“Independent Directors: A Complete Analysis”

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Introduction
Though the concept of independent directors cannot be by any means termed as a new concept yet it has gained worldwide significance & is being seen under new light in recent years. The concept has become a huge matter of debate after corporate frauds like Satyam Scam, Enron scandal etc came to light.

One of the factors that that has been identified to be common across all these major corporate failures around the world has been the “failure of the board of directors of a corporation to detect internal crisis early on & act in a timely manner to put the organization back on track before difficulties become irreversible.”

After witnessing various corporate failures, scandals & the ensuing crisis, attempts at every level have been made to make corporations strong & effective to counter various problems which crop up in routine dealings. It is at this point that office of independent director draws attention as it is increasingly being felt that through them, objectivity & rational perspective can be brought on board & they can to a large extent ensure transparency & accountability of a board. They are expected to enhance the standards of corporate governance. “Corporate governance is a key element in improving economic efficiency & growth as well as enhancing investor confidence…The corporate governance should promote transparent & efficient markets, be consistent with the rule of law & clearly articulate the division of responsibilities among different supervisory, regulatory & enforcement authorities.”

In the next chapter, the researcher will discuss the concept of independent directors.

CONCEPT OF INDEPENDENT DIRECTORS
The board of directors play a key role in balancing the interests of managers & shareholders. The board also undertakes various other roles like keeping a check on the work of the executive team, analyzing their own performance etc. However if we compare the workings of widely held corporations & those corporations which are owned by a small number of people (usually family owned) we realize that the roles and functions of the board changes drastically between the two. In widely held corporations (eg.US & UK) the board’s role is one of “vertical governance” that entails working on behalf of the shareholders to maximize managerial opportunism & maximize shareholder wealth.

Whereas in family owned corporations the board’s role is that of “horizontal governance”, of balancing between major stockholders who are also part of management & the minority shareholders & also protecting the latter by the former. It is while pondering on these issues that a need is felt to have “independent” people on board who are free from any kind of

1 Jayati Sarkar, ‘Board Independence & Corporate Governance in India: Trends & Challenges’ (2009) 44 Indian Journal of Indian Relations  
2 Preamble, OECD Principles of Corporate Governance, 2004  
4 Ibid
influence or bias & can work independently harmonizing the interests of various parties involved in a corporation. The role they play in a company broadly includes improving corporate credibility, governance standards & the risk management of the company. They are also expected to contribute through their vast amount of experience & expertise to improve overall functioning of the company. They bring a fresh perspective to the boardroom & since they have no other vested interests, their judgment isn’t clouded & they can work exclusively for the benefit of the company. In Indian scenario this institution assumes another important role i.e. protection of minority shareholder’s rights as majority of companies are family owned businesses and thus they exercise strong control over the management.

However there is another side to the story which too needs to be briefly discussed. There is a section of scholars who raise their doubts on the “independence” of the independent directors. Their selection process raises a lot of eyebrows. When they are practically handpicked by the promoters, owners how can their ‘independence’ be taken seriously? In such circumstances, why will such people be chosen who are likely to oppose the owners? Another crucial point here is that generally people acting as independent directors have their own hectic, full time careers to take care of. So the amount of time & energy they can devote to the board they serve remains a concern. Also their limited right to interfere in day to day proceedings of the company appears to be another flaw.

However inspite of certain misgivings, the researcher is firmly of the view that independent directors have a huge role to play in maintaining high standards of corporate governance.

**EVOLUTION OF INDEPENDENT DIRECTORS IN USA & UK**

The concept of independent directors can be traced to the developed economies of the West with the UK & the U.S.A. sharing credit for its evolution during the 1950s even before legislation mandated the induction of independent directors to ensure that corporate entities did not make depredations into the public interest driven by the profit motive alone at the cost of other values. The concept was exported into other countries over the years.

**USA**

In USA the concept of independent directors was primarily developed as a solution to manager-shareholder agency problem. This problem can be clearly understood by considering the analysis of Berle& Means that emanated from their seminal study of ownership patterns of US corporations during the period between 1880 and 1930. In simple terms the manager shareholder problem in USA corporations was that mangers being in control of the company

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7 UmakanthVarottil, ‘Evolution and Effectiveness of Independent Directors in Indian Corporate Governance’ (2010) SSRN
were acting against the interests of the shareholders & the shareholders being scattered & lacking financial resources to involve themselves in affairs of the company were unable to check the abuse of powers done by the managers. And thus managers were busy in furthering their own interests than those of shareholders. To check this problem it was felt that a body needs to be developed to check the actions of managers, who were basically in control and responsible for running the corporations to protect the interests of shareholders. Alchian and Demetz in their organization theory suggested that shareholders will be the best monitors as they are the constituents that receive the residual income of the firm but their theory does not fit well in the context of the companies with diffused shareholding due to the existence of collective action problems among shareholders, who therefore would be ineffective as monitors. Thus this ultimately led to the responsibility of monitoring being transferred to the board of directors. And while deliberating on the issue of board composition it was realized that bringing such directors on board who are independent of the management’s influence would actually bring about the desired results & will monitor better than ‘inside directors’. Thus from here the concept of independent directors emerged primarily to address the manager shareholder agency problem.

Then during the 1970s the concept of the independent director “entered the corporate governance lexicon … as the kind of director capable of fulfilling the monitoring role.” It was generally felt that independent directors would bring some objectivity & diversity to the board besides doing the monitoring role. Various arms of the government rapidly bought into this idea: the judiciary to begin with, and then the legislature, with greater emphasis placed by self regulatory bodies such as the stock exchanges & law review bodies such as the American Law Institute (ALI).

Later scandals surrounding Enron and Worldcom focused substantial criticism on the U.S. corporate governance & critics and scholars used these events to mount a strong challenge to the prevailing systems of corporate governance. Sarbanes-Oxley Act of 2002 (SOX) was enacted to restore confidence in the markets after the collapse of the dot.com stock market boom and corporate governance scandals. SOX prohibited corporate loans to executives, required CEO certification of financial statements and bolstered regulation of audits & audit committees. Thus the wave of corporate governance reforms was led by the enactment of the Sarbanes-Oxley Act and revisions to the listing rules of NYSE and NASDAQ that introduced mandatory board composition requirements for the first time. The Sarbanes Oxley Act does not mandate a general requirement regarding independence of the board but while dealing with audit committees, it provides that each member of the audit committee of a public company shall be an

8 Ibid
9 Ibid
10 Ibid
13 Ibid
14 UmakanthVarottil (n 7)
independent director & it is the revised rules of the NYSE and NASDAQ that require that all listed companies contain boards that have a majority of independent directors.\textsuperscript{15}

**UK**

The development of corporate governance in the UK has its roots in a series of corporate collapses & scandals in the late 1980s and early 1990s. This led to the setting up in 1991 of a committee chaired by Sir Adrian Cadbury which issued a series of recommendations - known as the Cadbury Report – in 1992.\textsuperscript{16} That report introduced the concepts of non-executive director and independent director (sub set of executive director); It assigned two principal responsibilities to non-executive directors, viz.: (i) to review the performance of the board & the executives; and (ii) to take the lead in decision making whenever there is a conflict of interest.\textsuperscript{17}

In 1995 a separate report (Greenbury Committee) set out recommendations on the remuneration of directors, & in 1998 another report (Hampel Committee) reaffirmed the role of non executive directors & the two reports were brought together in a single code (UK Corporate Governance Code).\textsuperscript{18} In a subsequent series of reforms focused principally on the role of non-executive directors, the Higgs Report recommended that “at least half of the members of the board should be independent” & also the concept of independence was defined in the Higgs Report in an extensive form.\textsuperscript{19} The Combined Code was amended to include the principal recommendations of the Higgs Report & the current version of the Combined Code issued in 2008 continues this trend & board independence has thus become an integral part of corporate governance in the U.K.\textsuperscript{20}

**Evolution of Independent Directors in India & Historical Significance of Clause 49**

Corporate governance is perhaps one of the most important differentiators of a business that has impact on the profitability, growth & even sustainability of business, it is a multi level & multi tiered process that is distilled from an organisation’s culture, values & ethics, especially of the people running the business & the way it deals with various stakeholders. \textsuperscript{21}

Before 1991, India followed socialist policies. It was only after economic liberalization in 1991 that India progressed towards a new era of growth and development. One of the most crucial step was enactment of The Securities & Exchange Board of India (SEBI), India’s securities market

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\textsuperscript{15} Ibid  
\textsuperscript{17} UmakanthVarottil (n 7)  
\textsuperscript{19} UmakanthVarottil (n 7)  
\textsuperscript{20} Ibid  
regulator, in 1992. Indian economy grew rapidly. The need for capital, amongst other things, led to corporate governance reform & many major corporate governance initiatives were launched in India since the mid-1990’s; most of these initiatives were focused on improving the governance climate in corporate India, which, at that time was somewhat rudimentary. ²²

The first major step towards corporate governance norms was taken by Confederation of Indian Industry (CII), when in 1998 it issued first voluntary code of corporate governance titled “Desirable Corporate Governance”. ²³ This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business & industry; the need to move towards international standards in terms of disclosure of information by the corporate sector & through all of this, to develop a high level of public confidence in business & industry. ²⁴ The CII Code contained detailed governance provisions related to listed companies, although it was voluntarily adopted by only a few companies & did not result in a broad overhaul of governance norms & practices by Indian companies. ²⁵

The second major corporate governance initiative in the country was undertaken by SEBI when in 1999 it set up a committee under Kumar Mangalam Birla to promote & raise the standards of good corporate governance. ²⁶ The primary objective of the committee was to view corporate governance from the perspective of the investors & shareholders & to prepare a Code to suit the Indian corporate environment. ²⁷ The recommendations were divided into mandatory & non mandatory; mandatory recommendations applied to listed companies with paid up capital of three crore& above while recommendations related to the role of Chairman, corporate restructuring, further issue of capital etc. fell under non mandatory recommendations. ²⁸ Regarding independent directors it was recommended (under mandatory recommendations) that the Audit committee must be constituted of three independent directors with one having financial & accounting knowledge. ²⁹ SEBI implemented the committee’s proposal in Feb. 2000 & revised its listing agreement to incorporate the recommendations & thus a new section, Clause 49 containing the rules was introduced. The listing agreement needs to be complied with by all companies seeking to list their stocks on a stock exchange in India. ³⁰ Clause 49 of the Listing Agreement can be rightly termed as starting point of the Indian corporate governance reforms.

²² Ibid
²⁴ Ibid
²⁶ SantoshPande and Kshama V Kaushik (n 21)
²⁸ SEBI, Report of theKumarMangalam Birla Committee on Corporate Governance <http://web.sebi.gov.in/commreport/corpgov.html> accessed 14 September 2015
²⁹ Ibid
³⁰ Listing Agreement 2000, Clause 49
Post Birla recommendations, SEBI in order to evaluate & improve the existing practices established a committee under the Chairmanship of Mr. Narayana Murthy (2002-03). Also international events like passing of the Sarbanes Oxley Act by the US after the Enron scandal in 2001 influenced government of India to look into this direction. The committee recommended enhancements in corporate governance, recommendations were accepted by the SEBI in 2003 & asked the stock exchanges to revise Clause 49 of the Listing Agreement based on the recommendations. The revised clause while prescribing composition of the Board of a company, laid down that at least half the board of a company listed on the stock market must have independent directors if it is headed by an executive Chairman & for company boards headed by a non-executive Chairman, the independent director must be one-third. The revised clause also indicated that the director cannot be related to promoters or management at the board level, or one below the board; an executive of the company in the preceding three years; a supplier, service provider, or customer of the company; or a shareholder owning 2 percent or more of the company.

Now with so many provisions & guidelines in place, everything seemed well with the Indian corporate governance until the Satyam scandal shook the very foundations of the corporate governance in India.

Satyam was one of the biggest companies which had cross listed on the NYSE in the USA meaning that it was largely compliant with Clause 49 & also with the NYSE listing requirements. Satyam’s promoters, represented by Mr. Raju,(who was also Chairman of the Board) held the controlling block of shares- In 2008, a board meeting was convened to consider the acquisition of two companies – Maytas Infra Limited & Maytas Properties Limited, which focused on infrastructure development & real estate both of which were unrelated to Satyam’s core business. Raju’s family owned approximately 30 % of these two Maytas companies thereby making it a transaction between members of the same family but the board unanimously approved the transaction although it later came to light that the independent directors had initially questioned the same. But the deal had to be withdrawn & shortly after this, Raju confessed to cooking the company’s books over several years to the extent that Rs 5,040 crore of cash on the company’s balance sheet doesn’t exist & the authorities arrested Raju, his brother B. Rama Raju who was the then managing director of Satyam. Four independent directors resigned post this development.

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32 Ibid
33 Listing Agreement 2000, Clause 49
36 Ibid
37 Lison Joseph, ‘RamalingamRaju admits to accounting fraud, resigns’ (India, 31 January 2012)
Satyam scandal is the classic example of complete failure of corporate governance. It highlighted the weak positioning of independent directors. They are supposed to act as watchdogs but in this case they completely failed to do so even though Satyam had people with stellar credentials as independent directors.

Shortly after the news of the scandal broke, the CII began examining the corporate governance issues arising out of the Satyam scandal & in late 2009, the CII task force listed recommendations on corporate governance reform. In early 2010 SEBI amended the Listing Agreement & brought about many changes relating to board independence etc. Further SEBI released the amendments to Clause 49 of the Equity Listing Agreement on April 17, 2014 & the revised Clause 49 updates & aligns the Listing Agreement with corporate governance changes bought out in the Companies Act, 2013. Clause 49 besides definition, enforces certain restrictions on the independent director like a person not to serve as an in more than 7 listed companies restricting the tenure for two terms of five years each.

After putting all these regulations in place a sincere effort has been made to ensure transparent & accountable running of companies but the problem lies in compliance & enforcement. The main problem with Clause 49 is that it has practically been imported from UK & USA & being implemented in India, ignoring the fact that corporate structure etc of India varies greatly from UK & USA. We follow what can be called as ‘insider model’ whereas UK & USA follow the ‘outsider model’. India is a classic insider system where most public companies are controlled (by virtue of dominant shareholding) by either business families or the state. Now when the board is dominated by members of the family they hold complete authority in appointing independent directors of their choice. Why will they appoint people who will go against their wishes? In such situations independent directors end up acting as a mere rubber stamp. Also enforcement of Clause 49 leave much to be desired.

**Position of Independent Directors under Companies Act, 2013**

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38 CII, Report of CII Task Force on Voluntary Governance  

39 Afra Afsharipour (n 18)  
40 Revised Clause 49  

41 Ibid

42 Umakanth Varottil, ‘A Cautionary tale of the transplant effect on Indian Corporate Governance’ SSRN (2009)  

43 Ibid

44 Afra Afsharipour (n 18)
In Indian corporate history, there is more than an even chance that 2013 will go down as a watershed year in terms of corporate governance reforms as it was the year a path breaking new Companies Act, 2013 found its way in to the statute book.\textsuperscript{45} The new Act, 2013 has brought in a lot of revolutionary changes addressing wide variety of issues but the author will in this chapter focus on provisions relating to independent directors.

The 2013 Act, for the first time has defined the term “Independent director”. The old Act,1956 did not contain any provisions regarding this so only listed companies had to follow this requirement as per Clause 49 of the Listing Agreement but now independent directors have been made mandatory for unlisted large public companies. The Act, 2013 differs from Clause 49 at various points but its requirements are far more stringent than Clause 49.

**Who can be Independent Director**

By listing out detailed criteria regarding the appointment the Act has brought in a significant change. Any promoter of the company or its holding, subsidiary or associate company or anyone related to them or anyone who has or had pecuniary relationship with the company during the two immediately preceding financial years or current financial year have been excluded from being appointed as independent director.\textsuperscript{46} All this has been done to maintain complete independence .The Act also lays down a term-based appointment for a period of five years, renewable, by special resolution for a second term, & not subject to retirement by rotation.\textsuperscript{47} This kind of stability enables them to work can work fearlessly & efficiently.

**Number of Independent Director**

There is a specific obligation on every listed public company that at least one-third of the board of directors should comprise of independent directors & also empowers Central govt. to include other class/classes of companies within the scope of this requirement.\textsuperscript{48} To make the process even simpler, an independent director may be selected from a data bank containing details of persons willing to be appointed, maintained by any bodyetc as may be notified by the Central government.\textsuperscript{49} But the hard fact remains that it is really difficult to find adequate amount of persons sufficiently qualified & also willing to take up this job.

**Remuneration**

\textsuperscript{46}Companies Act 2013, s 149(6)
\textsuperscript{47}Companies Act 2013, s 149(10) and (11)
\textsuperscript{48}Companies Act 2013, s 149(4)
\textsuperscript{49}Companies Act 2013, s 150(1)
Another significant step taken is that the Act also places limit on the amount of shares that can be held in the company by a relative of such a director.\textsuperscript{50} The Act also expressly disallows them from obtaining stock options.\textsuperscript{51} Profit related commission may be paid to them, but subject to the approval of the shareholders.\textsuperscript{52} The concern which arises here is wide disparity between the remunerations & the responsibilities given to perform.

**Responsibilities**

The Act has imposed manifold responsibilities on independent directors. The Act requires the individuals to submit a self-declaration confirming that they have satisfied the criteria prescribed for the position.\textsuperscript{53} It is also stated that any board meeting held at shorter notice (to transact urgent business) requires the presence of at least one independent director & if such is not present, the matter discussed at the board will be considered approved only once an independent director ratifies it.\textsuperscript{54} Further, they can be removed if they fail to attend any board meeting for 12 months period with or without permission from the Board.\textsuperscript{55}

**Separate meetings**

The Act makes it mandatory for all the independent directors to hold at least one meeting annually, without the presence of non independent directors & members of management.\textsuperscript{56} Here they are expected to review the performance of the Chairperson, non independent directors & the Board as a whole.\textsuperscript{57}

**Committees**

The Act has made it mandatory for independent directors to be a part of certain committees.

- **Corporate Social Responsibility Committee**: The Act provides that every company having net worth of rupees five hundred crore or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a CSR Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director.\textsuperscript{58} This provision has been included so that independent directors can keep a check on the workings of the CSR committee.

\textsuperscript{50} Companies Act 2013, s 149(6) (e)( iii)
\textsuperscript{51} Companies Act 2013, s 149(9)
\textsuperscript{52} Companies Act 2013, s 197(7)
\textsuperscript{53} Companies Act 2013, s 149(7)
\textsuperscript{54} Companies Act 2013, s 173(3)
\textsuperscript{55} Companies Act 2013, s 167
\textsuperscript{56} Companies Act 2013, Schedule IV
\textsuperscript{57} Ibid
\textsuperscript{58} Companies Act 2013, s 135(1)
• **Audit Committee**- The Act requires that the Board of every listed company & such other companies as may be prescribed shall constitute an Audit committee which shall consist of a minimum of three directors with independent ones forming a majority.\(^{59}\)

• **Nomination & Remuneration Committee (NRC)** - The Act requires that the Board of every listed company & such other companies as may be prescribed shall constitute an NRC consisting of three or more non executive directors out of which not less than one half shall be independent directors.\(^{60}\) The role of NRC is to (a) identify persons qualified to become directors, (b) recommend to the Board their appointment & removal, (c) evaluate directors performance, (d) recommend to the Board a policy relating to the remunerations for the directors etc.\(^{61}\)

**Independent Director’s Liability**

Also in order to provide an atmosphere where independent directors feel free to function to their full capabilities the 2013 Act protects them from liability, however, only to a certain extent. It is provided that they are liable only if any fraudulent act has been committed with the consent of such a director or where such director has not acted diligently & if such act is attributable to the board process.\(^{62}\)

**Code for Independent Directors**

The company & independent directors are required to “abide by the provisions specified in Schedule IV” of the Act,\(^{63}\) which provides a detailed Code for independent directors. However the code appears to be mandatory which can lead to certain issues like the code states that an independent director shall uphold ethical standards of integrity & probity, however what would constitute ethical behavior is not defined & is open to interpretation.\(^{64}\) Also it refers to appointment of independent director by the board after evaluating certain attributes, the concern that remains unaddressed is the manner in which companies need to carry out an assessment of the attributes as specified under ‘manner of appointment’ in the code from the databank maintained by the MCA.\(^{65}\)

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\(^{59}\) Companies Act 2013, s 177
\(^{60}\) Companies Act 2013, s 178
\(^{61}\) Ibid
\(^{62}\) Companies Act 2013, s 149
\(^{63}\) Companies Act 2013, s 149(8)
\(^{64}\) PwC India, *Companies Act, 2013 Key highlights and analysis* <https://www.pwc.in/assets/pdfs/publications/2013/companies-act-2013-key-highlights-and-analysis.pdf> accessed 13 September 2015
\(^{65}\) Ibid
Conclusion

The institution of independent directors has come a long way & has evolved over the years. In Indian context, Companies Act, 2013 has become a turning point for independent directors. They have been assigned wide powers & responsibilities. The major reason behind this is that it is being sincerely hoped that independent directors would be successful in implementing high standards of corporate governance & ensure that the companies are run in a transparent & efficient manner. They also carry with them the expectation that they would act as the protector of minority shareholder’s interests which is very important at least in Indian context.

However the kind of roles & responsibilities that have been assigned to them under Act, 2013 appear to be numerous & at certain times, overwhelming. It remains to be seen as to how many people would be willing to take so many responsibilities especially when remunerations are not at all attractive. It also remains to be seen whether independent directors, in reality are able to carry out so many functions as been assigned to them in an efficient manner. But at the same time it is too early to analyze whether these provisions would be successful in implementation or not.

To conclude, the researcher feels that all the desired regulations, provisions etc have been put in place to ensure office of independent directors are able to contribute in corporate governance. All that remains to be seen is whether independent directors are able to break away from their old mould of merely acting as rubber stamp & actually contribute to the growth of the company rather than simply playing an ornamental role.

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