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Are Independent Directors, Really Independent?

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ABSTRACT

As a result of "lax monitoring leading to crises at major listed businesses," the need for independent directors has been underlined in India. As one of the leading information technology corporations in India, Satyam Computer Services Ltd. (Satyam) was embroiled in a significant accounting crisis in 2009, which resulted in the resignation of independent directors; it became clear that their position must be urgently reviewed. In addition, given their limited responsibilities within the firm, the Satyam crisis "revealed the rising necessity to determine exactly the threshold for identifying the accountability of independent directors for prevention and detection of fraud. This paper studies the reasons behind the need to incorporate the concept of Independent Directors in the Indian Corporate Governance System and the issues attached to this model.

Keywords: *Independent Directors, Corporate Governance.*

I. INTRODUCTION

The concept of Independent Directors has been originated in the U.S. and the U.K. sometime in the 1950s.[3] The U.S. form of corporate governance is an outsider one, which means that the corporate governance systems have (1) diversified equity ownership, (2) minority investor protection is a top priority in securities law and regulation, and (3) recognised primacy of shareholder interests in the company law, and basically, the shareholders are the large institutions that retain no relationship with the company and are least interested in managing the company.[4] Thus, the introduction of independent directors was voluntary and intended to improve corporate governance and solve manager-shareholder agency problems and majority-minority agency problems.

Contrary to the U.S. and U.K. models, the Indian corporate governance model is an insider one. The “insiders” have a close relationship with the company as the businesses and companies in

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[3] Jeffrey Gordon, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices, Columbia Law and Working Economics No. 301 (September 2006).
[4] Umakanth Verotill, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Hastings Business Law Journal (2010).

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India are family-owned businesses.[5] The Promoters (business family groups) are the company's founders with a majority shareholding and have control over the company. These insiders have entire control over the company and dominate the affairs of the company. Thus, in this case, it is the minority shareholders whose voice is not being heard despite being the owners of the company. As the minority shareholders do not have many shares in hand, they do not have any rights that could potentially help them save their interests. It is the majority shareholders who designate senior executives, but they also frequently appoint themselves to the boards of directors or managerial positions. Senior management roles are generally held by family members in businesses that are owned and operated by family groupings. Thus, there was a need in the Indian Corporate structure to protect the rights of minority shareholders and solve the agency's problems.

Another reason why the need to transplant independent directors in the Indian corporate ecosystem is that the U.S. and U.K. corporate systems have a major impact all over the world. Also, almost all the evolving economies had opened their doors to foreign investments, and U.S. and U.K being the leading investors, there was an urgent need for a country like India to create and establish similar corporate governance models that looked familiar to investors to attract foreign investment in India. Thus, in the year 2000, the regime of Independent Directors was introduced under Clause 49 of SEBI (Listing and Disclosure Requirements) and then eventually was codified under Section 149 of the Companies Act, 2013.[6]

The debates surrounding independent directors became heated in the wake of significant financial scandals like Enron, WorldCom, and the Satyam scam in India, necessitating urgent redress. This took the form of Section 149 of the Companies Act 2013, which codifies the duties and obligations of independent directors in addition to laying out a thorough procedure ensuring their independence during selection. The idea of an Independent Director established under the Companies Act is to act as a conscience-keeper and watchdog to protect the rights of the minority shareholders and the stakeholders in general.

II. Issue with the concept of independent directors in the Indian context

The evolution of corporate governance and the subsequent adoption of the idea of independent directors were both influenced by liberalisation in India. It is crucial to remember that independent directors can only function effectively when they are free from the influence of

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[5] Id. at 2.
[6] Id. at 2.

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corporate management. However, there is a fundamental issue with this since the idea was taken straight from the outsider model and applied to the insider model without any changes. India is an insider model; the promoters have a controlling stake in the company. Thus the irony is that indirectly the independent directors are appointed by the promoters themselves to act as a watchdog.

This is the reason why independent directors are not encouraged to oversee the company's management; and second, even if they do, most independent directors lack the tools, mechanisms, independence, and knowledge (apart from the audit committee) required to do so.

The best way to address the rising corporate scandals and fraud may not be to tighten the rules of corporate governance for independent directors. This is primarily due to two factors: first, not all wrongdoings can be tracked down by independent directors because they are not involved in the day-to-day operations of the company; and second, the institution of independent directors may not be viable due to growing responsibility and liability, a lack of motivation to report wrongdoings, and a lack of recourse for protection under the current legal framework.

In such a situation, it is crucial that the government recognises the need to defend the actual independent directors as well. The role of the independent director is frequently at the mercy of the promoters in a nation like India, where significant corporations are majority controlled by business dynasties. Currently, the MCA's changes would put independent directors in a precarious position where, on the one hand, if they attempted to raise red flags, the majority shareholders might remove them via special resolution, and, on the other hand, if they did not, the MCA might take drastic measures like freezing their personal assets, removing and debarring them, etc.

III. Conclusion

Thus, the interests of the firm and the independent directors must be balanced by the government. Excessive regulation is bad since it will make the issue worse. Giving independent directors more protection is one way to accomplish this goal. Additionally, minority shareholders should be given a voice in the selection and removal of independent directors rather than just the majority. As one of its goals is to safeguard the interests of minority owners, this would promote the goal of choosing independent directors.

Independent directors would only be able to carry out their duties with diligence if they felt they were legally protected. Since independent directors are the foundation of corporate governance,

increasing the efficacy of their job is crucial to establishing strong governance standards.

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