

AUTHORS

Akshat Meharia – Jindal Global Law School (Student)

Aditya Banerjee- Jindal Global Law School (Student)

TOPIC

INDEPENDENCE OF INDEPENDENT DIRECTORS: THE WAY
FORWARD

INTRODUCTION

The independence of the Board of Directors of a Company is identified as a crucial aspect towards good corporate governance. The bearing of good corporate governance upon various facets of the Company's working and growth cannot be underemphasized. The model of corporate governance followed in India is majorly an insider model, which is characterized by a cohesive group of insiders i.e., the concentrated shareholding pattern.¹ The dispersed shareholding pattern is a minor fragment. By virtue of the dominance of the concentrated shareholding, there exists a reasonable possibility of exertion of influence by the majority shareholders over the Board of Directors.

The introduction of Independent Directors was but one step towards ensuring independence of board and good corporate governance. Having Independent Directors on board would foster transparency pertaining to the functioning of the Company (its Board), inspiring more confidence to the stakeholders of the Company. The independence would resultantly enhance the efficacy of the Company's performance. Therefore, in a country like India, the institution of Independence directors is of utmost significance towards protecting the impartial functioning of the Board. The concept of Independent Directors has been adopted by India from the US and the UK, where the concept of Independent Directors had originated much earlier.

Section 2(47) of the Companies Act, 2013 defines "Independent Director" as an independent director referred to in sub-section 6 of section 149.² Sub-section 4 of section 149 mandates the requirement in public listed companies of at least 1/3rd of the total directors to be independent directors. Sub-section 6 specifies the requisite conditions for being an independent director. Furthermore, Clause 49 of the Listing Agreement defines an Independent Director as a non-executive director of the company and prescribes certain requisite conditions for eligibility as an independent director.

ROLE OF INDEPENDENT DIRECTORS

¹ Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, RESEARCHGATE (Feb, 2010), https://www.researchgate.net/publication/228226340_Evolution_and_Effectiveness_of_Independent_Directors_in_Indian_Corporate_Governance.

² The Companies Act, 2013, S 2(47), No. 18, Acts of Parliament, 2013.

The Independent Directors are primarily entrusted with the role of balancing the interests of different stakeholders of the company by maintaining an independent and impartial functioning of the Company. The institution of Independent Directors can be referred to as vigilant officers/watchdogs of public shareholders towards their requisite roles to prevent any exploitation/oppression of the minority shareholders and prevent any influence upon the Board by the promoters or majority shareholders.³ The various roles of the Independent Directors as required by the Companies Act, 2013 are as follows:

- Section 135(1): Mandatory presence of Independent Director in the CSR Committee.
- Section 173(3): Presence of at least one Independent Director in board meetings called at a shorter notice and in Independent Director's absence, decision taken at the meeting to be final only upon the Independent Director's ratification.
- Section 177(2): Presence of Independent Directors in majority in Audit Committee.
- Section 178(1): Presence of at-least 50% of Independent Directors in nomination & remuneration committee.

The above statutory roles of the Independent Directors are aimed towards giving functionary roles in various aspects of the functioning of the Company to permit them to overlook the different management functions within the Company. Furthermore, Code II of Schedule IV (Code for Independent Directors) also provides for an exhaustive list specifying the Roles and functions of the Independent Directors.

SATYAM CORPORATE GOVERNANCE SCANDAL & FINANCIAL SCAM

Satyam Computer Services was established in 1987 by two brothers namely Rama Raju and Ramalinga Raju. The Company gained success and grew in a short span of time, becoming India's 4th largest IT Service Company at a point of time. It also got its securities listed in NSE, BSE and cross-listed on the NYSE.⁴ Satyam was greatly appraised for good Corporate Governance. In 2008, its board included 5 independent directors out of a total of 9 members/directors, 4 being academicians. At this time, 8% of the Company's shares were held by its promoters and the rest shareholding was dispersed.

³ Taha Hajara Muhammad, "*Independent*" director a myth (May 15, 2021) <https://ssrn.com/abstract=3846870>.

⁴ Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 Hastings Bus. Law Journal 281, 54 (2010), https://repository.uchastings.edu/cgi/viewcontent.cgi?article=1152&context=hastings_business_law_journal.

On 16th December 2008, a board meeting was convened to consider the proposal of acquiring Maytas Infra Ltd. and Maytas Properties Ltd.⁵ The promoter of Satyam held majority shares in the target companies. The Independent Directors brought several concerns pertaining to the acquisition proposal, inter alia, the diverse nature of the target companies from that of Satyam, outflow of excess cash as a consequence of the transaction, the transaction being a Related Party Transaction. Yet, the meeting concluded with a unanimous decision approving the said acquisition proposal. This was not received well by the shareholders/investors and the stock prices saw a steep decline. Consequentially, Satyam had to withdraw its decision. Subsequently, 4 Independent Directors also resigned.

On 7th January 2009, Mr. Ramalinga Raju resigned from the position of Chairman with a confession, wherein he mentioned/admitted the commitment of a financial scam i.e., falsification of financial statements to the tune of Rs. 7000 crores.⁶ Furthermore, he mentioned that the proposed buy-outs were merely an illusory transaction which was intended to manipulate the balance sheet to cover up the inconsistencies.⁷ Resultantly, the stock prices fell more than 70%, causing a loss to shareholders.

The Satyam Scam has been an epitome depicting the failure of Independent Directors, more so because of its robust Independent Directors majority board. An analysis of the role of Independent Directors vis-à-vis the 16th December board meeting exacerbates the scepticism pertaining to the functioning of Independent Directors. The unanimous board decision despite the concerns raised by the Independent Directors raises eyebrows towards the independent functioning of the Independent Directors. Furthermore, the 7th January events conclusively highlight the failure of the Independent Directors as vigilant officers of the Company. It raises several questions against the institution of Independent Directors, its practical working, the inadequacy of legal framework, the gap between the existing legal framework and its practical applications etc. It is pertinent to note the two important institutional loopholes that the episode highlights – Primarily, the Independent Directors failed to unearth the scam that continued for so long leads us to the fundamental fallacy that the Independent Directors are expected to discharge their duties (protect corporate mishaps) only on the basis of a superficial monitoring. In absence of involvement of the Independent Directors in the routine/daily working and an indirect access to the Company's information, the duty/expectation cast upon them to discover

⁵ *Id.* At 55.

⁶ Aron Almeida, *Satyam Scam – The story of India's Biggest Corporate Fraud*, TRADE BRAINS (Jun. 11, 2011, 10:30 PM), <https://tradebrains.in/satyam-scam/>.

⁷ Umakanth, *supra* note 5, at 58.

and prevent frauds is futile. Secondly, given the control of appointment, remuneration etc. of the Independent Directors lying with the owners of the company, it is not impossible for the Independent Directors to be swayed by extraneous considerations. Hence, thwarting the Independence of Independent Directors. In epitomizing independent directors as a guardian of various corporate interests, including possibly minority shareholders, the corporate governance norms create a false sense of security among corporate stakeholders.⁸

DEVELOPMENT OF LAW ON INDEPENDENT DIRECTORS POST-SATYAM SCAM

The increasing number of corporate scams at both national and international levels such as the Satyam scam led to increasing number of debates surrounding the issue of lack of 'independence' of independent directors. Although one of the main duties of an independent director is to act as a 'watchdog' for detecting the irregularities in the functioning of the company, the question worth raising is that whether such directors are actually independent? Therefore, the objective of formulating a more efficient system of corporate governance across companies in India manifested the inculcation of Section 149⁹ in the Companies Act, 2013. Before the inculcation of this statute, there was widespread ambiguity as to what constituted "independence" of an independent director. The first provision which brought some clarity to the term was the establishment of a clause 49¹⁰ of the Listing Agreement. Although the clause had a fair number of exclusions for the post of independent directors, such as family ties with the promoter or a majority shareholder, it failed to take into account the social relations which could hinder the independence of a director. However, with the inculcation Section 149 of the Companies Act of 2013, even these ambiguities were done away with by a detailed and exhaustive list of exclusions, duties and obligations of independent directors. Moreover, it also mentions a detailed procedure for selection, and expertise or experience required for the position to ensure their independence. Even though such provisions help in the fulfilment of objective criteria for independence, a thorough analysis of the existing reliefs point towards the fact that there has been very little subjective development for ensuring independence in practicality.

⁸ Umakanth, *supra* note 5, at 62.

⁹ *Supra* note 2, at section 149.

¹⁰ Section 149, Companies Act 2013.

FAILURE OF EXISTING RELIEFS TO SECURE INDEPENDENCE OF DIRECTORS

The multiple scandals pre and post the enactment of Section 149 shows the perennial problem of a large number of companies in India being dominated by the promoters and majority shareholders. This leads to exposing independent directors to a position of helplessness if any of their actions leads to countering the interests of the promoters. Evidence of the afore-stated claim can be found in the recent removal of Mr. Nusli Wadia from the position of independent director for the sole reason of him showing support to Cyrus Mistry in the dispute between Mistry and TATA Sons. Pvt. Ltd.¹¹ A decade ago, the landmark Satyam judgment criticized independent directors for not raising their voices against the wrongdoings of the board and raised accusations of them facilitating illegal actions by aristocrats, but even after a decade of various enactments and amendments to improve their position of independence, an independent director was still sacked for standing up for what he believed to be true, and for performing his duty diligently.

Although the new Companies Act and SEBI provide regulations for independent directors to perform their duty in good faith, the protection awarded to them for performing such duties is grossly insufficient against spiteful actions of the management. The fact that in the aforementioned Tata-Mistry case, an independent director was removed by a simple majority vote in a special shareholders meeting, where the majority shareholders were allowed to vote¹² shows the vulnerability of such directors in promoter driven companies. One of the proposed amendments which could solve such a discrepancy is that such decisions should not be taken in the presence of, or by the sole discretion of the promoter. An enquiry or investigation report should be prepared about the conduct of the director, and an independent expert committee should vote on the credibility of the grounds stated for the director's removal. Such a process will entail independent directors to stand against a malpractice without the fear of being removed by the majority shareholders or other consequences. Moreover, it would bring transparency in the procedure since it would prevent the promoters and majority shareholders from removing non-executive directors without a substantial witness to prove the claim.

Ajay Tyagi, the chairman of SEBI also pointed out that even though such independent directors meet the regulatory requirements on paper, there is hardly any independence in their conduct

¹¹ TATA-MISTRY SPAT SHOWS INDEPENDENT COMPANY DIRECTORS VULNERABLE IN INDIA MINT, <https://www.livemint.com/Companies/M1HMKGMfrN6SAkVj9lrwL/TataMistry-spat-shows-independent-company-directors-vulnera.html> (last visited Jun 30, 2021).

¹² Ibid.

and decisions.¹³ Such assertions by the chairman of the SEBI itself points towards the urgent need for amending provisions with the purpose of strengthening the position of independent directors. Although Clause 49 requires the Board to formulate a Nomination and Remuneration Committee, nomination by such a committee is followed by an approval of the Board in a general meeting according to Section 152(2)¹⁴ of the Companies Act, which results in such directors “owing their selection to the majority shareholders and promoters”, thereby preventing independent directors from raising their voices against them due to the fear of instant removal. One of the suggestions made by an Expert Committee was the compulsory provision of appointment of a minority appointed director.¹⁵ Although such a director would not owe its selection to the promoter, he would still not be independent in the true sense of the term. Such an appointment would be against the universal corporate principle that acts done for the benefits of the company should be executed irrespective of it harming the interests of the minority shareholders.¹⁶ A reasonable alternative to the existing process of selection in my opinion would be to appoint a statutory, independent selection committee, the composition of which would be fixed by the statute in such a manner that it encompasses the interest of the company as a whole, and the selection is not left at the discretion of one person or a group of persons. Such a committee would have the final say in the appointment after analyzing their experience, past actions, and a thorough background check.¹⁷ Although the selection of such a member to the board should be allowed to be challenged, but the same would only be entertained in case of a substantial claim backed by evidence, or some grave misconduct.

Another condition which leads to questions being raised on the independence of a director is the unsatisfactory manner of remuneration awarded to such directors. A collective reading of

¹³ SEBI: INDEPENDENCE OF INDEPENDENT DIRECTORS REMAINS A KEY CONCERN MINT, <https://www.livemint.com/companies/news/independence-of-independent-directors-remains-a-concern-sebi-11574862805855.html> (last visited Jun 30, 2021).

¹⁴ Section 152, Clause 2, Companies Act 2013.

¹⁵ ABOUT MCA MINISTRY OF CORPORATE AFFAIRS - MINORITY INTERESTS, <https://www.mca.gov.in/MinistryV2/minority+interests.html> (last visited Jun 30, 2021).

¹⁶ INDEPENDENT DIRECTORS: ARE THEY REALLY INDEPENDENT? INDIAN COMMERCIAL LAW REVIEW AND PRACTICE BLOG, <http://icrap.in/612-2/> (last visited Jun 30, 2021).

¹⁷ LATEST LAW NEWS, LEGAL NEWS INDIA, LEGAL NEWS, DAILY LEGAL UPDATES INDIA INDIA LEGAL, <https://www.indialegalive.com/viewpoint/independent-directors-independence-myth-38085> (last visited Jun 30, 2021).

Sections 197(5)¹⁸, 197(9)¹⁹, and 149(9)²⁰ of the Companies Act points towards the fact that independent directors get a sitting fee and remuneration for attending the meetings. Additionally, such directors are paid “profit-related commissions” on the approval of members. In regular practice, it is seen that such commissions are only paid if the independent directors allow the resolutions to be passed without raising objections against them²¹, since such commissions cannot be released without the wish of the promoters and majority shareholders. This leads the independent directors to agree with every resolution passed in a board meeting to sustain their confidence and earn reward. The best alternative to put an end to such pecuniary conflicts would be making it compulsory to fix a rate of commission by the statute in addition to the sitting fees. The rate of such a commission can depend on a firm-to-firm basis depending on their nature and size.

Another grave problem which puts the independent directors at a tough spot is the lack of information provided to them, but even if a small discrepancy occurs related to the information, it is the independent directors who are blamed for their neglect of bringing the issue to the forefront since they are expected to perform the job of the “watchdog” of a company by keeping a check on the actions of managers and shareholders. For instance, in a recent turn of events Uttam Prakash Agarwal, an independent director of Yes Bank resigned from his post stating the reason to be that it was more of a management driven company rather than board driven company, and the blame was placed on the shoulders of the independent director in case of discrepancies.²² This makes it abundantly clear that the sole reason for him resigning from the post was lack of adequate corporate governance. Such incidents showcase that independent directors are left with no option but either to resign from the post, or get ready to be fired or defend their case in front of shareholders. Under certain extreme circumstances, it might even lead to criminal charges as seen in the Satyam scam. The fact remains that independent directors do owe fiduciary duties to the company, but they are not provided with sufficient data

¹⁸ Section 197, Clause 5, Companies Act 2013.

¹⁹ Section 197, Clause 9, Companies Act 2013.

²⁰ Section 149, Clause 9, Companies Act 2013.

²¹ Supra Note 17.

²² UTTAM PRAKASH AGARWAL: KNOW WHY DID UTTAM PRAKASH AGARWAL RESIGNED FROM YES BANK AS AN INDEPENDENT DIRECTOR THE ECONOMIC TIMES, <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> (last visited Jun 30, 2021).

and resources to perform such duty. In the end, they are left as “sacrificial lambs” in the hands of promoters and majority shareholders.²³

CONCLUSION

The statutes of our country have evolved a great deal in strengthening the practice of corporate governance, beginning from post Satyam scam till date. The afore-discussed contentions clearly point towards the importance of independent directors and the paramount role played by them to take into account the interest of all the subjects of a company, and at the same time keeping a check on their actions. However, even after significant developments, the recent scenarios act as evidence to the fact that the independence of such directors is still a big question mark. There is an urgent need to take stringent measures in amending the statutes in a manner that the independent directors can maintain their independence, which would aid them in fulfilling their duty of supervising over the affairs of the company. The Ministry of Corporate Affairs should scrutinize their indispensability and role with the motive of augmenting corporate governance norms. The main arenas which require immediate attention are the process of selection and removal, method of remuneration, and source of information. These are the main hindrances in ensuring the independence of a director, especially in a country like India where majority of the companies are family-based with the promoter holding enough power to undermine the interests of minority shareholders and independent directors. Therefore, keeping in mind the nature of system prevailing in India, it is pertinent to mention that for establishing an effective corporate governance, independence of the board is as important as the independence of the director. Independence is not a virtue that needs to be exercised in one subject in particular, but in the institution as a whole by the collective effort of all its subjects.

²³ OPINION: INDEPENDENT DIRECTORS ARE AN ENDANGERED SPECIES IN INDIA MINT, <https://www.livemint.com/opinion/columns/opinion-independent-directors-are-an-endangered-species-in-india-1560791542332.html> (last visited Jun 30, 2021).