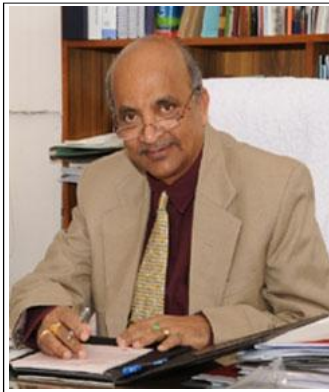


Corporate Governance: Redefining The Role Of Independent Directors



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INTRODUCTION

By convention, independent directors have been viewed as a bulwark against abuse of a corporate entity. While it is debated as to whether or not the institution of independent directors contributes to the performance of the firm, the general perception with regard to independent directors as providers of an effective internal monitoring system

has eroded in light of their failure to prevent several corporate scandals of epic proportions. This raises the question as to the suitability of independent directors in ensuring superior standards of corporate governance. Furthermore, the altered scenario requires a revisit as to the duties of independent directors and their evaluation in context of the changing requirements that an independent director is mandated to fulfill.

INDEPENDENT DIRECTORS: CONTEXTUAL BACKGROUND

The Companies Act makes no distinction between different divisions of directors¹. *Australian Securities and Investment Commission*² stated that there exists no distinction between the executive directors and the non-executive directors with respect to the fiduciary duties owed to the company in common law³. *Commonwealth*⁴ and *Dorchester*⁵ attest to such a view. While there exists uniformity in the fiduciary duties owed by the executive and the non-executive directors, the execution of such duties determines the variations in the functions to be performed.⁵ While non-executive directors are generally appointed to render independent judgment on issues of strategy, performance, resources and standards of conduct⁷, they are enjoined to act in a fiduciary capacity similar to that of the executive director for those duties specifically allocated to them.

Having established the framework governing non-executive directors, it is prudent to scrutinize the developments which have led to the evolution of independent directors who are necessarily non-executive in nature.⁸ The 1970s saw the voluntary initiation of independent directors as a measure to ensure suitable standards of corporate governance⁹. Numerous corporate scandals led to regulations which necessitated the presence of independent directors in the boardrooms

of listed companies.¹⁰

In India the term *independent director* was not concretely defined till the introduction of clause 49 of the listing agreement to the Indian stock exchange¹¹ which primarily highlights the responsibilities of an independent director.¹² The Sarbanes-Oxley Act of the U.S.A passed to counter the corporate scandals arising out of misstating financial documents¹³ and the Cadbury Committee report¹⁴ of the U.K which form the background for the introduction of clause 49 of the listing agreement exemplify the envisaged invigilatory role of an independent director.

The underlying context in which authoritative committee reports¹⁵ in the U.K have emphasized on the role of independent directors is an *inadequate internal monitoring system* leading to failure of corporate governance. Thus it is appropriate to assume that the concept of Independent directors subsumes the crucial function of ensuring corporate compliance with legal requirements.

INDIAN SCENARIO: RELEVANCE OF INDEPENDENT DIRECTORS

Such a conclusion marks a departure from the position in India where empirical studies suggest that an overwhelming number of independent directors view their function as *strategic advisors* with no liability attached for failing to act as a monitoring mechanism to prevent corporate scandals.¹⁶ This perception negates the foundation of independent directors as expert advice need not satisfy any criterion of independence at all. The en masse resignation of the independent directors of various companies in the post-Satyam scenario¹⁷ wherein prosecution of independent directors was debated confirms the conception that most independent directors conceive their supervisory role to be severely limited. This highlights the dichotomy between the officially envisioned role for an independent director and the heavily reduced version in practice.

I shall examine several interlinked reasons which strike at the purported efficacy of independent directors in ensuring good corporate governance practices. First, the transplantation of the concept of independent directors as it exists in the U.S.A and the U.K to the Indian model and the suitability, thereof. Herein as Umakanth Varottil argues, the diffused ownership structure in the U.S.A and the U.K forms a different corporate context than the promoter dominated Indian corporate ownership scenario.¹⁸ Thus, the institution of independent Directors has been designed to operate in the absence of influence from a cohesive group of authority wielding shareholders which is present in most Indian companies.

Subsequently, the offset of a powerful shareholder group is a misplaced sense of loyalty by the independent directors towards the group rather than the interests of the corporate firm.¹⁹ The absence of a statutory mandate

for a *nomination committee* independent from extraneous influences for the purpose of appointing independent directors strengthens the hold of the promoters with regard to the appointment process.²⁰ Further, the loopholes in clause 49 such as a limited interpretation of *relatives* who cannot be appointed as independent directors²¹, lack of expertise requirements and deeming nominee directors who protect specific interests as independent directors²² permit abuse of the mechanism.

The role of the independent directors is better understood while examining the functions of the audit committee which is mandated by clause 49. The Blue Ribbon Committee underlined the importance of the audit committee and the authenticity it provides through its expertise and independence.²³ The audit committee is granted extensive oversight and review authority which includes ensuring accurate disclosure of financial statements.²⁴ A minimum of two-thirds of the audit committee shall comprise of independent directors.

SEBI's order against *Pyramid Samaira*²⁵ elucidated on the functions of independent directors in listed companies. Banning three independent directors from participation as directors in any listed company for a period of two years, SEBI said that independent directors who are a part of the audit committee owe a *duty of care*²⁶ to the company and by not checking the credibility of the financial statements, they would be *negligent* in their conduct or *participants in the fraudulent acts*²⁷ of the management.²⁸ Given the expectations from the audit committee, it is necessary for the independent directors to possess a suitable level of financial expertise which is not the case as clause 49 requires financial literacy rather than expertise as a minimal requirement.²⁹ The Naresh Chandra committee report focused extensively on the contributions of independent directors; it emphasized on financial competence and thereby, ability to ensure veracity of financial statements apart from reiterating the fiduciary duty of care owed by the independent directors but this stands in contrast to clause 49 from which the expected level of performance cannot be derived.³⁰

The increasing expectations with regard to the functional roles and capacity to monitor of independent directors are highlighted by the indictment of Keshub Mahindra in his capacity as the non-executive chairman of Union Carbide India Limited.³¹ Studies conducted to assess the contribution of independent directors towards value addition to firms have concluded positively

in the favor of independent directors.³² The presence of the independent directors in the audit committee might create a sense of security to ordinary investors as it appears to be an impartial business expert functioning as a monitoring mechanism against fraudulent practices.³³

When this sense of assurance is examined in context with the aforementioned reasons which question the value of independent directors, Prithvi Haldea's denouncement of independent directors that they "*end up serving a negative purpose, that of providing a false sense of security to the minority shareholders*" rings

ominously true.³⁴ In a practical insight, Haldea highlights broad categories such as relatives and retired professionals as the pool from which independent directors in India are appointed. Herein, both the categories remain obligated to the promoters due to filial concerns for the former and a constant stream of income for the latter.³⁵

ADVOCATING A PARADIGM SHIFT

Mere compliance with regulations mandating the presence of independent directors does not ensure corporate governance. It is necessary to strengthen the institution of independent directors in order to sustain its relevance as an enforcer of good corporate governance. First, to deal with the nature of independent directors appointed, an independent nomination committee is necessary. Alternatively, the government can identify a pool of people capable of discharging the appropriate functions of an independent director from which the listed companies can appoint their independent directors.

Subsequently, the flippant attitude of independent directors with regard to their functions in the boardroom needs paradigm shift. Deepak Parekh argues that liability cannot be pinned on independent directors as it would result in a reduction of competent people available for appointment as independent directors.³⁶ I submit that advocating for zero liability compromises the primary requirement of diligent oversight expected from an independent director as it tantamounts to accepting the position that an independent director exists to provide a *false sense of security*. While the expert committee suggest that independent directors should be absolved from liability in most instances³⁷ and that liability can arise only when an independent director is in charge of the matter, the duty of oversight requires liability if the independent director *should have been in charge but failed to do so*.

An independent director cannot claim *ignorance of the management's actions* as a ground to escape liability as his duty is to ensure that those actions are in compliance with legal regulations. While independent directors cannot be made liable for executive actions beyond the purview of their supervisory authority, accountability with regard to their role in the audit committee and other allocated functions is crucial. "*Differential liability based on asking the Right questions at the right time*" should form the basis for making independent directors accountable.³⁸

To conclude, it is prudent to examine multiple avenues of corporate governance operating at different levels of the corporate hierarchy rather than limiting it to appointment of independent directors in listed companies. Employee representation, stringent monitoring of corporate compliance with regulations, broadening the application of corporate governance norms to non-listed companies, incentivizing and protecting whistle blowers from corporations and rigorous certification norms to identify a company as adhering to good corporate governance practices are a few aspects which shall contribute to

achieving the purpose of corporate governance; *quality monitoring guaranteeing the interests of the shareholders within legal parameters.*

CONCLUSION

In this article, I have examined the challenges facing independent directors. From the process of appointment till the expertise possessed by them, the concept of independent directors as it exists today is fraught with practical hurdles. The amalgamation of ownership and control in Indian corporate structures posts the independent directors in a piquant situation wherein they

are supposed to monitor the actions of individuals to whom they owe a sense of loyalty. The objective of this article is to make a case for a thorough revamp of the institution of independent directors from its present form to a structure wherein appointment of independent directors is not controlled by promoters and suitable expertise is mandated. Further, liability for envisioned functions of the independent directors ensures a suitable model wherein minority shareholders and the public at large can repose trust in the concept of independent directors.

- 1 See S.2(30), Indian Companies Act, 1956
- 2 Australian Securities and Investment Commission v. MacDonald, [2009] ALMD 5385
- 3 Paul L. Davies, GOWER AND DAVIES' PRINCIPLES OF COMPANY LAW, 491-494 (8th Edn., 2008).
- 4 Commonwealth Oil and Gas Co Ltd. V. Baxier and Eurasia [2009]CSIH 75.
- 5 Dorchester Finance v. Stebbing, [1989] BCLC 498.
- 6 See Daniels v. Anderson (1995) 16 ACSR 607
- 7 Report of the Committee on the Financial Aspects of Corporate Governance ["Cadbury Committee"] 4.11 (1992)
- 8 All independent directors are non-executive whereas the vice-versa may not always be the case
- 9 See Jeffrey N. Gordon. *The Rise of Independent Directors in the United States. 1950-2005: Of Shareholder Value and Stock Market Prices.* 59(6) STANFORD LAW REVIEW (2007).
- 10 See Larry E Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28(1) JOURNAL OF CORPORATION LAW (2003)
- 11 SEBI Circular: SEBI/CFD/DIL/CG/1/2004/12/10, October 29 2004
- 12 Annexure I, Clause-49 of Listing Agreement, I(A)(iii); one of the essential requirements of an independent director is that he has to be a non-executive director
- 13 See Ss.301, 407 and 204, Sarbanes-Oxley Act, 2002
- 14 Report of the Committee on the Financial Aspects of Corporate Governance ["Cadbury Committee"], 20-36 (1992)
- 15 See Report of the Committee on the Financial Aspects of Corporate Governance ["Hampel Committee"], 21-49 (1998); See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee, 20-37 (1999).
- 16 Vikramaditya S. Khanna and Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence*, 22(1) NATIONAL LAW SCHOOL OF INDIA REVIEW 35, 35-39 (2010)
- 17 Id
- 18 Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6(2) HASTINGS BUSINESS LAW JOURNAL 281, 281-292 (2010)
- 19 See Leo E. Strine Jr. et al, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law (2009)* available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=1349971 (Last visited on 24 June 2011).
- 20 While the Corporate Governance Voluntary Guidelines, 2009 emphasize on the importance of a nomination committee to curtail the influence of the promoters, there is no directive obliging compliance with such a recommendation.
- 21 Annexure I, Clause-49 of Listing Agreement, I(A)(iii)(a).
- 22 Annexure I, Clause-49 of Listing Agreement, I(A)(iv).
- 23 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee, 20-37 (1999).
- 24 Annexure I, Clause-49 of Listing Agreement, II(D).
- 25 SEBI Order No: WTM.MSS.ID2/92/2011, available at <http://www.sebi.gov.in/cmorder/pyramidmar2011.pdf> (Last visited on April 1, 2010)
- 26 Id, at 7
- 27 8, Australian Securities and Investment Commission v. MacDonald, [2009] ALMD 5385
- 28 See *Statewide Tobacco Services Ltd v. Morley* (1992) 8 ASCR (305); See *Commonwealth Bank of Australia v. Friedrich & Ors.* (1991) 9 ACLC 946.
- 29 Annexure I, Clause-49 of Listing Agreement, II
- 30 Naresh Chandra Committee Report on Corporate Audit and Governance, Chapter IV(2002)
- 31 State of Madhya Pradesh and Ors. V. Keshub Mahindra & 8 Ors., Criminal Appeal No. 369/2010, May 7, 2010 (Court of Sessions, Bhopal)
- 32 Vikramaditya S. Khanna and Bernard S. Black, *Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India* (2007) available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=914440 (Last visited on 25 June 2011).
- 33 Rajesh Chakrabarti et al, *Independent Directors and Firm Value: Evidence from an Emerging Market (2010)* available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=1631710 (Last visited on 25 June 2011)
- 34 Prithvi Haldea, *Naked Truth about Independent Directors (2009)* available at http://www.directorsdatabase.com/IDs_Myth_PH.pdf (Last visited on 25 June 2011)
- 35 While Clause 49 prohibits material pecuniary relationships, the attractive remuneration that the post of an independent director attracts is *per se* sufficient to remain beholden to the promoters.
- 36 Partha Sinha and Shubham Mukherjee, *Government shouldn't hound independent directors: Deepak Parekh, HDFC Chairman*, THE ECONOMIC TIMES (June 18, 2010) available at http://articles.economicstimes.indiatimes.com/2010-06-18/news/27606946_1_deepak-parekh-bhopal-gas-tragedy-keshub-mahindra (Last visited on 26 June 2011).
- 37 Naresh Chandra Committee Report on Corporate Audit and Governance, (2002) supports no liability for independent directors while the Narayana Murthy Committee Report, 2003 suggests a limited version of liability.
- 38 Are Independent Directors Liable, BUSINESS STANDARD (June 30, 2010) available at <http://www.businessstandard.in/india/news/are-independent-directors-liable/399821>.