-failure-uttam-prakash-agarwal/articleshow/73188045.cms>

²⁵ Nageswaran, V. A. (2019, June 17). Opinion | Independent directors are an endangered species in India. *Livemint*. Retrieved October 6, 2020, from <https://www.livemint.com/opinion/columns/opinion-independent-directors-are-an-endangered-species-in-india-1560791542332.html>

²⁶ H. (2006). Beyond "Independent" Directors: A Functional Approach to Board Independence. *Jstore*, 119(5), 1553-1575. Retrieved October 6, 2020, from <https://www.jstor.org/stable/4093581>

the mandatory Online proficiency assessment test before the appointment of any Independent director in the board of the Company. This was done in order to strengthen corporate governance and ensuring that the Directors are qualified enough and have expertise in the field and honour their duties properly²⁷. Exemption to this test is those who have been in a public listed company or unlisted company for more than ten years. Though this step by the ministry is being criticized as it would limit the number of eligible independent directors. But can this test really evaluate the competency of independent directors is still debatable²⁸?

We have evolved over time and coming up with ways to strengthen corporate governance in our country. We have seen above the role played by the independent directors in balancing the interests of all and the basic to maintain independence, which is the main problem faced. I believe that we have to introspect the selection, removal and the source of information of the independent directors as highlighted above are the basic and the major problems faced by directors in the concentrated shareholding pattern. Hence a need to remove the barriers present in the process of the functioning of the directors in the company without any threat from the board and provide the necessary resources needed for better efficiency in their working. Importance must be given to the characteristics of the independent directors. And also keeping in mind the system we should not just put the responsibility of the corporate governance on the shoulder of independent directors, but should be a collective effort made by a company as a whole. Managing the company affairs, maintain there is transparency in the management of the company all this would engage the investors to invest more in the companies where the who promote corporate governance.

²⁷ Devika, Saba, Auroshree, Shah, C., Bhumika, & Editor. (2019, December 07). Online Proficiency Assessment Test for Independent Directors. Retrieved October 06, 2020, from <https://www.scconline.com/blog/post/2019/12/07/online-proficiency-assessment-test-for-independent-directors/>

²⁸ Supranote 16