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INDEPENDENT DIRECTORS AND CORPORATE GOVERNANCE

Maitrayani Bhosale

4th Year B.A. LL.B. (Hons) Student from Maharashtra National Law University Mumbai

ABSTRACT

The board of directors is a group of people who take the key decisions for a company, and it is their duty to work in the interest of the shareholders. The board consist of executive and non-executive directors. The non-executive directors are not employed in the company directly, but they are employed in the company to give decisions from an independent point of view. Independent directors are the people who are entrusted by the shareholder to represent them. Moreover, the corporate governance principles and Companies Act, 2013 mandates the composition of independent directors. Hence, the main question is whether the independent directors are independent in their decision making. Hence, the actions of the independent directors should be monitored into order to increase the return on investment for shareholders.

Key Words: *Board independence, Independent directors, Corporate Governance*

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1. INTRODUCTION

"Citizens never support a weak company and
birds do not build nest on a tree that does not bear fruits"
-Salman Khurshid[1], quoting Kautilya's Arthashastra

Independence is a human quality that can be acquired by individuals and is an essential component for independent directors in exercising their functions. It includes to give decision without any biases or not being unduly influenced by vested interests.

With the increasing number of corporate scandals in developing and developed countries like WORLDCOM, Enron and Satyam, the need to improve the corporate governance has increased much more than ever. One of the major factors which has led to these scandals is "failure of the

[1] Indian Ministry of State for Corporate Affairs, Corporate Governance Voluntary Guidelines, https://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf

board of directors of a corporation to detect internal crisis early on and act in a timely manner to put the organization back on track before difficulties become irreversible."

In India, scandals like Satyam have led to increased focus on the functioning of corporate board along with rights and duties of board members and the importance of disclosure. Thus, we can see that every major scandal has led to renewed attempts in improving the standards of corporate governance. It can be seen that time and again the Indian Government has issues guidelines and set up committees to keep up with the trends to improve corporate governance in India. This has included a whole lot of regulations to improve the quality of board members, the responsibilities of board members, their tenure and remuneration etc.

The objective of this research paper is to examine how the scandals has led to several policies and regulations by the government, to examine how the independent directors affect the performance of a corporation, this article also throws light on some of the reports that were given by Indian committees and recommended international best practices for the functioning of independent directors. Also, the determination of optimal proportion of independent directors, their qualifications, set of criteria for defining independent director and the most important is whether board independence matters in corporate governance.

2. WHO IS AN INDEPENDENT DIRECTOR?

Companies Act, 2013 does not provide us with specific definition of independent directors but it does establish separate criteria for having independent directors on a board.

Independent director is a non-executive director of a company who helps in improving the decision making in a company and standards of corporate governance.

Independent directors are not related to the company in any manner. The purpose of having independent directors in the company so that they can bring an element of objectivity to board process which would be in general interest of the company and thereby benefit the minority interest and small shareholders.

The appointment of independent director in India is governed by Section 149 of The Companies Act, 2013 along with rules and regulation. Under section 149 of the Companies Act, 2013:

Public listed Companies (mandatory): Every public listed company must have at least 1/3rd of total number of directors as independent directors.

a. Qualifications and eligibility criteria for independent directors: Section 149(6) of the Companies Act, 2013 states who all can serve as independent directors:
    - Integrity and expertise: The independent director elected must be a (i) person of integrity (ii) shall possess relevant expertise and experience, as the Board of Director wishes him to.
    - Not a promoter: The elected director should not be a promoter of the company, any of its subsidiaries, or any of its holding or associate companies.
    - No relationship with promotes or directors: the elected person should not have any direct or indirect relationship with the promoters and directors of the company.
    - No pecuniary relationship: The Independent Director should not have or have had any pecuniary relationship with the company or its holding subsidiary, or associate companies in the period of previous two financial years.
    - Restriction on relatives: During the two immediately preceding financial years and the current year, the independent director should:
        (i) Hold any interest or security in the company exceeding Rs. 5 million, or two percent of the paid-up capital.
        (ii) Be indebted to the company
        (iii) Provide a guarantee or security for the indebtedness of a third party.
    - No managerial position or employment: The independent director appointed or any of their relatives should not have held any Key Managerial Person (KMP) position or should not have been employed in the company, its holdings, subsidiaries, or associates' companies during the three immediately preceding financial years.
    - Restriction on voting power: The independent director so appointed along with their relatives should not hold two percent or more voting power in the company.
    - Prescribed qualifications: The independent director should have any additional qualifications as may be prescribed by relevant authorities.

Schedule IV of the Companies Act, 2013 prescribes duties, role, functions, and guidelines for professional conduct for independent directors. Some of the duties of independent directors are:

- Pay adequate attention in the board meetings and ensure that adequate deliberation is held before approving related party transaction and ensure that the same are in the interest of the company.
- Ensure that the company has adequate and functional vigil mechanism.

- Report unethical behavior, actual or suspected fraud, violation of company's code of conduct, ethic policy etc.
- Have a key role in appointing and where necessary recommendations in the removal of executive director, KMPs and senior management.
- Moderate and arbitrate in the interest of the company, in situation of conflict between the shareholder and the company.
- Balance the conflicting interest of the shareholders.
- Scrutinize the performance of management in meeting the light of agreed goal and objective and monitor the reporting of performance.
- Be well informed about the company and the external environment in which it operates.
- Participate actively in the committee of board in which they are chairperson and member of.

3. HISTORY OF INDEPENDENT DIRECTORS

They are usually referred to as company's watchdog, independent directors are important part of a company. In US and India, these countries have incorporated independent directors in their legislation but in UK they have non-executive directors in place of independent directors.

a) ***Berle and Means Thesis***: The book which was published by Adolf Berle and Gardier Means named "The Modern Corporation and Private Property" in 1930 shaped the US business thought and practice in period from 1930 to 1970. The authors mainly focused on the separation of ownership and control in a company. The authors were concerned not only about the manager's lack of accountability towards the investors but also about the society at large[2].

Hence, the Berle and Means study proved influential and has helped a lot to sought agency problems over the years.

b) ***Economic Analysis of Agency Problem***: As there was separation of ownership and control, it led to manager-shareholder agency problem. This problem became the focal point to study for economists as to what is the role of board of directors in these agency problems. There were few economists who applied the principle of agency to these corporations.

[2] Brian Cheffins, The Rise and Fall of the Berle-Means Corporation, (Last visited on Oct 29, 2023), https://corpgov.law.harvard.edu/2018/08/06/the-rise-and-fall-of-the-berle-means-corporation/

They argued that whenever, a principal gives power to his agents of decision making, the agent may not always act in the interest of the principal. The principals are the shareholders here and agents are the managers or directors of the company.

They came up with the solution of enabling a proper mechanism of monitoring these managers to protect the interest of the shareholders. Hence, the question which remained was if the board was comprised of insiders, will the board be as effective as it needs to be? The answer was negative as they will only think about making profit for themselves. Hence, the independent directors came into picture as their only role is to monitor the board meetings and the actions of the directors. Their main objective is to protect the shareholder from the abuse of managers. Hence, the monitoring of board and independent director concept emanate from manager-shareholder agency problem which is not only today's problem but has been a problem from decade's altogether.

c) ***Emergence of Independent Directors in US***: The idea of independent director was first introduced in US in 1950s as the outcome of good corporate governance and as a response to manager-agency problem. This concept emerged as a belief that the independence in the board will bring objectivity in the decision making and hence improve the performance of the company.

d) ***Emergence of 'Monitoring Board'***: Only in 1970s, the term "Independent Directors" were used in corporate field. However, the term which was used for IDs were "outside directors". Initially there were very few outside directors as compared to inside directors as they continued to constitute a majority in the board. With the emergence of independent directors, a concept of monitoring board was identified. In practice, board's main function was advisory, which was providing advice to the CEO rather than protecting the interest of shareholders. Hence, these practices created a feeling of dismay among the policymakers. The main objective of creating monitoring boards was to monitor the functions of the directors and to decide whether these directors should be replaced or not. Hence, there were recommendations made by academicians for creation of mandatory rules for monitoring boards rather than leaving it to the discretion of companies. Also, in 1970s the apart from monitoring board and independent directors, that decade also marks for recognition of independent directors for the first time by SEC and NYSE. Both the Securities and Exchange Commission (SEC) and New York Stock Exchange (NYSE) recommended creation of the board compromising of independent directors. In 1976, a committee was formed which issued the Corporate Director's Guidebook that

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recommended boards to include non-management directors. The Business Roundtable suggested that "outsider should have a substantial impact on the board's decision-making process[3]". This was followed by various corporate governance scandals in US such as Enron and WorldCom. These scandals resulted in the enactment of legislations such as Sarbanes Oxley Act in 2002. The New York Stock Exchange (NYSE) and National Association of Security Dealers Automated Quotations (NASDAQ) amended their listing rules.

e) ***Judicial reliance on board independence***: While there were efforts made to increase the independence of board for the interest of shareholders, the judicial interpretation was changing at the same time as they were placing more weightage to the decision of independent boards while reviewing corporate actions.

f) ***Emergence of Independent Directors in UK***: There is a lot of similarity between in corporate governance practices between US and UK. The idea of independent directors was ignited in UK in the "Cadbury Committee Report" in 1992 which was much recent than US developments. It was the beginning of UK's corporate governance. The committee introduced the concept of independent directors and non-executive directors. The committee recommended that there should be at least 3 non-executive directors in a board out of which 2 should be independent directors. The committee stated 2 main responsibilities of non-executive directors i.e.,

(i) To evaluate the performance of the board and

(ii) To take lead in decision making whenever there is conflict of interest[4].

In 1995, *Greenbury Report on Director's Renumeration*, was a comprehensive report was published which addressed the renumeration of directors. This committee recommended an independent renumeration committee and linked executive pay to their performance. This committee limited excessive pay to the executives. But these recommendations did not go far enough as they were regarded as failure[5].

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[3]Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, (Last visited on Oct 29, 2023), https://repository.uclawsf.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1152&context=hastings_business_law_journal

[4]The financial aspects of corporate governance, (Last visited on Oct 29, 2023), https://www.ecgi.global/sites/default/files/codes/documents/cadbury.pdf

[5] Maeve O' Connell, Greenbury Report (UK), (Last visited on Oct 29, 2023), https://arrow.tudublin.ie/cgi/viewcontent.cgi?article=1035&context=buschacart

The Cadbury Committee's *Code of Best Practice* was review again by Hampel Committee in 1998, which was chaired by Sir Ronald Hampel. This committee consolidated the recommendations of Cadbury Committee and Greenbury Committee and introduced a combined code. After the Enron and other scandals in US, the UK constituted a committee known as Higgs Committee which recommended that half of the members of large companies need to be independent non-executive directors.

However, there are three characteristic features of UK Corporate Governance which are noteworthy i.e.,

(i) The position of CEO and chair of the board should be held by different individuals as both of these roles are decided and well defined.

(ii) The chairman should hold meetings with the independent non-executive directors separately without the presence of executive directors .

(iii) The board should appoint one senior independent director from among the independent directors present in the company who would be available as a contact person for chairman, other independent directors and shareholders[6].

With the revision of Listing Rules in 2014, it included that a proposed ID who has been voted by majority, needs to be appointed by a second separate vote by minority shareholders only.

4. STEPS TAKEN BY INDIA TO INCORPORATE INDEPENDENT DIRECTORS

Corporate Governance is a recent concept which has been the talk of the town. The regulator needs to update the Act and regulations from time and again to keep up with the changing market and to protect the investor's money. After the economic liberalization in 1991, there was rapid growth and development in the country. One of the most important changes in 1992 was establishing Securities Exchange Board of India to regulate the India's securities market and to protect the interest of the investors.

One of the first mention of Independent Directors in Indian Corporate history can be seen in the committee set up under the chairmanship of Kumar Mangalam Birla in 1999. The primary objective of the committee was to prepare a code that was suitable to the environment of Indian

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[6]Harald Baum, The Rise of Independent Director: A Historical and Comparative Perspective, (Last visited on Oct 29, 2023), https://deliverypdf.ssrn.com/delivery.php?ID=646117100022001072124125102126107104118081007014064089086094006069118089081024106108050122101118013124055088105120074108080109023074053015000070099065024096102023076058082010065104003112019097094097064101069088072125084011104113028094020025116020124084&EXT=pdf&INDEX=TRUE

market and to protect the interests of shareholders and investors[7]. It was recommended that Audited Committee must be formed which must contain three independent directors out of which one having financial and accounting knowledge.

SEBI implemented the committee's recommendations and added Section 49 in Listing agreements. After the Enron Scandal in US, the government of India constituted Narayan Murthy Committee in 2002. The recommendations of the committee were accepted, and Clause 49 of the Listing Agreements was revised. The revised section laid down the composition of Board. The revised clause stated that if the board was headed by a non-executive director, then at least 1/3rd of the board must have independent director. And if the board was headed by an executive director, then at least half of the Board must be independent director. It also laid down that the director must not be related to the promoters, directors or KMPs of that company in any manner in preceding 3 years. But after the Satyam scandal, the Indian market was a mess. It was a complete failure of corporate governance. It threw a light on the weak positioning of independent directors. They were supposed to act as the watchdog of the company but failed to do so in this case.

After the Satyam scandal, the CII started examining the corporate governance issues related to the Satyam scandal and came out with recommendations on corporate governance reform in 2009. In 2010, the SEBI amended the Listing Agreements and brought changes relating to board structure and independence. In 2014, SEBI brought in the amendments to the Equity Listing Agreement Clause 49 of and aligned it with changes brought in Companies Act, 2013. There were further restrictions which were placed on independent directors i.e., they cannot serve as independent director in more than 7 listed companies, and they cannot be reappointed after completion 2 terms of 5 years.

5. HOW DOES BOARD INDEPENDENCE AFFECT THE COMPANY'S PERFORMANCE

The term independent director has been used interchangeably with non-executive directors but not all non-executive director is independent. The study on board independence with firm performance has shown mixed results. It is either positive, negative or no relationship with the firm. Firm performance is studied by looking at market-based measures or accounting based measures. The

[7]Report of the Kumar Mangalam Birla Committee on Corporate Governance, (Last visited on Oct 29, 2023) https://www.sebi.gov.in/sebi_data/commondocs/corpgov1_p.pdf

accounting-based measures is studied by Return on Assets, return on Investment and earning per share.

India: The study showed that having board independence did not at all times guaranteed improved performance. Effective monitoring mechanism in the firm could reduce agency problems. Since, the businesses in India were family owned therefore, the independent directors have do not have much of independence in the company. Hence, the study has shown that having board independence did not guarantee to improve firm performance due to poor monitoring roles of independent directors. One of the important roles of independent director is to exercise proper oversight over the company and monitor company's performance.

USA: In USA, the board are annually elected, the size of the board is small, and 100 percent independent nominating committees have more discretionary accruals which had negative effect on the company. In larger Australian Stock Exchange (ASX) companies as opposed to smaller and medium sized firms, the independence renumeration were aligning CEO compensation with firm success. It demonstrated that IDs played a critical role in overseeing the chairman and executive director compensation process for public companies and subsequently in ensuring that their compensation was consistent with their performance.

Hong Kong: the businesses in Hong Kong have shown no positive relationship between firm performance and board independence as they were family run. But there has been positive relationship between them because they were non-family run firms. It was because the number of IDs in family run business was much less than in non-family run business. The decision of having independent directors on the board was on voluntary basis. If the company was not complying to it, then they had to explain for the same. From the results, we can see that having a good number of IDs on board improves corporate performance.

In countries like Malaysia, Hong Kong and Singapore, the presence of Independent directors has shown positive effects on the company. One of the main factors for this was that there were not many family-owned business

A study which was conducted of 277 listed Malaysian companies which studied the association between board independence and firm performance. It was found out that from 2002 to 2007, the performance of companies with more IDs was much better than companies with a smaller number of IDs. Another study of 279 Malaysian firms listed on KLSE and 271 Singapore firms listed on the Singapore Stock Exchange revealed that the number of IDs on Audit committee had a significant impact on the business and negative impact on the abnormal accruals. It meant that the more the number of IDs on the board the less were the abnormal accruals.

In the study conducted of 481 Public- listed companies in Malaysia for board independence, board diligence and board liquidity. It was found out that there was significant relationship between board independence and disclosure of information. Hence, when board was independent, the company would be more transparent and disseminate information which would result in company's liquidity.

From the above studies which were conducted in different parts of the world we could see that the independence of independent directors is a problem. The concept of independent directors on the board has positive and sometimes no effect as well. It depends on various factors like if the business is run by a family or is it a non-family run company, the number of IDs on the board, how much the CEO is allowing the IDs to exercise their independence and give decisions which were in the interest of the shareholders. Hence, having IDs on the board do have a positive impact on the firm performance if implemented properly.

6. CASE STUDIES

a. NSE Scam:

This is one of the recent cases where we can see that there was failure of corporate governance which reflected the poor control of board and committees especially independent directors. The following were the causes of the scam i) the price sensitive information was leaked to some of the brokers ahead of others that allowed them to take favorable position in trading which led to disadvantage to others. (ii) improper appointment of Mr. Ananda Subramanian as Chief Strategic Officer and subsequently redesignating him as Group Operating Officer (GOO) by MD and CEO at a hefty compensation without following due process for the recruitment for key positions[8].

After the case was filed against NSE, Ms. Chitra Ramakrishna who was the CEO of NSE admitted that she was being guided by unknown spiritual guru who was living in Himalayas to make key decisions in the company[9]. It is strange that no one in the company noticed the exchange of unpublished sensitive information (UPSI) was being shared to some brokers and the decisions

[8] Dr. Kembal Srinivasa Rao, Role of Independent directors in steering corporate governance, (Last visited on Oct 31, 2023), https://timesofindia.indiatimes.com/blogs/kembai-speaks/role-of-independent-directors-in-steering-corporate-governance/

[9] Explained: The NSE scam, the 'faceless yogi' and trips to tax havens https://timesofindia.indiatimes.com/business/india-business/explained-the-nse-scam-the-faceless-yogi-and-trips-to-tax-havens/articleshow/89717719.cms

were taken by some unknown guru. The role of independent directors in these cases become very important. We can see that the role of oversight mechanism which needs to be done by independent directors was not done. If there would have been proper oversight mechanism by the IDs and the decisions were given with proper due diligence probably this scam would have never taken place. Hence, these types of scams could be prevented with better role of IDs.

b. Satyam's case:

The Satyam's scam shook the whole corporate balance in India. Satyam was one of the largest in company in India. It was one of the largest accounting frauds in history of corporate India and it is termed as India's Enron. In this case we can see that there was a failure of corporate governance which was due to poor oversight mechanism by board members especially Independent Directors. Despite Satyam receiving numerous corporate awards like Golden Peacock Award for Global Excellence in corporate accounting, it was one of the nation's biggest scams within months of receiving the awards. This scam shed light on various flaws in the corporate governance in India- fraudulent accounting, unethical conduct, role played by auditors, ineffective board, and failure in oversight by independent directors. there were total 5 IDs in Satyam's board. There were serious allegations against the IDs that they had approved the acquisition of Mytas Infra and Mytas Properties, which was owned by the Raju family. Without even taking the interest of the shareholders into account, the directors passed the resolution to go along with the decision of acquisition of Mytas. Also, the company was spending a lot of money on unrelated business. These all instances show that there was no proper oversight mechanism by the independent directors. Also, Raju Ramalingam, the chairman of the company was showing fake transaction, employee, bills, and receipts to the audit committee. He even manipulated balance sheet to deceive the investors. In this also, even the audit committee had not properly discharged their functions wherein the audit committee mostly consist of IDs.

In the end, Ramalingam said that only he was aware and was involved in this whole scam and other directors were not even aware of the fraudulent actions that were done by Ramalinga. But this raises a big question as to how this scam of Rs. 7000 can be done by only one person?

c. Jeet Singh Sodhi v State of Maharashtra[10]:

The Bombay HC in this case held that the independent and non-executive directors won't be held liable for the actions of the company, especially when these actions relate to the day-to-day functioning of the company where the IDs don play any role.

d. Sunil Bharti Mittal v Central Bureau Investigation & Ors.[11]:

In this case the court held that the person can only be held liable if there was sufficient evidence to prove that there was criminal intent behind his actions. He had an active role or where the statutory regime attracts the doctrine of vicarious liability.

The judicial pronouncements of High Court and Supreme Courts show that the if any independent director can satisfy that the alleged violation has been committed without his knowledge, consent, connivance, or negligence, then he shall not be held liable. Therefore, the liability of the IDs would differ from case-to-case basis.

7. ALTERNATE STRUCTURE AND KEY SUGGECTIONS FOR IMPROVING THE APPOINTMENT OF INDEPENDENT DIRECTORS

To enhance the independence of independent directors, there are several provisions under the law. But there still needs to be some more provisions according to author to increase their independence. Ajay Tyagi, the former chairman of SEBI has pointed out that even though the independent directors meet the regulatory requirements on paper, there is hardly any independence in their conduct[12]. These statements itself makes it clear towards the urgent need for amending the provisions relating to IDs for the purpose of strengthening corporate governance.

8. PROBLEMS AND SUGGESTIONS

- The main problem with Section 49 of the Listing agreements is that it is the copy paste of UK and USA laws. It needs to be taken into consideration that the corporate structure of India varies greatly from UK and US. India follows a system of 'insider model' whereas UK and USA follow the 'outsider model'. In India most of the companies are family owned or it is owned by the state. Hence, when the business is owned by the family why would they

[10] Satvinder Jeet Singh Sodhi and Anr. Vs State of Maharashtra on 1st July, 2022,(Last visited on Oct 31, 2023), https://indiankanoon.org/doc/13551621/

[11] Sunil Bharti Mittal v CBI, (Last visited on Oct 31, 2023), https://indiankanoon.org/doc/159121041/

[12] Anirudh Laskar, Independent directors have failed minority shareholder, (Last visited on Oct 31, 2023), https://www.livemint.com/news/india/independent-directors-have-failed-minority-shareholders-says-sebi- chief-11617698351094.html#:~:text="I%20must%20admit%20that%20notwithstanding,at%20a%20corporate%20governance%20summit

want independent directors who against their wishes and would not give decisions in their favor. Therefore, in India independent directors are just on paper and ticking the boxes of legal compliance but, they end up acting as mere puppet of CEO and other directors. And leave Clause 49 which can only be desired until and unless the government comes up with a model which is favorable to Indian corporate market.

- In India, usually the appointment of independent director is done by promoter or existing board members which is one of the major problems. How can you expect the independent directors to be independent when they have been appointed by the promoters or board members itself and they can be removed anytime at the will of these people if they do not follow what they say.
- Also, another problem is that their remuneration is controlled by these board members. As Independent directors (ID) only benefit from the company is remuneration under section 197(5) of the Companies Act. Both these problems defeat the whole purpose of independent directors. Hence, the solution to both problems is to appoint independent directors through non-controlling shareholders or to be appointed through statutory independent selection committee. At least by this method the directors will be able to give decision unbiased and independently.
- Another problem which is raised is unsatisfactory manner of remuneration awarded to such directors. By reading section 197(5), 197(9) and 149(9) of the Companies Act, 2013 together we can see that the IDs get sitting fee and remuneration for attending the meetings. And they are paid "profit-related commissions" on the approval of members. In practical, we can see that the commission is only paid when the ID allow the resolution to be passed without raising the objections against the same and such commissions cannot be received by the ID without the wish of the promoters and majority shareholders.

Hence, we can see that how these provisions are compelling the IDs to agree with every resolution passed by the board to have their extra share of money in their pocket. To solve this problem, the solution is to have a fixed rate of commission by the statute and sitting fees.

9. CONCLUSION

The role of independent director has been in limelight for quite a while due to the failure in ensuring compliance related to corporate governance. This research paper has mentioned studies which states that the more the number of independent directors, the better is the performance of the company. However, because the business run in India are mostly family owned, the independent directors can't function in their full capacity and have no choice but to listen to the directions given by the chairman. For these types of firms, the concept of independent director is just on paper and is not practically benefiting the company`. Hence, there is a need to bring a new type of oversight mechanism of these types of companies i.e., which are family owned.

The government from time to time have given out guidelines, duties, functions, and roles that are supposed to be played by an independent director in a company. Schedule IV of the Companies Act, 2013 lays down guidelines and functions of independent director. The compliance to these standards and responsibilities by the independent director will increase the faith of the shareholders in the company, particularly minority shareholders and will increase the overall goodwill of the company.