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EVOLUTION AND EFFECTIVENESS
OF INDEPENDENT DIRECTORS IN
INDIAN CORPORATE
GOVERNANCE

Umakanth Varottil

I. INTRODUCTION

An independent board of directors in public listed companies is seen as an integral element of a country’s corporate governance norms. Board independence has taken on such a pivotal status in corporate governance that it has become almost indispensable. Consequently, governance reform in recent years has increasingly pinned hope as well as responsibility on independent directors to enable higher standards of governance.

Although the institution of independent directors has been the subject of debate lately, the concept itself is hardly of recent vintage. Independent directors were introduced voluntarily as a measure of good governance in the United States in the 1950s before they were mandated by law. Thereafter, owing to sustained efforts by the Delaware courts and stock exchanges in deferring to decisions of independent boards, independent directors took on greater prominence. Following the Enron cohort of
scandals, independent directors were recognized by statute as well.\(^4\) A similar, but more recent, trend is ascertainable from the United Kingdom as well. The requirement for board independence there was triggered by the Cadbury Committee Report ("Cadbury Report") in 1992.\(^5\) With these developments, board independence became well-entrenched in the U.S. and the U.K.

The turn of the century witnessed a proliferation of independent director requirements beyond the borders of the U.S. and the U.K. This is due to the profound impact that reforms have had on corporate governance norm-making around the world, particularly in relation to the appointment of independent directors as an essential matter of good governance. The Cadbury Committee Report has led the development of corporate governance norms in various countries such as Canada, Hong Kong, South Africa, Australia, France, Japan, Malaysia, and India, to name just a few.\(^6\) Similarly, the U.S. requirement of independent directors has also resulted in readjustment of corporate governance norms in various countries.\(^7\) Since the 1990s, "at least 26 countries have witnessed publication of guidelines that stipulate minimum levels for the representation of outside directors on boards of publicly traded companies."\(^8\) This demonstrates the significant impact of Western-style corporate governance norms (particularly the independent director) on other countries.

This Article analyzes the effect of incorporating the independent director concept into one such country, India. In 2000, the Securities and Exchange Board of India ("SEBI") mandated that all large public listed companies in India are to have a minimum number of independent

directors. Since then, ongoing reforms by SEBI have solidified the requirement of board independence as a prerequisite for enhanced corporate governance.

The purpose of this Article is two-fold: (i) to identify the rationale for the emergence of independent directors by tracing their evolution in the U.S. and the U.K. where they originated; and (ii) to examine the transplantation of that concept into India with a view to evaluating the effectiveness of independent directors in that country. This Article finds that there are significant differences in the corporate ownership structures and legal systems between the countries of origin of independent directors on the one hand and India on the other. Due to the diffused shareholding structures in the U.S. and the U.K., the independent directors were ushered into corporate governance norms in those countries in order to operate as a monitoring mechanism over managers in the interest of shareholders. Each stage in the evolution of board independence bears testimony to this fact.

However, transplanting a legal concept to a country such as India without emphasizing local corporate structures and associated factors is likely to produce unintended results and outcomes that are less than desirable. Due to the concentrated ownership structures in Indian companies, it is the minority shareholders who require the protection of corporate governance norms from actions of the controlling shareholders. Board independence, in the form it originated, does not provide a solution to this problem. While this Article is skeptical about the effectiveness of board independence in India, it suggests reforms to embolden independent directors that may empower them to play a more meaningful role in corporate governance.

Part II of this Article outlines the key differences in corporate structures and governance between the U.S. and the U.K. (where independent directors originated) and India (into which the concept was transplanted) and identifies the specific agency problems that are operative in the respective countries. Part III sets out to establish that the emergence of the independent director in the U.S. and U.K. correlates to the theory of the monitoring board whereby independent directors were to act as monitors of managers in the interests of shareholders. Part IV analyzes the legal regime relating to corporate governance and independent directors in India. Part V evaluates the empirical evidence pertaining to the effectiveness of independent directors in enhancing corporate governance standards in India. Part VI sets out some normative suggestions for the way forward, and Part VII concludes.

II. COMPARATIVE CORPORATE GOVERNANCE: SETTING THE TONE

While the specific focus of this Article is on the role of independent directors, that focus fits within the broader context of the different types of regimes in the field of corporate governance. Essentially, the purpose is to examine the implications of extracting the concept of independent directors from one type of corporate governance system and transplanting the same into another type. This Part seeks to determine the differing characteristics in the ownership structures and systems of corporate governance between the U.S. and the U.K. on the one hand and India on the other.  

A. DIFFERENT MODELS OF CORPORATE GOVERNANCE

Since independent directors originated primarily in the U.S. and the U.K. and were thereafter exported to other countries, a key question is whether the concept can be implemented across various jurisdictions. Do fundamental differences between jurisdictions make implementation in some more effective than in others? This naturally leads us to a study of the differences in corporate governance systems in various countries.

1. The United States and United Kingdom

Both the U.S. and the U.K. exhibit characteristics of the outsider model of corporate governance. There are four core features of this system. (1) dispersed equity ownership with large institutional holdings, (2) the recognized primacy of shareholder interests in the company law, (3) a strong emphasis on the protection of minority investors in securities law and regulation, and (4) relatively strong requirements for disclosure.

The U.S. and the U.K. display dispersed share ownership with large institutional shareholdings. This essentially follows the pattern of the Berle and Means corporation which is represented by dispersion of ownership. Shareholders typically have no interest in managing the company and

10. For a broader discussion of these corporate governance systems and the specific characteristics that are applicable to India, see Umakanth Varottil, A Cautionary Tale of the Transplant Effect on Indian Corporate Governance, 21 Nat. L. Sch. Ind. Rev. 1 (2009).


12. Id.

13. Id.

14. Id.

15. Id.

retain no relationship with the company except for their financial investments—the separation of ownership and control is at its best.\footnote{17} Due to the existence of diffused shareholding and the separation of ownership and control, the primary effort of corporate law in these jurisdictions is to curb the "agency costs arising from self-serving managerial conduct,"\footnote{18} by acting as a check on the activities of managers and by enhancing their accountability towards shareholders.

Other key characteristics of these countries are the emphasis they place on the efficiency of the securities markets and on disclosure and transparency. They follow a market-based system (with lesser reliance on mandatory rules, and greater emphasis on default rules) that provides a significant role to market players as opposed to regulators and the state. Such a regime focuses heavily on capital markets and imposes high disclosure standards that require companies to disclose information and leaves decision-making on investment matters to the various participants in the market. It also presupposes the existence and predominance of proper market systems and sophisticated players (such as knowledgeable professionals like lawyers, accountants and investments bankers, a competent judiciary and other important fiduciaries such as a cadre of independent directors with a strong foundation in corporate laws and practices).\footnote{19} In fact, since "diffuse ownership yields managerial agency costs as a problem, . . . it is associated with institutions like independent and transparent accounting, which mitigate these costs."\footnote{20}

The assertion that the U.S. and the U.K. are leading countries that follow the outsider model of corporate governance receives near-unanimous support in existing literature. First, in the U.S. and U.K., "unlike most of the rest of the world, most large corporations are public and not family-controlled."\footnote{21} In these countries,shareholding is diffused\footnote{22}
and it is not common to find companies that have a dominant or controlling shareholder.  

2. India

India follows the insider model of corporate governance, which is characterized by cohesive groups of "insiders" who have a closer and more long-term relationship with the company. This is true even in the case of companies that are listed on the stock exchanges. The insiders (who are essentially the controlling shareholders) are the single largest group of shareholders, with the rest of the shareholding being diffused and held by institutions or individuals constituting the "public." The insiders typically have a controlling interest in the company and thereby possess the ability to exercise dominant control over the company’s affairs. In this regime, the minority shareholders do not have much of a say as they do not hold sufficient number of shares in the company so as to be in a position to outvote or even veto the decisions spearheaded by the controlling shareholders.

As to the identity of the controlling shareholders, they tend to be mostly business family groups or the state. This tends to be particularly true of Asian countries, which are "marked with concentrated stock ownership and a preponderance of family-controlled businesses while state-controlled businesses form an important segment of the corporate sector in many of these countries." This is also otherwise referred to as the "family/state" model.

By virtue of their control rights, these dominant shareholders are able to exercise control over the company. They are virtually able to appoint

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24. Nestor & Thompson, supra note 11, at 9. See also Rafael La Porta, et al., Law and Finance, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta, Law and Finance] (describing insider systems as "characterized by the significance of the state, families, non-financial corporations, employees, and banks as a source of funding and/or control").
27. Rampant state ownership in several countries is unsurprising on account of the fact that privatization is yet to be completed in those countries. See La Porta, et al., Around the World, supra note 21, at 496.
29. See Nestor & Thompson, supra note 11, at 12.
30. See Berglof & Thadden, supra note 25, at 12.
and replace the entire board and, through this, influence the management strategy and operational affairs of the company. For this reason, the management will likely owe its allegiance to the controlling shareholders. The controlling shareholders nominate senior members of management, and even more, they often appoint themselves on the boards or as managers. It is not uncommon to find companies that are controlled by family groups to have senior managerial positions occupied by family members. Similarly, where companies are controlled by the state, board and senior managerial positions are occupied by bureaucrats.

Further, such a system does not possess either robust capital markets or sophisticated market players; if at all, these are in an early stage of evolution in some countries that have experienced significant capital markets explosion in the last decade. For this reason, the state continues to perform a greater role in the regulation of corporate activity by imposing mandatory standards and bright-line rules. There is a perceived reluctance on the part of the state in relying on market participants or a market-based regulation, perhaps owing to their lack of sophistication as compared to the outsider systems.

Indian companies display ownership concentration in the hands of a few persons, and hence India is considered as part of the insider model of corporate governance. Business families predominantly own and control companies (even those that are listed on stock exchanges). This is largely due to historical reasons whereby firms were mostly owned by family businesses. In addition, it is quite common to find state-owned firms as well. Other categories in which ownership structures can be found are: (i) control by multinational companies; and (ii) diffused ownership. However, diffused ownership (in the sense of the Berle-Means corporation) can be found only in a handful of Indian listed companies, where such structures exist more as a matter of exception rather than the rule. Academic studies

31. The BRIC countries (Brazil, Russia, China and India) are apt examples of economies historically bereft of developed capital markets that have more recently attempted rapid adoption of systems and practices from more developed capital market economies.

32. There is one strand of thought that describes India as a “hybrid of the outside-dominated market-based systems of the U.K. and the U.S., and the insider-dominated bank-based systems of Germany and Japan.” Sarkar & Sarkar, supra note 26, at 163. However, this observation does not find broader acceptance in the literature pertaining to ownership structures in India.


34. Prior to 1991, Indian businesses were subject to tight control and regulation by the government. For this reason, all businesses were concentrated in the hands of rich and influential business families and entities who had the wherewithal to obtain licenses from the government, which were required for various aspects of running the business, including establishment, operation, expansion and closure. See Sarita Mohanty, Sarbanes-Oxley: Can One Model Fit All?, 12 NEW ENG. INT'L & COMP. L. ANN. 231, 235 (2006).

35. There are indeed several listed companies that are government-owned, where either the central government or a state government owns the (often substantial) majority interest in the company. Such companies are also referred to as Public Sector Undertakings ("PSU").
too have demonstrated the high concentration of ownership in Indian listed companies.  

Like many other emerging economies, the legal and regulatory framework in India is arguably not altogether conducive to corporate activity and investor protection, although significant improvements have been effected to the system after the liberalization process began in 1991. For instance, the Indian Companies Act, which was enacted in 1956 and has subsequently undergone several amendments, is unduly complex and still contains vestiges of strong government control of companies. There are a number of procedures to be complied with for incorporating companies, and moreover, winding up of companies involves a cumbersome, costly and time consuming procedure. However, there is optimism at least on two counts. First, there has been tremendous progress in the area of investor protection since 1991. SEBI, India’s securities market regulator, was established in 1992 to regulate the Indian capital markets, and SEBI has since enacted a plethora of subsidiary legislation governing the stock markets (both primary and secondary). Second, there exists an increasingly robust body of law to deal with minority shareholder grievances.  

However, while law on the statute books is one thing, its enforcement another. Even where laws do exist, they are sometime ambiguous and ridden with uncertainties, thereby placing obstacles in enforcement. Further, there are serious deficiencies in enforcement of laws and regulations due to the ineffectiveness of the enforcement machinery such as the courts and other specialized tribunals. These courts and tribunals are  

36. Chakrabarti, supra note 28, at 11 (indicating that “[e]ven in 2002, the average shareholding of promoters in all Indian companies was as high as 48.1 percent”). See also Shaun J. Mathew, Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities, 3 COLUM. BUS. L. REV. 800 (2007) (finding an average promoter stake of over 48 percent in companies listed on the Bombay Stock Exchange). George S. Geis, Can Independent Blockholding Play Much of a Role in Indian Corporate Governance?, 3 CORP. GOVERNANCE L. REV. 283 (2007); Varottil, supra note 10, at 18-20.  


39. The more prominent among such legislation relate to the establishment of a detailed disclosure regime for companies, a share depository for electronic trading of shares and a sophisticated trading and settlement system in the secondary markets. See Armour & Lele, supra note 37, at 20.  

40. Indian Companies Act, §§ 397-98, provides remedies to minority shareholders when affairs of the company are conducted in a manner prejudicial to the interests of the company, the shareholders or public interest, or if it is oppressive to the shareholders. The Indian Companies Act, No. 1 of 1956; India Code (1993). This is known as the remedy of “oppression and mismanagement.” Apart from a rich body of precedents having been established in this area of law, there is also a special tribunal in the form of the Company Law Board to deal with cases on this count. Armour & Lele, supra note 37 at 31.
overburdened resulting in significant delay in dispute resolution and justice delivery. This is true even in the area of corporate governance and investor protection.\textsuperscript{41}

Further, unlike in the more developed economies, it is hard to find a sufficient number of competent professionals such as auditors, independent directors and rating agencies who can potentially act as gatekeepers of corporate governance. For this reason, the affected parties and the legal system are compelled to rely on courts, tribunals and other regulatory bodies to seek remedies, and those may not be effective in law enforcement altogether.\textsuperscript{42} Here again, these are issues faced by most developing countries in common, which are also part of the insider model of corporate governance.

B. REVIEWING THE MODELS IN CONTEXT OF THE AGENCY PARADIGM

At this stage, it is appropriate to review the insider and outsider models against the “agency problems” paradigm. As Reiner Kraakman explains, corporate law attempts to “control conflicts of interest among corporate constituencies.”\textsuperscript{43} These conflicts are referred to in economic literature as “agency problems.”\textsuperscript{44}

Corporate law and corporate governance literature define three generic agency problems.\textsuperscript{45} The first agency problem relates to the conflict between the company’s managers and its owners (being the shareholders).\textsuperscript{46} This “manager-shareholder agency problem” exists largely in jurisdictions with predominantly diffuse ownership. This is due to collective action and the resultant inability of shareholders to properly monitor the actions of managers. The second problem relates to the conflict between the majority or controlling shareholders and minority shareholders.\textsuperscript{47} Such “majority-minority agency” conflicts are largely prevalent in jurisdictions

\textsuperscript{41} More generally, it has been observed empirically that “in securities law, we find that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter . . .” Rafael La Porta, et. al., \textit{What Works in Securities Laws?}, 61 J. Fin. 1, 27-8 (2006) [hereinafter La Porta, \textit{What Works}].


\textsuperscript{44} For a detailed analysis of agency theory in economic literature, \textit{see Michael Jensen \& William Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure}, 3 J. Fin. ECON. 305 (1976).}


\textsuperscript{46} \textit{KRAAKMAN, supra note 43} at 22.

\textsuperscript{47} Id.
that display concentrated shareholding; the interests of minority shareholders being significantly diluted.\textsuperscript{48}

Advancing this discussion in the context of various corporate governance systems, we find that the outsider systems of the U.S. and the U.K. are largely concerned with the manager-shareholder agency problem. Corporate law, as well as measures to enhance corporate governance, is designed to resolve this agency problem. It was this very conflict that the concept of an independent board initially emerged to address in the U.S. and subsequently in the U.K.

However, we find that the insider systems such as India's are less concerned with the manager-shareholder agency problem—that problem is much less important in those systems. There is no separation of ownership and control as the majority or controlling shareholders are well-endowed with the power to hire and fire managers and therefore oversee managerial aspects of a company. Instead, the concentration of corporate ownership in insider systems afflicts them with the majority-minority agency problem. Hence, India predominantly suffers from the majority-minority conflict and not the manager-shareholder agency problem. Mechanisms designed to suit one type of system of ownership and corporate governance (e.g., outsider) may not be suitable in another system (e.g., insider). More specifically, the mechanism of altering board structure and composition introduced to deal with the manager-shareholder conflict prevalent in the U.S. and the U.K. will not produce the same results in dealing with the majority-minority agency problems dominant in India.

III. ORIGIN OF INDEPENDENT DIRECTORS IN THE UNITED STATES AND UNITED KINGDOM

The objective of this Part is to briefly explore the origins of the concept of the independent director which, as discussed earlier, can be related to the U.S. and the U.K. The seeds of the independent director concept were sown in the theory of the monitoring board. Whenever independent directors have been looked upon as a monitoring mechanism in companies—whether by the legislature, judiciary or self-regulatory organizations—it has always been with a view to addressing the manager-shareholder agency problem. An understanding of the theories and practice in this Part will widely illuminate the analysis of whether the independent director concept will find its place in dealing with the majority-minority agency problem and, if so, to what extent.

\textsuperscript{48} A third agency problem relates to the conflict between a firm's owners/controllers and other stakeholders such as creditors, employees, customers, or the non-shareholding public. \textit{Id.} However, this third agency conflict is beyond the interests of this article.
A. THEORETICAL FOUNDATIONS FOR THE ORIGIN OF INDEPENDENT DIRECTORS

The concept of the independent director originated in both legal and economic theories. These theories help explain why the concept was conceived as a mechanism to deal with the manager-shareholder agency problem. This was essentially due to the fact that the manager-shareholder agency problem was predominant in the U.S. and the U.K.

1. The Berle and Means Study

An appropriate place to begin this survey is to consider the analysis of Berle and Means in their study of U.S. corporate ownership patterns between 1880 and 1930. Berle and Means concluded that there is a "separation of ownership and control" in which the individual interest of shareholders is made subservient to that of managers who are in control of a company. Due to the diffusion in ownership, the shareholders are unable to maintain vigil over the managers, as widely dispersed shareholders lack sufficient financial incentives to intervene directly in the affairs of the company. Managers, being unchecked, may abuse their position by acting in their own interests rather than the interests of the shareholders which they have a duty to promote. The Berle and Means study proved influential. Much of the effort in corporate law and governance reform over the years has sought to address the agency problem identified by Berle and Means. The board of directors and independent directors, in particular, are cardinal institutions in redressing that conflict.

2. Economic Analysis of the Agency Problem

As the separation of ownership and control leads to the manager-shareholder agency problem, it became the subject of study by economists,
particularly in the context of the role of the board of directors in addressing that agency problem. This wave of scholarship created the form “nexus of contracts” theory where the firm was viewed through the lens of contract analysis.\(^{54}\) Applying principles of agency to the modern corporation,\(^{55}\) Jensen and Meckling argued that whenever a principal engages an agent to do something which involves some decision-making authority given to the agent, the latter may not always act in the interests of the principal.\(^{56}\) This imposes significant agency costs as the principal is required to establish appropriate incentives for the agent and monitor the agent’s action.\(^{57}\)

In such a structure, one obvious question is who will monitor the monitors?\(^{58}\) Alchian and Demsetz explored this issue through team organization theory.\(^{59}\) They argued that in any economic organization, incentive to productive effort can be maintained if input productivity and rewards are metered properly.\(^{60}\) In order to avoid ending up with a series of monitors who meter productivity, Alchian and Demsetz suggest that the party entitled to the final residual income would be the appropriate monitoring authority because that party stands to reap the highest reward if the monitoring is at its best, thereby incentivizing such authority to monitor the firm’s activities properly.

Viewing the agency theory in the context of the Berle & Means corporation, it becomes clear that shareholders (who are the principals) suffer from agency costs on account of the actions of managers (the agents and persons in control of the corporation). The end result of this approach is the need for proper monitoring of the managers so as to protect the interest of the shareholders. In Alchian and Demsetz’s paradigm, shareholders will be the best monitors as they receive the residual income of the firm. However, the collective action problem facing shareholders makes effective monitoring by diffuse owners particularly difficult.\(^{61}\) This

\(^{54}\) Jensen & Meckling, supra note 44, at 310. See also Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288, 290 (1988) [hereinafter Fama, Agency Problems]. This wave of research is dominated by economists who addressed individual rights in terms of allocating the costs and rewards among various participants in a business organization. See also Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416 (1989).

\(^{55}\) Jensen & Meckling, supra note 44, at 309.

\(^{56}\) Id. at 308.

\(^{57}\) Id. Jensen and Meckling argue that it may be possible to reduce agency costs, but that it can never be brought down to zero.

\(^{58}\) Stephen M. Bainbridge, Participatory Management Within a Theory of the Firm, 21 J. CORP. L. 657, 672 (1996) [hereinafter Bainbridge, Participatory Management].


\(^{60}\) Id. at 778.

\(^{61}\) Bainbridge, Participatory Management, supra note 58, at 672.

Because of the separation of ownership and control, it simply does not describe the modern publicly held corporation. As the corporation’s residual claimants, the shareholders should act as the firm’s ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations. In general,
difficulty has ultimately led to the monitoring role being foisted on the board of directors of a company.

There is still the residual question of the composition of the board. If the board of directors comprises insiders, will the board act as an effective monitor of the managers’ activities? The answer is surely to be in the negative. A board comprised of managers cannot be expected to monitor the managers’ own actions. Hence, the composition of the board acquires importance. Directors who are independent of the management are likely to serve the monitoring role more effectively than inside directors. The monitoring role is therefore the reason d’être of independent directors. Such a role confers authority on a monitoring board of directors to monitor the managers in the interests of the shareholders. It is clear that the theoretical foundation of independent directors is the monitoring function of the board; the board’s role is to protect the interest of the shareholders against manager abuse.

It is therefore evident that the theoretical underpinnings of the monitoring board and the independent director concept emanate from the agency cost theory that relates primarily to the manager-shareholder agency problem. Acknowledgement of the majority-minority agency problem in the literature is sparse because academics were not confronted with the issue at all as they were primarily dealing with outsider systems of corporate governance.

shareholders of public corporations have neither the legal right, nor the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation’s agents.

62. Clarke, Three Concepts, supra note 1. Note, however that in the U.K., directors are required to provide entrepreneurial leadership of companies in addition to their monitoring role. Such a dual role has been the subject matter of academic critique. See Richard C. Nolan, The Legal Control of Directors’ Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report, 6 THEORETICAL INQ. L. 413 (2005).

63. N. Arthur, Board Composition as the Outcome of an Internal Bargaining Process: Empirical Evidence, 7 J. CORP. FIN. 307, 310 (2001) (stating that “[m]uch of the existing literature examines board composition from an agency cost perspective and argues that representation by outside directors will increase with the conflicts of interests between management and outside shareholders”). See also Barry D. Baysinger & Henry N. Butler, Revolution Versus Evolution in Corporate Law: The ALI’s Project and the Independent Director, 52 GEO. WASH. L. REV. 557, 564 (1984) (stating that it would “appear intuitively that board independence should play a major role in the resolution of agency problems associated with large, dispersed-owner corporations”); Douglas M. Branson, The Very Uncertain Prospect of “Global” Convergence in Corporate Governance, 34 CORNELL INT’L L.J. 321, 360 (2001) (identifying the independent director concept as a solution to the Berle-Means manager-shareholder agency problem); Dan R. Dalton, et al., Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance, 19 STRATEGIC MGMT. J. 269, 270 (1998) (noting that a “preference for outsider-dominated boards is largely grounded in agency theory . . . built on the managerialist notion that separation of ownership and control . . . potentially leads to self-interested actions by those in control”); Daniel P. Forbes & Frances J. Milliken, Cognition and Corporate Governance: Understanding the Boards of Directors as Strategic Decision-Making Groups, 24 ACAD. MGMT. REV. 489, 491 (1999) (commenting that “a high proportion of outsiders will enhance some aspects of board functioning, such as board effort norms, as agency theory would suggest . . .”).
B. EMERGENCE OF INDEPENDENT DIRECTORS IN U.S. CORPORATE PRACTICE

In practice, the independent director emerged as a response to the same manager-shareholder problem that sparked its development in legal and economic theory. American boardroom practice is replete with instances favoring independent directors as a solution to the manager-shareholder agency problem. As we shall see, the concept emerged as a voluntary mechanism based on the belief that a board with some level of independence will introduce objectivity in decisionmaking, add to the diversity and advisory capabilities of the board and hence improve the company’s performance (ultimately reflected in the company’s stock price). Various arms of the government rapidly bought into this idea: the judiciary, the legislature, and finally self-regulatory bodies such as the stock exchanges and law review bodies such as the American Law Institute (“ALI”). What commenced as a voluntary movement in the 1950s took on a mandatory form following the various corporate governance scandals (such as Enron, WorldCom, and Tyco) that occurred at the turn of the century and resulted in the enactment of stringent legislation in the form of the Sarbanes-Oxley Act\(^\text{64}\) in 2002. The NYSE and NASDAQ also amended their listing rules. Similar changes occurred in the U.K., with the Cadbury Report and its successors. However, these developments are more recent than those in the U.S. Critically, all these initiatives are aimed towards addressing the manager-shareholder agency problem. It is to this aspect that I shall now turn in greater detail.

1. Changing Board Composition: The Voluntary Phase

Most academic studies review board composition from the 1950s.\(^\text{65}\) Prior to 1950, boards largely consisted of “insiders” who were executives of the companies, and the essential role of the board was to manage the company, or to advise the management of the company.\(^\text{66}\) At most, boards included certain “outside” directors, who were not executives or employees of the company, but were otherwise affiliated with the company.\(^\text{67}\) However, since the 1950s, boards gradually began inducting more outside directors,\(^\text{68}\) although in the initial years the numbers of outside directors were relatively few and the inside directors continued to constitute a

\(^64\) Sarbanes-Oxley, supra note 4.
\(^66\) Id. at 1468.
\(^67\) Id. Such directors are usually referred to as “affiliated” or “gray” directors.
\(^68\) Id. at 1472-73.
significant majority on the board.  

2.  *Emergence of a ‘Monitoring Board’*

It was only during the 1970s that the concept of the independent director “entered the corporate governance lexicon . . . as the kind of director capable of fulfilling the monitoring role.” By this time, the role of an outside director had been further refined to include the “independent director” and the “affiliated” or “gray” director. Together with the concept of independent directors, the need for a “monitoring board” was clearly identified.

At a conceptual level, the shift in the thinking towards a monitoring board can be attributed to the work of Professor Eisenberg. It was found that, in practice, the board’s principal function was advisory, providing counsel to the company’s chief executive rather than oversight in the shareholders’ interests. Furthermore, even outside directors largely carried out the same role thereby creating some consternation among the policymakers. The goal was a “monitoring model,” boards that constantly monitored the results achieved by managers (led by the chief executive) and determined whether the incumbents should stay or be replaced. A corollary to the monitoring function was that it should be comprised of a substantial number of independent directors so that the monitoring may be carried out in a fair, objective and dispassionate manner. Professor Eisenberg therefore recommended the creation of mandatory rules for board composition rather than leaving it to the judgment of companies and their managers:

Specifically, these rules must, to the extent possible: (1) make the board independent of the executives whose performance is being monitored; and (2) assure a flow of, or at least a capability for acquiring, adequate and objective information on the executives’ performance.

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69  *Id.* at 1475 (noting that existing studies tend to overstate the presence of independent directors serving on pre-1970 boards).
70  *Id.* at 1477.
71  The recognition of the failure of monitoring on boards was precipitated by the collapse of Penn-Central and Watergate-related scandals. *Id.* at 1514-15. *See also* Joel Seligman, A Sheep in Wolf’s Clothing: The American Law Institute Principles of Corporate Governance Project, 55 GEO. WASH. L. REV. 325, 328-40 (1987).
73  *Id.* at 155.
74  *Id.* at 154. Although neither law policy clearly defined the role of the outside directors, Professor Eisenberg noted that the “outside director was not fulfilling the policy-making role contemplated by corporate law.” *Id.*
75  *Id.* at 164-65.
76  *Id.* at 170.
While the monitoring board represents a paradigm shift in board functions, it is clear that such a board was conceived in the context of the manager-shareholder agency problem created by diffuse ownership. The monitoring board has been created to monitor only one constituency, the managers. The majority-minority shareholder conflict is nowhere in the reckoning of this analysis.

Apart from the development in the 1970s of the monitoring board and a more nuanced form of the independent director, that decade also saw regulatory attention paid to independent directors for the first time. Both the Securities and Exchange Commission ("SEC") and the NYSE recommended the creation of audit committees of the board comprising independent directors.\textsuperscript{77}

At the same time, business and professional organizations began subscribing to the view that independent directors would enhance the monitoring functions of the board. In 1976, a subcommittee of the Corporation, Banking, and Business Law Committee of the American Bar Association issued the Corporate Director’s Guidebook that called for boards to be comprised of non-management directors.\textsuperscript{78} The Business Roundtable recommended that “outsiders should have a substantial impact on the board’s decision-making process.”\textsuperscript{79}

The ALI’s \textit{Principles of Corporate Governance} reflected the growing consensus favoring independent boards.\textsuperscript{80} The ALI was confounded with the problems raised by Berle and Means, undertaking an ambitious effort to address those problems.\textsuperscript{81} Tentative Draft No. 1 of the ALI Principles required the boards of large publicly held companies to be comprised of a majority of independent directors.\textsuperscript{82} The draft also required companies to have audit and nomination committees.\textsuperscript{83} Subsequent versions were diluted, however, containing only recommendations for the independent director.\textsuperscript{84} Nevertheless, the ALI’s process makes it clear that the independent director was a response to the specific agency problems created by diffuse ownership.

\textsuperscript{78} Id. at 546-47.
\textsuperscript{79} Id. at 548.
\textsuperscript{80} See Bainbridge, ALI, supra note 50, at 1034.
\textsuperscript{81} Id. at 1034-35.
\textsuperscript{82} Id. at 1037.
\textsuperscript{83} Id. at 1038.
\textsuperscript{84} Bainbridge, ALI, supra note 50, at 1034-40. For a thorough discussion of the controversy surrounding drafts of the Principles, see James D. Cox, \textit{The ALI Institutionalization and Disclosure: The Quest for the Outside Director’s Spine}, 61 Geo. Wash. L. Rev. 1233 (1993). See also Karmel, supra note 77.
3. Judicial Reliance on Board Independence

While efforts were underway to reform board structure by instilling greater independence, judicial interpretation of state law began to place significant weight on decisions of independent boards while reviewing corporate actions. This was particularly the case in the state of Delaware.83 The deference by Delaware courts to independent boards can be examined under three distinct categories: (i) self-dealing transactions; (ii) derivative suits; and (iii) hostile takeover situations.

a. Self-dealing transactions

Under Delaware law, the focus is on “whether a director, officer, or controlling shareholder of a corporation has a financial interest in a transaction that is not shared by the other shareholders in a corporation.”86 Section 144 of the Delaware General Corporation Law (“DCGL”) provides for a safe-harbor that legitimizes self-dealing transactions in certain circumstances. One such circumstance is where (i) the material facts pertaining to the conflict of interest and terms of the transaction are disclosed to the board of directors (or the appropriate committee thereof), and (ii) the transaction has been approved by a majority of disinterested directors, even if such directors constitute less than a quorum.87 This provision induces companies to appoint outside directors on their boards so that they are able to pass decisions on conflicted transactions.88 This is particularly necessary because certain kinds of conflicted transactions are inevitable in modern businesses, with executive compensation being the prime example, and approval of such transactions by a set of outside directors who are disinterested in such decisions will help companies appoint and reward their managers suitably.89 On this issue, we find that courts are again confronted with the manager-shareholder agency problem, whereby courts defer to the decisions of disinterested directors who are expected to act in the interest of shareholders by supervising conflict-of-interest transactions that may benefit managers to the detriment of

85. See Usha Rodrigues, Fetishization of Independence, 33 J. CORP. L. 447, 464 (2008). Delaware courts have been progressive in dealing with corporate law cases and placing reliance on actions of corporate fiduciaries where necessary. The importance of board independence has been accentuated because of the activist nature of the Delaware courts in dealing with corporate law matters.
86. Id. at 467.
87. Delaware General Corporation Law, § 144(a)(1). Note that the provision deals with “disinterestedness” of the directors rather than “independence.”
88. Lin, supra note 1, at 905-06.
shareholders.

Beyond the contours of Section 144 of DGCL and the conflict of interest involving officers and directors lies another type of self-dealing transaction. That pertains to conflict of interest transactions involving controlling shareholders.\(^{90}\) Such transactions manifest themselves mostly in freezeout mergers.\(^{91}\) In this context, the Delaware Supreme court placed reliance on the independent director institution as a solution to the controlling shareholder agency problem. In the seminal case of *Weinberger v. UOP Inc.*,\(^{92}\) the court made a suggestion that one method to solve the controlling shareholder conflict would be to employ independent directors who can consider the transaction at arm’s length.\(^{93}\) This suggestion was picked up by Delaware courts in subsequent cases\(^{94}\) holding that “the use of a well functioning committee of independent directors shifts the burden of proof in the context of mergers with a controlling shareholder.”\(^{95}\) This string of cases displays two characteristics: (i) for the first time, independence was determined with reference to the controlling shareholder rather than merely with reference to managers;\(^{96}\) and (ii) independence was not considered a position to be determined *ex ante* through prescribed qualifying factors, but was to be determined by courts *ex post* based on the actual behavior of such directors in decisionmaking on the conflicted transaction; it is not sufficient for directors to satisfy prescribed criteria for independence, but rather to clearly demonstrate that they have in fact acted independent of the controlling shareholders.\(^{97}\)

The freezeout illustration shows the keenness of Delaware courts in

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90. Note that in the analysis of various developments pertaining to independent directors in the U.S. in this Part, we encounter the controlling shareholder’s role for the first time only at this juncture.

91. A freezeout is defined as “a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller’s stock.” Guhan Subramanian, Fixing Freezeouts, 115 YALE L.J. 2, 5 (2005).

92. 457 A. 2d 701, 710 (Del. 1983).

93. In the *Weinberger* case, the Delaware Supreme Court lamented the absence of an independent process for negotiating the deal and laid the foundation for the role of independent directors in such situations: “Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm’s length.” *Id.* at 709.


96. Hence, a director ought to have no financial relationships either with the managers or with the controlling shareholders in order to qualify as independent for this purpose. *Id.* at 478.

97. Rodrigues notes:

[T]he independence of directors is evaluated not just in terms of their lack of ties with the acquirer, but also in terms of their behavior. Delaware courts conduct a fact-intensive *ex post* inquiry into the special committee’s actions. The key point is that courts assessing the situational interestedness of directors do not focus solely on relationships; they also inquire whether the directors’ actions demonstrate “true” independence.

*Id.*
regulating controlling shareholder transactions too, apart from transactions involving officers and directors. To that extent, it extends the role of the independent directors beyond the manager-shareholder agency problem to cover even the majority-minority shareholder problem. This is indeed a unique instance considering that the U.S. courts are often left to deal with the manager-shareholder agency problem. What are the lessons to be learnt from this episode, and how have they been considered in other jurisdictions? First, independence is to be reckoned not only with reference to managers but also with reference to controlling shareholders. This aspect of independence has indeed been transplanted to other jurisdictions, including India,98 where there are controlling shareholders in most companies. Second, independence ought not to be considered as a predetermined qualification for appointment of directors ex ante, but the actual performance of the directors is also an important factor in determining independence. This aspect does not seem to have found its way past the borders of Delaware. Neither the federal laws in the U.S. nor the stock exchange regulations in that country prescribe independence requirements in that fashion. Independence is considered on the basis of preset rules, and it is a status conferred on the person at the time of appointment and not based on the actions of such person after appointment and with reference to any specific conflicted transaction. Similarly, such ex post determination has not found its way into other jurisdictions such as India or even the U.K. for that matter. Hence, while Delaware law on controlling shareholder transactions provides some useful lessons to deal with that problem (which is widespread in emerging insider economies), the prescribed solutions have not been considered in their entirety in India.99

b. Derivative suits

Under Delaware law, before a shareholder can initiate a derivative action on behalf of a company against its directors or officers, such shareholder must make a demand on the board of directors requesting it to

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98. For a discussion of this issue, see Part IV.B infra.
99. Academics such as Rodrigues have argued that independence is situational and should be defined to deal with the specific conflicts at hand. Rather than having a preset definition of independence as a qualification, they suggest that independence should be considered on a case-by-case basis. See Rodrigues, supra note 85. However, it must be noted that implementation of such suggestions are bound to be met with practical difficulties. Ex post determination of independence requires courts to swiftly determine cases and lay down principles of law that provide certainty as to the concept of independence. While that may be practicable in jurisdictions such as Delaware that possesses a fairly advanced system of corporate law adjudication, such approach would be fraught with difficulties in jurisdictions that lack such judicial infrastructure, and an emerging economy such as India would surely point in that direction. As Lin notes: “Even if courts were capable of making such evaluations intelligently, the uncertainty of the resulting standard could both raise litigation costs and hamper business planning.” Lin, supra note 1, at 964.
initiate action on behalf of the company. Since the board may not be inclined to sue its own members or officers, it is quite possible that the board may reject such a demand. In order to prevent such a situation, such a demand on the board may be excused when the demand is considered to be futile, whereby the shareholder may bring a suit without making a demand. Delaware law lays down the standard for determining demand futility as follows: “whether taking the well-pleaded facts as true, the allegations raise a reasonable doubt as to (i) director disinterest or independence or (ii) whether the directors exercised proper business judgment in approving the challenged transaction.”

These requirements too encourage companies to have outside directors on their boards and committees. However, in this case, the concept of independence is not as clear as in the case of conflicted transactions discussed earlier. The test of independence is the lack of “domination or control,” which is “very fact specific, and the courts have differed as to what factors to take into consideration.” It appears, therefore, that the role of outsider or independent directors in rejecting demands for derivative actions essentially again deals with the manager-shareholder agency problem, but to a lesser extent the majority-minority agency problem.

100. Although the demand requirement applies mostly in suits against the insiders, it is a matter of curiosity that the requirement originated in suits against third parties. See Paul N. Edwards, *Compelled Termination and Corporate Governance: The Big Picture*, 10 J. Corp. L. 373, 398 (1985).


102. See Lin, *supra* note 1, at 907.

103. See Part III B.3.a supra.

104. Lin, *supra* note 1, at 908. There is no clear indication as to the person who may exercise “dominance or control” in order to disqualify the independence of a director. Dominance or control may be exercised by the officers or directors (thereby creating the manager-shareholder agency problem) or by the controlling shareholder (thereby creating the majority-minority agency problem). See id. at 907–08.

105. In fact, courts have generally placed scant reliance on the beholdenness of a director to a controlling shareholder. As Rodrigues observes with reference to *Aronson*:

> Understanding how the independence inquiry arises in the derivative context, we can examine what it means for directors to be independent. Early articulations by Delaware courts stressed the idea of “domination and control”: plaintiffs had to allege particularized facts demonstrating “that through personal or other relationships the directors are beholden to the controlling person.” Obviously, one could argue that a director is beholden to the person who put her on the board. Nevertheless, the beholdenness that leads to a finding of domination and control requires more than a simple indebtedness for office. In *Aronson*, the court also made clear that allegations of stock ownership alone, at least when less than a majority, are not enough to prove non-independence—even when coupled with the allegation that a proposed controller not only owned 47% of the outstanding stock of the corporation, but also had nominated the director at issue. As the court dryly observed: “That is the usual way a person becomes a corporate director.”

Rodrigues, *supra* note 85, at 472 (internal citations omitted).
c. Defensive measures against hostile takeovers

The “deal decade” of the 1980s gave rise to defensive measures adopted by companies in response to hostile takeovers. The most notable among the defensive measures was the “poison pill.” While the pill and other defensive measures aided incumbent directors and managers from entrenching their positions in the company, it was often susceptible to challenge as being contrary to the interests of shareholders. Due to the inherent conflict of interest, “directors [were required to] show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of a hostile acquisition. The court again placed reliance on an independent board’s decision on this count. It held that the proof of showing good faith and reasonable investigation “is materially enhanced . . . by the approval of a board comprising of a majority of outside independent directors . . . .” Although the court did not attempt a definition of “independence” in Unocal, that option was exercised subsequently in Unitrin Inc. v. American General Corp. This inference of director independence by courts in situations involving defensive measures encouraged companies to appoint independent outside directors on their boards.

However, hostile takeovers of the kind witnessed during the “deal decade” involved the interests of hostile acquirers and the incumbent boards and managers. Hostile takeovers often occurred in companies where there were no controlling shareholders. Hence, the mechanism of outside independent directors relied upon by the Delaware courts for hostile takeovers was again meant to protect the interests of shareholders against actions of managers, and was essentially catered to resolve the manager-shareholder agency problem.

106. In Unocal v. Mesa Petroleum Co., the Supreme Court of Delaware made a pertinent observation that takeover defenses raise “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.” 493 A.2d 946 (Del. 1985).
107. Id. at 955.
108. Id.
109. 651 A.2d 1361 (Del. 1995). Quoting Aronson, see supra note 101, the court held that “independence ‘means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.’” Unocal, supra note 106, at 1375. In such circumstances, the measures used to determine independence would also depend on the nature of the proposed sale, whether the company is in distress, and similar factors.
110. See John Armour & David A. Skeel, Jr., Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation, 95 GEO. L.J. 1727 (2007) (describing that hostile takeovers are thought to play a key role in making managers accountable to shareholders in a dispersed shareholding system). See also Mathew, supra note 36 (indicating that hostile takeovers will have a lesser impact in systems that display concentrated shareholding).
4. Regulatory Prescriptions on Board Independence

The corporate governance scandals involving Enron, WorldCom and other companies triggered a wave of reforms in the U.S. It is worth pausing for a moment to briefly reflect on what caused that corporate governance crisis. At the outset, boards did have a role (or failure thereof) to play in precipitating the corporate governance crisis. The 1990s witnessed a shift in executive compensation from cash payments to stock-based compensation (including stock options). This created perverse incentives to company managers as it enabled them to boost the short-term stock performance of the company and then encash the options at a high price. As Professor Gordon notes: "Boards had simply failed to appreciate and protect against some of the moral hazards that stock-based compensation created, in particular, the special temptations to misreport financial results."

This was the manager-shareholder agency problem manifested at its best. Stock options to managers promoted short-termism that prompted them to inflate financial figures and that went unchecked by directors. While the managers benefited, shareholders suffered, and the board seemed to be waiting on the sidelines.

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. However, it does require that each member of a public company’s audit committee shall be an independent director.

Charles M. Elson details the failure of independent directors to police management in the Enron case:

But how does this emphasis on director independence and equity relate to the board failure at Enron? The answer is straightforward: the Enron directors lacked independence from management. They may have held company equity, but without the appropriate independence from Enron management, they lacked the objectivity needed to perceive the numerous and significant warning signs that should have alerted them to the alleged management malfeasance that led to the company’s ultimate meltdown and failure.


111. John C. Coffee, Jr., Understanding Enron: It's About the Gatekeepers, Stupid, 57 BUS. LAW. 1403, 1413-14 (2002). See also COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 48 (discussing the danger of serious financial manipulation and distortion of boardmember priorities thanks to stock options). Charles Elson details the failure of independent directors to police management in the Enron case:


113. Sarbanes-Oxley, supra note 4. This section also provides that “a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.” See also Clarke, Three Concepts, supra note 1, at 86.
majority of independent directors.\textsuperscript{114} Each of the exchanges defines an independent director.\textsuperscript{115}

Although the definitions of the two exchanges are largely similar, there are some differences in the approach and in certain details. Both provide for a broad definition of independence whereby a director does not qualify as independent unless the board affirmatively determines that the director has no material relationship with the listed company.\textsuperscript{116} In addition to the general test, a director would not be considered independent if she falls within one of the specific tests laid down.\textsuperscript{117}

Both exchanges also require regular executive sessions among the non-management directors without management being present.\textsuperscript{118} They also require the establishment of nomination committees for nomination and selection of directors.\textsuperscript{119} It is the expectation that placing nomination or selection decisions in the hands of independent directors would enhance the independence and quality of the nominees that are being considered for directorship. This curbs the power of the inside directors or managers to influence the board composition, particularly when it comes to the appointment of independent directors.

Interestingly, both exchanges exempt controlled companies from provisions mandating independent directors.\textsuperscript{120} A controlled company is one where more than 50 percent of the voting power is held by an individual, a group or another company.\textsuperscript{121} This appears to be in recognition of the fact that independence of directors need not, or even cannot be expected to, act as a check on management as the controlling shareholders would be in a position to assume that role.\textsuperscript{122} The rationale for

\begin{itemize}
  \item \textsuperscript{114} NYSE Manual, supra note 3; NASDAQ Rules, supra note 3, § 5605(b)(1).
  \item \textsuperscript{115} See NYSE Manual, supra note 3, § 303A.02; NASDAQ Rules, supra note 3, § 5605(a)(2).
  \item \textsuperscript{116} Such relationship may be either direct or as partner, shareholder or officer of an organisation that has a relationship with the company. NYSE Manual, supra note 3, § 303A.02(a). The NASDAQ rules require a determination by the board of directors as to whether the relationship of the director with the listed company would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. NASDAQ Rules, supra note 3, § 5605(a)(2).
  \item \textsuperscript{117} These include: (i) employment by the individual or family member with the listed company as an executive officer within the last three years; (ii) receipt by the individual or a family member of compensation from the company of certain specified amounts; (iii) association with a firm that is the company’s internal or external auditor; (iv) employment as an executive officer of another company where any of the listed company’s present executive officers serve on that company’s compensation committee; and (v) employment as executive officer of a company that has payment transactions with the listed company for property or services in an amount which is beyond a specified amount. NYSE Manual, supra note 3, § 303A.02(b); NASDAQ Rules, supra note 3, § 5605(a)(2).
  \item \textsuperscript{118} NYSE Manual, supra note 3, § 303A.03; NASDAQ Rules, supra note 3, § 5605-2. This is to empower non-management directors to serve as a more effective check on management by promoting free and frank discussions among them.
  \item \textsuperscript{119} NYSE Manual, supra note 3, § 303A.04; NASDAQ Rules, supra note 3, § 5605(e).
  \item \textsuperscript{120} NYSE Manual, supra note 3, § 303A.00; NASDAQ Rules, supra note 3, § 5615(c).
  \item \textsuperscript{121} Id.
  \item \textsuperscript{122} This also fits well into the theory that, in the U.S., independent directors are considered as monitoring the managers and for addressing the agency problem between the shareholders and
the exception appears to be that where there is a controlling shareholder, the other shareholders may not be afforded sufficient protection by independent directors. This recognizes the fact that:

[NYSE and NASDAQ] see independent directors as a protection for shareholders specifically against management, not against other shareholders. A shareholder who controls a company does not need an external rulemaker to protect him from a management team that he has the power to appoint. Minority shareholders may need protection from controlling shareholders, but the exchanges are apparently willing to leave this task to other bodies of law, such as federal securities law requiring disclosures, and state corporate law mandating certain fiduciary duties.123

Moreover, this exception has been found necessary to protect the interests of controlling shareholders. If controlled companies have majority independent boards, those boards may work against the interests of the controlling shareholders resulting in unintended consequences.124 This risk is most prevalent in family businesses and VC-capitalized firms.125 This exception has also invited some criticism as errant companies found this avenue an attractive means to evade board independence requirements prescribed by NYSE and NASDAQ.126

This background clarifies two key factors: (i) the mandatory independent director requirement was introduced in the Sarbanes-Oxley era reforms as a reaction to corporate governance scandals that involved the manager-shareholder agency problem; and (ii) it is the express intention of the policymakers not to consider the independent director as a solution to the majority-minority agency problem and hence exceptions were carved out for “controlled companies.”

It is possible to conclude with a great deal of conviction that the rise of the independent director in the U.S. is entrenched in the search for an optimal board composition that can resolve the agency problem between managers and shareholders. The current U.S. policy prescribes a board with a majority of independent directors as capable of undertaking that task. Since the U.S. corporate structure was never confronted with the majority-minority shareholder problem, its corporate governance norms have not been guided by any concern towards addressing that problem. At the least, independent directors have not been envisaged as a means of managers.

123. Clarke, Three Concepts, supra note 1, at 94 (emphasis in original). This is also consistent with Professor Davies’ observation that board structure and composition do not have as much a role to play in addressing the majority-minority agency problem as do other mechanisms under company law. Davies, supra note 45.


125. Id.

resolving that problem.  

C. EMERGENCE OF INDEPENDENT DIRECTORS IN U.K. CORPORATE PRACTICE

The history of the independent director institution is comparatively short in the U.K., with its lifespan being less than 20 years. Apart from that, the literature on the role of independent directors in U.K. companies is limited compared to that in U.S. companies. Nevertheless, there is a great amount of similarity in corporate governance practices between the U.S. and the U.K. Of course, there exist some areas of divergence, but the similarities far outweigh the differences, at least on matters of principle (as opposed to matters of detail). Even where there are differences, they have a bearing largely in terms of “degree rather than kind.” Hence, my effort in this section is to briefly discuss the emergence of the independent director concept in the U.K., with greater emphasis on those areas where U.K. has followed a different trajectory from that of the U.S.

The genesis of the independent director in the U.K. can be ascribed to the 1992 Cadbury Report. That report introduced the concepts of non-executive director and independent director. Non-executive directors have been foisted with the role of bringing “an independent judgment to bear on issues of strategy, performance, resources, including key appointments and standards of conduct.” More specifically, the Cadbury Report assigns two principal responsibilities to non-executive directors, viz.: (i) to review the performance of the board and the executives; and (ii) to take the lead in decision-making whenever there is a conflict of interest. Note that the role aptly fits that of the independent director in the Anglo-American context, which is to monitor the managers in the interest of the shareholders. In other words, the non-executive director is expected to act

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127. The only exception that one can point to relates to the role of independent directors in approving transactions involving conflicts of interests of controlling shareholders, such as the case of freezeout mergers. This is a principle judicially recognized under Delaware law. For details, see supra notes 86 to 97 and accompanying text.

128. See Cheffins, Putting Britain on the Roe Map, supra note 23, at 148 (noting that “with respect to corporate governance, the USA has more in common with Britain than it does with other major industrial nations”). See also Geoffrey Miller, Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England, 1998 COLU. BUS. L. REV. 51, 51 (observing: “While it is relatively easy to identify salient differences between the English and U.S. systems and the rest of the developed world, it is more difficult to identify major contrasts within the Anglo-American world itself.”).

129. Miller, supra note 128, at 51.

130. Cadbury Report, supra note 5. This report is considered to be one of the most influential studies on corporate governance. See R.P. Austin, H.A.J. Ford & I.R. Ramsay, Company Directors: Principles of Law and Corporate Governance 14 (2005).

131. Cadbury Report, supra note 5, ¶ 4.11.

132. Id. ¶¶ 4.4-4.6.
as a catalyst in the resolution of the manager-shareholder agency problem.

Independent directors are a sub-set of non-executive directors. As regards independent directors, "apart from their directors' fees and shareholdings, they should be independent of and free from any business or other relationship which could materially interfere with the exercise of independent judgment." The board of the company is conferred sufficient discretion to determine whether the definition has been satisfied with reference to each individual director. Note again that independence is clearly linked to the lack of any relationship with the company or the managers. There is no reference whatsoever to a controlling shareholder's role. Clearly, independence is connected with the manager-shareholder agency problem.

In terms of board composition, every company is required to have at least three non-executive directors, of which at least two are independent. In addition, boards are required to constitute nomination committees for nomination of board members and audit committees for ensuring integrity of financial reporting. The Cadbury Report formed the basis for the development of corporate governance norms in the U.K.

Subsequently, there were two committees that submitted reports on areas involving corporate governance. The Greenbury Committee recommended the establishment of remuneration committees of boards to determine the remuneration of company executives. The Hampel Committee reaffirmed the role of the non-executive directors. The end-result of these committee reports was the issuance of the 1999 Combined Code on Corporate Governance which forms part of the United Kingdom Listing Rules that imposed several of these governance requirements on a "comply or explain" basis.

133. Id. ¶ 4.12.
134. Id.
135. Id. ¶ 4.30. The nomination committee is to comprise of a majority of non-executive directors.
136. Id. ¶ 4.35. The audit committee is to consist of only non-executive directors, with a majority of them being independent.
139. FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE, 1999. The original Code on Corporate Governance issued in 1999 has since been revised periodically. See Nolan, supra note 62, at 438. For the current code, see Combined Code 2008, infra note 146.
140. Id. at 418. This approach requires listed companies either to comply with the provisions of the Combined Code, or alternatively, to explain the noncompliance. But there are some empirical issues that emerge from such an approach, considering that there is evidence of "serial non-compliers" identified in studies. See Ian MacNeil & Xiao Li, Comply or Explain: Market Discipline and Non-Compliance with the Combined Code, available at http://ssrn.com/abstract=726664; Sridhar Arcot, Valentina Bruno & Antoine Faure-Grimaud, Corporate Governance in the UK: Is Comply or Explain Approach Working?, available at http://ssrn.com/abstract=1532290.
In a subsequent series of reforms focused principally on the role of non-executive directors, the Higgs Report\(^{141}\) recommended that “at least half of the members of the board should be independent.”\(^{142}\) Furthermore, the concept of independence was defined in the Higgs Report in an extensive form.\(^{143}\) The Higgs Report recommended a specific role to non-executive directors that included contribution towards business strategy as well as scrutiny of the performance of management.\(^{144}\) In that sense, the role includes both advisory as well as monitoring functions. The Combined Code was amended to include the principal recommendations of the Higgs Report, including as to board composition.\(^{145}\) The current version of the 2008 Combined Code continues this trend,\(^{146}\) and board independence has therefore become an integral part of corporate governance in the U.K.\(^{147}\)

As far as U.K. is concerned, the agency problem it faces is similar to that in the U.S., where there is a separation of ownership and control. Shareholding is diffused, with institutional shareholders making up for a large portion of share ownership. Although the collective action problem is less severe due to greater institutional shareholding, it does not disappear. There continues to be a need for a monitoring board of directors enhanced with the appointment of independent directors. The monitoring board in the U.K. serves to tackle the manager-shareholder agency problem, as Professor Cheffins notes:

Since investors in a country with an ‘outsider/arms-length’ system of ownership and control have good reason to be fearful of ‘agency costs’ arising from self-serving managerial conduct, a key corporate


\(^{142}\) Id. ¶ 9.5.

\(^{143}\) Id. See also Suggested Code Provision A.3.4, id. at 81. Under Provision A.3.4, independence is compromised if the director was an employee of the company, had a material business relationship with the company, had close family ties with relevant personnel, represented a significant shareholder or served on the board for more than 10 years.

\(^{144}\) Id. See also Suggested Code Provision A.1.4, id. at 80.

\(^{145}\) AUSTIN, FORD & RAMSAY, supra note 130, at 21.


Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

governance objective should be to improve the accountability of corporate executives. Consistent with such reasoning, Britain's Cadbury, Greenbury and Hampel Committees have sought to influence managerial behavior by enhancing the role of non-executive directors and by improving links between pay and performance.148

This trend has not only been followed by the legislature and policymakers, but by the judiciary as well. For instance, in *Equitable Life v. Bowley*,149 Langley J. held:

> It is well known that the role of the non-executive directors in corporate governance has been the subject of some debate in recent years. It is plainly arguable, I think, that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management.

> The court's concern, quite evidently, is to protect the interest of shareholders from the actions of management and that is precisely the role envisaged for non-executive and independent directors.

> We therefore find that not only is the U.K. an outsider system with diffused shareholding and collective action problems, but since there are no controlling shareholders in most companies, the primary role foisted on non-executive and independent directors is to tackle the manager-shareholder agency problem. The majority-minority agency problem does not persist in the U.K. due to which we see no preference from policymakers or the judiciary for using the independent director institution towards that issue at all.

**IV. ADOPTION OF INDEPENDENT DIRECTORS BY EMERGING ECONOMIES: LESSONS FROM INDIA**

Although concepts in corporate governance originated in the outsider systems of the U.S. and the U.K., they have been transplanted to several other countries in the last decade. The transplantation has occurred even in

148. Cheffins, *Britain as Exporter*, supra note 6, at 11. Professor Cheffins continues to make an interesting contrast with the position in insider systems:

> While agency costs seem unlikely to pose a serious problem in countries with an insider/control-oriented system of ownership and control, a different danger exists. This is that core investors will collude with management to cheat others who own equity. For instance, a controlling shareholder might engineer "sweetheart" deals with related firms in order to siphon off a disproportionate share of a public company's earnings. Minority shareholders can also be prejudiced if a company is dominated by an entrepreneur who, motivated by vanity, sentiment or loyalty, continues to run the business after he is no longer suited to do so or transfers control to family members who are ill-suited for the job. It follows that in insider/control-oriented jurisdictions, providing suitable protection for minority shareholders should be a higher priority than reducing agency costs and fostering managerial accountability. Correspondingly, the corporate governance issues that will matter most in such countries are likely to be of a different character than they are in Britain.

Id. at 11-12.

insider systems that possess shareholding structures and other corporate governance norms and practices that are entirely different from those in the outsider systems. This phenomenon can be ascribed to a number of reasons. First, several developments in the outsider systems of corporate governance have had a profound impact around the world. These include legislation such as the Sarbanes-Oxley Act in the U.S. and recommendations such as those of the Cadbury Committee in the U.K. Second, several emerging economies had opened their markets to foreign investment during the last decade of the 20th century. The process required development of their own corporate governance norms simultaneously with the explosion of corporate governance reforms in the outsider systems discussed above. Third, concurrent with the opening up of emerging economies to foreign investment, particularly from the leading investing countries of the U.S. and the U.K., there was a need to develop corporate governance systems that were familiar to investors from those countries. Transplantation was a convenient response to this need. Among all the transplanted concepts, the independent director presents some of the greatest challenges both from a theoretical and practical standpoint.

A. EVOLUTION OF CORPORATE GOVERNANCE NORMS

A major wave of economic reforms was initiated in India in the year 1991. A thrust towards economic liberalization led to a new era in Indian corporate governance. The year 1992 witnessed the establishment of SEBI as the Indian securities markets regulator. SEBI rapidly began ushering in securities market reforms that gradually led to corporate governance reforms as well. Curiously, the first corporate governance initiative was sponsored by industry. In 1998, a national task force constituted by the Confederation of Indian Industry ("CII") recommended a code for "Desirable Corporate Governance," which was voluntarily


adopted by a few companies.\textsuperscript{153} Thereafter, a committee chaired by Mr. Kumar Mangalam Birla ("Birla Committee") submitted a report to SEBI "to promote and raise the standard of Corporate Governance in respect of listed companies."\textsuperscript{154} Based on the recommendations of Birla Committee, in 2000 SEBI inserted Clause 49 into the Equity Listing Agreement; prescribing corporate governance norms that were applicable to all listed companies of a certain size.\textsuperscript{155} India's corporate governance norms therefore came to be governed through a clause in the listing agreement popularly referred to as "Clause 49."\textsuperscript{156} Although both the CII Code as well as the Birla Committee's report expressly cautioned against mechanically importing forms of corporate governance from the developed world,\textsuperscript{157} several concepts introduced by them were indeed those that emerged in countries such as the U.S. and the U.K. These include the concepts such as an independent board and audit committee.

Thereafter, following Enron, WorldCom, and other governance scandals, SEBI decided to strengthen Indian corporate governance norms. In the wake of the enactment of the Sarbanes-Oxley Act in the U.S., SEBI appointed the Narayana Murthy Committee ("Murthy Committee") to

\begin{footnotes}
\textsuperscript{153} Confederation of Indian Industry, \textit{Desirable Corporate Governance: A Code}, (1998), available at http://www.acga-asia.org/public/files/CII_Code_1998.pdf [hereinafter CII Code]. The CII Code, which was directed at large companies, contained some of the measures that continue to date, such as the appointment of a minimum number of non-executive independent directors, an independent audit committee, the unimpeded flow of key information to the board of directors and norms for corporate disclosures to shareholders.

\textsuperscript{154} See SE\textsc{curities and Ex}change \textsc{Board of India, Report of the Kumar Mangalam Birla Committee on Corporate Governance}, 2000, available at http://www.sebi.gov.in/commreport/corpgov.html [hereinafter Birla Report]. This report built upon the pattern established by the CII Code and recommended that "under Indian conditions a statutory rather than voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance." \textit{Id.} \S 1.7. For a detailed discussion regarding the transition from the CII Code to the Birla Report, see, Bernard S. Black & Vikramaditya S. Khanna, \textit{Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India}, 4 Journal of Empirical Studies (2007), available at http://ssm.com/abstract=914440.

\textsuperscript{155} Securities and Exchange Board of India, \textit{Circular No. SMDRP/POLICY/CIR-10/2000} (Feb. 21, 2000), available at http://www.sebi.gov.in/circulars/2000/CIR102000.html. Clause 49 contained a schedule of implementation whereby it was applicable at the outset to large companies and newly listed companies, and thereafter to smaller companies over a defined timeframe.

\textsuperscript{156} Some discussion about the Equity Listing Agreement ("Listing Agreement") is in order. It is a contractual document executed between a company desirous of listing its securities and the stock exchanges where the securities are to be listed. The execution of the Listing Agreement is a pre-condition of listing securities on a stock exchange. Since the format of the Listing Agreement is prescribed by SEBI, all stock exchanges are required to follow the standard Listing Agreement, and hence its terms do not vary from one stock exchange to another. See Securities and Exchange Board of India, \textit{Listing Agreement}, available at http://www.nseindia.com/content/equities/eq_listagreec.zip. See also The \textsc{Securities Contracts (Regulation) Act}, 1956, No. 42, Acts of Parliament, 1956 \S 21. [hereinafter SCRA] (providing that a company that applies for listing of securities on a stock exchange shall comply with the provisions of the Listing Agreement).

\textsuperscript{157} CII Code, \textit{supra} note 153, at 1; Birla Report, \textit{supra} note 154, \S 2.6, Endnote.
\end{footnotes}
examine Clause 49 and recommend changes to the existing regime.\textsuperscript{158} Following the recommendations of the Murthy Committee, on October 29, 2004, SEBI issued a revised version of Clause 49 that was to come into effect on April 1, 2005.\textsuperscript{159} However, since a large number of companies were not yet in a state of preparedness to be fully compliant with such stringent requirements, SEBI extended the date of compliance to December 31, 2005.\textsuperscript{160} Hence, detailed corporate governance norms were introduced into Indian corporate regulations only from January 1, 2006.\textsuperscript{161} Clause 49 in its present form provides for the following key features of corporate governance:\textsuperscript{162}

(i) boards of directors of listed companies must have a minimum number of independent directors, with independence being defined in a detailed manner;\textsuperscript{163}

(ii) listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent;\textsuperscript{164} the roles and responsibilities of the audit committee are specified in detail;\textsuperscript{165}

(iii) listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency;\textsuperscript{166}

(iv) the CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal

\textsuperscript{158} Securities and Exchange Board of India, Committee on Corporate Governance, Report, 2003, available at http://www.sebi.gov.in/commreport/corpgov.pdf [hereinafter Murthy Report]. The need for a review of Clause 49 was triggered in part by events that occurred in the U.S., such as the collapse of Enron and WorldCom. \textit{Id.} ¶ 1.6.1. Considerable emphasis was placed in this report on financial disclosures, financial literacy of audit committee members as well as CEO and CFO certification, all of which are matters similar to those dealt with by the Sarbanes-Oxley Act.


\textsuperscript{161} These norms have been subjected to some periodic amendments and clarifications thereafter. \textit{See} Securities and Exchange Board of India, Circular No. SEBI/CFD/DIL/CG/1/2008/08/04 (Apr. 8, 2008); Securities and Exchange Board of India, Circular No. SEBI/CFD/DIL/CG/2/2008/23/10 (Oct. 23, 2008); Securities and Exchange Board of India, Circular No. SEBI/CFD/DIL/LA/2009/3/2 (Feb. 3, 2009).

\textsuperscript{162} Clause 49 applies to all listed companies (or those that are seeking listing), except for very small companies (being those that have a paid-up capital of less than Rs. 30 million and net worth of less than Rs. 250 million throughout their history). While several requirements of Clause 49 are mandatory in nature, there are certain requirements (such as remuneration committee, training of board members and whistle blower policy) that are merely recommendatory in nature. \textit{See} SEBI Circular Oct. 29, \textit{supra} note 159.

\textsuperscript{163} Where the Chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should comprise independent directors; in other cases, independent directors should constitute at least one-third of the board size. Listing Agreement, \textit{supra} note 156, at cl. 49(1)(A).

\textsuperscript{164} \textit{Id.}, cl. 49(1)(A).

\textsuperscript{165} \textit{Id.}, cl. 49(1)(D).

\textsuperscript{166} \textit{Id.}, cl. 49(IV).
controls, and
(v) annual reports of listed companies must carry status reports about compliance with corporate governance norms.

However, there are some existing proposals to reform some of these corporate governance provisions, specifically those relating to independent directors, under the Companies Bill, 2009, which is pending in Parliament. Moreover, following the Satyam scandal, and based on recommendations provided by various industry and professional bodies, the Ministry of Corporate Affairs has proposed a voluntary code of conduct to be adopted by companies.

B. CLAUSE 49 AND INDEPENDENT DIRECTORS

It is necessary at this stage to examine the specific provisions in Clause 49 relating to independent directors.

1. Basic Requirements

Boards of listed companies are required to have an optimum combination of executive and non-executive directors, with at least half of the board comprising of non-executive directors. As regards the minimum number of independent directors, that varies depending on the identity of the chairman of the board. Where the chairman holds an executive position in the company, at least one half of the board should consist of independent directors, and where the chairman is in a non-executive capacity, at least one third of the board should consist of independent directors. Another condition was imposed in 2008 to determine the number of independent directors. Where the non-executive chairman is a promoter or a person “related to any promoter” of the company, at least one half of the board should consist of independent directors. The insertion of this condition was necessitated due to the then

167. Id., cl. 49(V).
168. Id., cl. 49(VI).
169. The concept of “independent director” is proposed under the Bill to be introduced in the Indian Companies Act for the first time. Companies that have a prescribed minimum share capital are required to have at least one-third of their board consist of independent directors. This will be a uniform requirement and the distinction between companies with executive chairman and non-executive chairman will be removed. See The Companies Bill (Proposed), 2009, No. 59, Lok Sabha, cl. 132(3), available at http://www_icai.org/resource_file/17166companies_bill_2009.pdf.
170. This recent set of changes to India’s corporate governance norms are detailed in Part V C infra.
171. Listing Agreement, supra note 156, cl. 49(I)(A)(i).
172. Id., cl. 49(I)(A)(ii).
173. See SECURITIES AND EXCHANGE BOARD OF INDIA, CIRCULAR NO. SEBI/CFD/DIL/CG/1/2008/08/04 (Apr. 8, 2008). This was subject to a further clarification in SECURITIES AND EXCHANGE BOARD OF INDIA, CIRCULAR NO. SEBI/CFD/DIL/CG/2/2008/23/10 (Oct. 23, 2008).
174. Clause 49(I)(A)(ii) of the Listing Agreement explains “related to any promoter” as follows:
prevailing practice. Chairmen of companies retained themselves in a non-executive capacity, but were often relatives of the promoters (in case of individuals) or controllers of parent/holding companies (where promoters were other companies). For example, in family-owned companies, the patriarch or matriarch of the family would be the non-executive chairman, while the day-to-day management (in executive capacity) would be carried out by persons from the subsequent generations such as children and grandchildren. Promoter-related chairmen were thus able to exert significant influence. With this amendment to Clause 49, chairmen are required to be truly independent to justify the composition of the board with one-third being independent rather than one half.

2. Independence

An independent director is defined as a non-executive director who:

- apart from receiving director’s remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director.

Apart from the general statement above, there are certain specific factors that help determine whether or not a director is independent. Note

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**Note**

a. If the promoter is a listed entity, its directors other than the independent directors, its employees or its nominees shall be deemed to be related to it;
b. If the promoter is an unlisted entity, its directors, its employees or its nominees shall be deemed to be related to it.

Listing Agreement, supra note 156, cl. 49(I)(A)(ii). In this context, it must be noted that the concept of "promoter" has specific legal significance in the Indian context. The expressions "promoter" and "promoter group" are defined to include (i) the person or persons who are in control of the company, (ii) the person or persons who are instrumental in the formulation of a plan or program pursuant to which securities are offered to the public, and (iii) the person or persons named in a securities offering document as promoters. See Issue of Capital and Disclosure Requirements, 2009, Securities and Exchange Board of India Regulations, 2009, Reg. 2(1)(2a). Controlling shareholders holding a substantial number of shares in the company would be treated as "promoters" or as part of the "promoter group." In that sense, the expressions "controlling shareholders" and "promoters" are used interchangeably in this Article, because the former expression is familiar to readers of corporate governance literature in Anglo-American jurisdictions, while the expression "promoters" is familiar in the Indian context.

175. Listing Agreement, supra note 156, cl. 49(I)(A)(ii).
177. These are that the director:
   a. is not related to promoters or persons occupying management positions at the board level or at one level below the board;
   b. has not been an executive of the company in the immediately preceding three financial years;
   c. is not a partner or an executive or was not a partner or an executive during the preceding three years, of any of the following:
   i. the statutory audit firm or the internal audit firm that is associated with the company,
that all these factors dictate as to who cannot become independent directors. There is a complete absence of positive factors that would qualify a person for being an independent director (except perhaps for the age of the person). For example, there is no mention of the types of qualification or experience the person should possess prior to appointment to the position so as to be able to discharge board responsibilities effectively. This is a serious deficiency in the definition of independence. It encourages companies to appoint persons who satisfy the formal requirements of independence, but who may otherwise not be suited for the job.178

Directors are, however, required to ensure some minimum commitment towards boards on which they sit. Companies are required to have at least four board meetings a year.179 Apart from that, there may be meetings of various committees of the board that directors are required to attend if they are members of such committees. Towards that end, there are maximum limits as to the number of boards and committees on which independent directors can sit. An independent director cannot be a member of more than 10 committees or act as chairman of more than 5 committees across all companies.180 This is to ensure that the director is not so busy as to be unable to devote sufficient time and attention towards responsibilities in each company. The Listing Agreement, does not, however specify any positive commitment that each director has to make towards a company, for instance in terms of the minimum number hours or days to be spent each year on a company.

3. Nomination and Appointment

Clause 49 does not contain any specific procedure for nomination and appointment of independent directors. That process occurs in the same manner as it does for any other director. It therefore requires us to explore

ii. the legal firm(s) and consulting firm(s) that have a material association with the company.

e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;

f. is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares;

g. is not less than 21 years of age.

Id., cl. 49(I)(A)(iii).

178. It is not the case that all companies in India adopt that path. Of course, there are reputable companies that appoint eminently suited individuals to be position despite the absence of any positive qualifications. But, one cannot rule out the possibility of certain mid-cap and small-cap companies (who may usually stay below the radar screen of public scrutiny) that may adopt the undemanding approach of appointing persons that are independent, but without the requisite competence to effectively undertake the task of board membership and monitoring management.

179. Id., cl. 49(I)(C)(i).

180. Id., cl. 49(I)(C)(ii).
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the provisions of the Indian Companies Act to examine how directors are appointed and the various factors that play out in that regard.

In India, the appointment of each director is to be voted on individually at a shareholders’ meeting by way of a separate resolution. Each director’s appointment is to be approved by a majority of shareholders present and voting on such resolution. Hence, controlling shareholders, by virtue of being able to muster a majority of shareholders present and voting on such resolution can control the appointment of every single director and thereby determine the constitution of the entire board. Similarly, controlling shareholders can influence the renewal (or otherwise) of the term of directorship.

More importantly, shareholders possess significant powers to effect the removal of a director: all that is required is a simple majority of shareholders present and voting at a shareholders’ meeting. The only protection available to directors subject to removal is that they are entitled to the benefit of the principles of natural justice, with the ability to make a representation and explain their own case to the shareholders before the meeting decides the fate of such directors. The removal can be for any reason, and there is no requirement to establish “cause,” thereby making it a potential weapon in the hands of controlling shareholders to wield against directors (particularly those directors that the controlling shareholders see as errant to their own perceptions regarding the business and management of the company).

The absence of a specific procedure for nomination and appointment of independent directors makes it vulnerable to capture by the controlling shareholders. Assuming that one of the purposes of the independent directors is to protect the interest of the minority shareholders from the actions of the controlling shareholders, such a purpose can hardly be achieved given the current matrix of director appointment, renewal and removal. The absolute dominance of controlling shareholders in this process creates a level of allegiance that independent directors owe towards controlling shareholders. If controlling shareholders cease to be pleased

181. Section 263 of the Companies Act provides as follows:
   At a general meeting of a public company or of a private company which is a subsidiary
   of a public company, a motion shall not be made for the appointment of two or more
   persons as directors of the company by a single resolution, unless a resolution that it
   shall be so made has first been agreed to by the meeting without any vote being given
   against it.

Companies Act, supra note 40, § 263.

182. The mechanism that applies for appointment of directors applies equally to renewal of the
term once the director’s office comes up for retirement.

183. The Companies Act, supra note 40, § 284 provides: “(1) A company may, by ordinary
resolution, remove a director . . . before the expiry of his period of office . . . .”

184. One observer notes: “one of the major weaknesses in Indian corporate governance has been
provisions allowing the appointment of purportedly independent directors who are old friends or
associates of management or of controlling shareholders.” Shyamal Majumdar, Opinion, “Nodders” in
the Boardroom, BUSINESS STANDARD (India), Dec. 25, 2008.
with the efforts of an independent director, such a director can be certain that his or her term will not be renewed, even if such director is spared the more disastrous consequence of being removed from the board.

The position of the controlling shareholders further gets reinforced due to the dispersed nature of the remaining shareholding in the company. In most Indian companies, institutional shareholders do not individually hold a significant percentage shareholding, even though the aggregate shareholding of all institutional shareholders may be fairly substantial. This factor adds to the vast powers already available to controlling shareholders in determining the board composition of an Indian company.

There are possible alternative approaches that can considerably dilute the influence of the controlling shareholders in the appointment of independent directors. The first approach is to have an independent nomination committee of directors that will determine the persons who will be placed on the board as independent directors. As we shall see shortly, this is not a mandatory requirement under Clause 49.

Another alternative method of director election that provides some powers to minority shareholders is cumulative voting or proportionate voting rights. In such a system, the appointment of directors can be determined through proportional representation, such that minority shareholders are able to elect such directors on the board correlative to the percentage of their shareholding in the company. The Indian Companies Act does provide for cumulative voting in Section 265:

> the articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a public company or of a private company which is a subsidiary of a public company, according to the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise, the appointments being made once in every three years and interim casual vacancies being filled in accordance with the provisions,

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185. For a discussion of the shareholding pattern generally in Indian companies, see discussion supra Part II.A.2.

186. See infra note 247 and accompanying text.

187. See infra Part V.A.3.

188. The proportional representation may be by a single transferable vote or by a system of cumulative voting. As described by Professor Gordon:

> Cumulative voting operates in two distinct settings. First, a single shareholder (or cohesive group) owning a significant minority block can automatically elect a director to the board. But second, cumulative voting lowers the cost of mobilizing diffuse shareholders because electoral success—in the sense of placing a nominee on the board—requires much less than 50% of the votes. For example, for a ten-person board elected annually, a dissident need to rally only a 10% shareholder vote to put a director on the board. So cumulative voting offers significant potential for shareholder selection of at least some directors who would be independent in this genealogical sense.

mutatis mutandis, of section 262. The key factor is that this provision is not mandatory and is only optional permitting companies to incorporate the system of proportional representation in their articles of association. It is hardly surprising then that very few companies, if any at all, have adopted the system of proportional representation to elect their directors because controlling shareholders do not have any incentive to incorporate these provisions by amending the articles association as their own influence in the voting process will be diluted.

4. Allegiance of the Independent Directors

Under Clause 49, there is no indication at all as to the constituencies that independent directors are to serve. It is not clear whether independent directors are to serve the interests of the shareholder body as a whole or whether they are required to pay greater attention to the interests of the minority shareholders. Considering that Indian companies predominantly display concentrated share ownership, it seems logical that independent directors should bear the interests of minority shareholders in mind, but there is no direct evidence of that intention in the express wording of Clause 49. In the absence of any express signals, this leaves Indian independent directors in the unenviable position of having to determine for themselves the constituency they are to serve. Similarly, there is no indication as to whether independent directors are to bear in mind the interests of non-shareholder constituencies, and if so, in what situation. The inability of Clause 49 to pinpoint the interests independent directors are to serve arguably renders their position futile and this makes the institution somewhat ambiguous. In outsider economies, the absence of such clarity causes less ambiguity as board members generally, and independent directors more specifically, serve to preserve shareholder value, but in insider economies where divergent interests are involved in the shareholder body, the lack of clarity in the role is inexplicable.

5. Role of Independent Directors

Much as Clause 49 does not specify to whom the independent directors owe their allegiance, it also does not contemplate any specific role for them. There is no separate task or function assigned to independent

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189. The Companies Act, supra note 40, § 265.
190. This is in stark contrast to the position in another emerging economy, China, where the law expressly requires independent directors to consider the interests of minority shareholders. See Minority Director, CHINESE SECURITIES REGULATORY COMMISSION, Zheng jian fa (2001) No. 102, http://www.csrc.gov.cn/n575458/n4001948/n4002030/4079260.html [hereinafter China Independent Director Opinion].
directors. The most prominent among such functions in the context of the majority-minority agency problem could have been for independent directors to consider and approve related party transactions that involve self-dealing by controlling shareholders. But, there is nothing of the kind envisaged. Independent directors are treated like any other director for purposes of role and decision-making and there is neither a specific privilege conferred nor a specific duty or function imposed on independent directors, in either case specifically by law, on the board.

However, as regards board committees, there are some specific requirements pertaining to independent directors. All companies that satisfy a minimum size are mandated by the Indian Companies Act to constitute an audit committee. The audit committee must be comprised of at least two thirds non-executive directors, but no reference is made to independence. In case of listed companies, however, Clause 49 provides that an audit committee shall be constituted consisting of three directors, with at least two-thirds of them (including the chairman) being independent directors. In the case of audit committee members (unlike for independent directors on the board), there is a need for positive qualifications regarding competence: all members shall be “financially literate” and at least one of them must have “accounting or related financial management expertise.”

Unlike the case of independent directors on the entire board, the audit committee’s mandate is fairly clear and elaborate. These include oversight of the company’s financial reporting process, recommendations regarding appointment of auditors and review of their performance, review

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191. Section 292A of the Companies Act provides:
Every public company having paid-up capital of not less than [fifty million] rupees shall constitute a committee of the Board known as “Audit Committee” which shall consist of not less than three directors and such number of other directors as the Board may determine of which two thirds of the total number of members shall be directors, other than managing or whole-time directors.
The Companies Act, supra note 40, §292A.

192. Listing Agreement, supra note 156, cl. 49(II)(A)(i).

193. Id., cl. 49(II)(A)(ii).

194. The term “financially literate” is defined to mean “the ability to read and understand basic financial statements, i.e. balance sheet, profit and loss account, and statement of cash flows.” Id., cl. 49(II)(A)(ii), Explanation I.

195. This requirement is defined as follows:
A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. Id., cl. 49(II)(A)(ii), Explanation II.

196. Clause 49 prescribes a list of 13 functions that the audit committee is required to discharge in addition to reviewing various types of information. Id., cl. 49(II)(D)-(E).
of financial statements before submission to management and the like.\textsuperscript{197} As far as related party transactions are concerned, the audit committee is required to verify the disclosures made in that behalf in the financial statements. Curiously enough, the audit committee only has a disclosure obligation regarding related party transactions. It has no approval rights.\textsuperscript{198} Hence, independent directors have not been conferred any roles or responsibilities to monitor transactions that may cause erosion of value to the company and its shareholders while enriching one or more groups of insiders such as managers or controlling shareholders.

Apart from the audit committee, only one other board committee, \textit{viz.}, the “Shareholders/Investors Grievances Committee,” is required to be constituted as a mandatory matter.\textsuperscript{199} This committee is not required to comprise any independent directors, although in practice they do carry a number of independents on them. The role of this committee is insubstantial in the overall scheme of things as it is required to “look into the redressal of shareholder and other investor complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, etc.”\textsuperscript{200} Many of these matters have now become insignificant with the advent of dematerialized trading in shares and the use of modern technology to track investor communication.

As far as the remuneration committee is concerned, that is only a non-mandatory requirement.\textsuperscript{201} It is for the companies themselves to decide whether to include such committees or not, although in the case of large listed companies, it is almost always the case that such companies have a remuneration committee where independent directors play a significant role.

Finally, as we have seen earlier, the nomination committee generally plays an important role in corporate governance. But India does not impose a mandatory requirement to constitute nomination committees to nominate independent directors. For this reason, the controlling shareholders are able to significantly influence the process of nomination and appointment of independent directors. The absence of a nomination committee presents a significant obstacle to the protection of minority shareholder interest as controlling shareholders are able to determine the identity of individuals who occupy the position of independent directors and they are likely to ensure the appointment of such individuals who will be sympathetic to the perspectives of the controlling shareholders with

\textsuperscript{197} \textit{Id.}., cl. 49(I)(D).
\textsuperscript{198} This is in contrast with the position in the U.S. where Delaware General Corporation Law, § 144 expressly provides powers to an independent committee to approve self-dealing transactions or China’s conferral of a specific role on independent directors to acknowledge and express their opinion on related party transactions. China Independent Director Opinion, \textit{supra} note 190.
\textsuperscript{199} \textit{Listing Agreement, supra note 156, cl. 49(IV)(G)(iii).
\textsuperscript{200} \textit{Id., cl. 49(IV)(G)(iii).}
\textsuperscript{201} \textit{Id., cl. 49, Annexure IC ¶ 2.}
complete allegiance in fact towards them.

Moreover, at a broad level, the absence of any specific role for directors creates difficulties at a practical level. Neither independent directors themselves nor the corporate community in general are able to comprehend what is expected of independent directors. For instance, at least a majority of the independent directors in India that I interviewed for the purposes of this Article\(^{202}\) believed their role to be one of advising management from a business or strategic standpoint rather than to act as monitors of management or the controlling shareholders. In the absence of any such clarity in regulatory intentions in the Indian context, one cannot expect any meaningful level of monitoring from independent directors.

6. **Effectiveness of Clause 49**

In an overall sense, Clause 49 makes a considerable effort to codify the independent director concept in India. Moreover, when it comes to enforcement of the requirements under Clause 49, India fares well in terms of the law on the statute books. Previously, there were no specific sanctions for violation of the Listing Agreement, which contains the corporate governance norms.\(^{203}\) At most, stock exchanges could threaten to delist companies from the stock exchanges. That would not be a viable solution because it would be the shareholders that suffer from the consequences of delisting as it would deprive them of liquidity in the markets and even a resultant fall in the value of their shareholding. Conscious of this shortcoming, certain statutory amendments were introduced in 2004. Section 23E was inserted into the Securities Contracts (Regulation) Act, 1956 ("SCRA") that provided a penalty of up to Rs. 250 million (approx. US$5.4 million) for violation of the listing conditions.\(^{204}\) This imposes significant deterrence against non-compliance (including the corporate governance norms embodied in Clause 49). However, as we shall see later, there could still be drawbacks in the implementation of these

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202. See infra note 245 and accompanying text.

203. The difficulties that emanate from such an inchoate position regarding enforcement are evident from the parallel situation in Hong Kong. See Chee Keong Low, *Silence is Golden: The Case of CITIC Pacific in Hong Kong* (2009) available at http://ssrn.com/abstract=1381990. Low highlights "a lacuna in the regulatory framework in Hong Kong with some anomalous outcomes likely[,]... while the company and its directors will be censured for their breach of the Listing Rules they are unlikely to be correspondingly sanctioned under the Securities and Futures Ordinance." Low argues that "the rectification of such anomalies requires the introduction of statutory backing to the Listing Rules which was first discussed by the government in 2003." Id. at 2.

204. Section 23(E) reads:

If a company . . . fails to comply with the listing conditions or delisting conditions or grounds or commits a breach thereof, it or he shall be liable to a penalty not exceeding twenty-five crore rupees.

SCRA, supra note 156, § 23(E)
enforcement provisions in the Indian context. The discussion in this Part reveals the nexus between developments pertaining to the independent director concept in the developed outsider economies of the U.S. and the U.K. on the one hand and the emerging insider economy of India. Since the late 1990s, the developments in Indian corporate governance have closely followed those of the outsider economies. This is a result of the possible convergence of corporate governance norms towards the U.S. and the U.K. models.

However, a closer examination of the specific norms pertaining to independent directors in India indicates that they were adopted in that country without suitable changes to reflect the agency problems prevalent there. Although the independent director concept was evolved as a solution to the manager-shareholder agency problem in the U.S. and the U.K., they have been incorporated in India without substantial modifications. For instance, the independent director concept does very little to address the majority-minority agency problem which is prevalent in India. There has been no deliberation on whether the concept deals with the majority-minority agency problem at all, nor have there been any suitable adjustments in its applicability to deal with that agency problem. This results in a mismatch in the application of the independent director concept that is clear from a close scrutiny of Clause 49 in India. The aforesaid survey of the development of corporate governance norms in India coupled with an analysis of the legal provisions indicates several failures in the transplant.

V. EFFECTIVENESS OF INDEPENDENT DIRECTORS IN INDIA

After having analyzed the evolution (i.e., transplantation) of the independent director concept in India, it is necessary to determine the success of independent directors in that country. This is achieved through an analysis of empirical studies as well as anecdotal evidence by means of case studies. In this Part, it becomes evident from the empirical and anecdotal analysis that the concept has not been entirely effective in practice, at least not to the extent anticipated by regulators at the time of its inception.

Here, I survey existing empirical literature and case studies relating to the effectiveness of independent directors in India. The availability of studies (empirical or anecdotal) on independent directors in India is fairly limited. At an empirical level, there are some recent studies that examine the role of corporate governance in general and its impact on corporate performance. This literature employs the event study method. These studies are relevant to the extent that independent directors form one of the

205. See Part V.B.1. infra.
instruments or institutions employed to enhance corporate governance in India. Recent empirical surveys have been conducted by professional bodies and consultants who focus more specifically on independent directors. These have received limited attention from a legal academic standpoint, and it is hoped that the survey in this Part will contribute to a more concerted move in that direction. In order to supplement this survey, in 2008 I also interviewed fifteen individuals, being independent directors, chairpersons of boards, CEOs, CFOs, controlling shareholders or promoters of various Indian companies, partners of law firms and academics, and the responses from such interviews are discussed as appropriate.\(^{206}\)

A. INDEPENDENT DIRECTORS IN INDIA: EMPIRICAL SURVEY

There are some recent empirical studies pertaining to India that examine the effectiveness of independent directors. These studies pertain to corporate governance in general, of which independent directors are only one component. For instance, the event studies in the Indian context deal with the impact of Clause 49 reforms as a whole without specifically focusing on independent directors. On the other hand, there are other empirical studies primarily carried out by professional bodies that examine board practices that focus more specifically on the institution of independent directors. This section analyzes the findings of these studies and draws conclusions regarding the role of independent directors in India.

1. Effect on Corporate Performance

There is an emerging body of empirical literature on Indian corporate governance,\(^{207}\) but for the present purposes it would suffice to review two recent empirical studies. In the first,\(^{208}\) an event study, Professors Black and Khanna study the impact of corporate governance reforms reflected by the formation of the Birla Committee\(^{209}\) and find that over a two-day event window around May 7, 1999,\(^{210}\) the share prices of large firms, to which the corporate governance reforms were then intended to apply, rose by roughly 4 percent relative to other small firms, thereby signaling the investors’ expectations that corporate governance reforms will increase market value

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206. Most of the individuals were interviewed based on the understanding of anonymity, and hence their names are not specified in this Article.

207. For a review of this empirical literature, see Rajesh Chakrabarti, William L. Megginson & Pradeep K. Yadav, Corporate Governance in India, 20 J. APP. CORP. FIN. 59, 70-71 (2008).

208. Black & Khanna, supra note 154.

209. Id.

210. The authors selected May 7, 1999, as the core event date for the study as that is the date on which the Government announced the formation of the Birla Committee to suggest corporate governance reforms. The authors also rely on the fact that that “investors had reason to expect the [Birla Committee] proposals to be similar to the CII Code.” See Black & Khanna, supra note 154, at 6.
of firms.\textsuperscript{211} The second study by Dharmapala and Khanna acknowledges the importance of enforcement in corporate governance reform.\textsuperscript{212} The authors study the impact of the introduction of Section 23E to the Securities Contracts (Regulation) Act, 1956 in 2004 that imposed large penalties of Rs. 25 crores (Rs. 250 million) for noncompliance with the Listing Agreement (that also includes Clause 49 containing the corporate governance norms).\textsuperscript{213} Using a sample of over 4,000 firms during the 1998-2006 period, the study reveals a "large and statistically significant positive effect (amounting to over 10 percent of firm value) of the Clause 49 reforms in combination with the 2004 sanctions."\textsuperscript{214}

While these event studies are optimistic about the impact of recent corporate governance measures in India, it would imprudent to conclude that independent directors have been effective in India. These studies examine the impact of Clause 49 in its entirety, of which the independent director is only one part. There are other measures such as the audit committee, financial disclosures, CEO/CFO certification, whistle blower policy, a corporate governance code and the like that are part of the package.

Since event studies by themselves do not provide much evidence regarding the effectiveness of independent directors, it is necessary to examine studies on corporate governance practices, particularly those relating to board practice. Recent events in India such as the Satyam corporate governance scandal have spurred a number of surveys. While there is one academic survey\textsuperscript{215} that explores corporate governance practices in Indian companies, there are three recent surveys by professional bodies that cover similar ground.\textsuperscript{216} The remainder of this

\begin{itemize}
\item \textsuperscript{211} Id.
\item \textsuperscript{213} Id. at 9.
\item \textsuperscript{214} Id. at 3.
\item \textsuperscript{215} Balasubramanian, Black \& Khanna, supra note 150. This study was based on responses to a 2006 survey of 370 Indian public listed companies.
\item \textsuperscript{216} The AT Kearney, AZB \& Partners and Hunt Partners ("AAH") 2007 survey studied board composition across various public companies are listed on the Bombay Stock Exchange and the National Stock Exchange. AT Kearney, AZB \& Partners, and Hunt Partners India Board Report—2007: Findings, Action Plans and Innovative Strategies (2007) (copy on file with the author) [hereinafter AAH Report]. The FICCI \& Grant Thornton ("FICCI-GT") survey analyzed corporate governance at "mid-market" listed companies in India by reviewing the nature and extent of corporate governance practices in approximately 500 companies across various sectors that were targeted to participate in the survey, FICCI \& Grant Thornton, CG Review 2009: India 101-500 (Mar. 2009), available at http://www.wcgt.in/assets/FICCI-GT_CGR-2009.pdf [hereinafter FICCI-GT Report]. The KPMG Audit Committee Institute’s survey presented findings on a poll conducted between November 2008 and January 2009, involving over “90 respondents comprising CEOs, CFOs, independent directors and similar leaders, who were asked about the journey, experience and the outlook for corporate governance in India,” KPMG Audit Commitee Inst., The State of Corporate Governance in India: A Poll (2009) available at http://www.in.kpmg.com/TL_Files/Pictures/CG%20Survey%20Report.pdf
\end{itemize}
section discusses the relevance of these surveys and the conclusions that emanate from them.

2. **Number of Independent Directors**

   As we have seen earlier, boards are required to have at least one third of their size comprised of independent directors, and if the chairman is an executive director or related to the promoters, then at least one half. This requirement has been mandatory for all large companies since January 1, 2006. However, Balasubramanian, Black and Khanna find that 7 percent of the firms surveyed do not have the minimum one-third independent directors and further a number of other companies that have a common chairman and CEO do not have the minimum one-half independent directors. They find that only 87 percent comply with board independence rules. The fact that 13 percent companies are yet to even comply with the minimum formal requirement of independent directors is startling. First, the definition of independence does not require any positive factors but only the absence of relationships with the company or its controlling shareholders. Hence, the pool of candidates for companies to choose from is fairly large, especially in a country whose total population exceeds one billion. Further, it has generally not been difficult for companies to find independent directors. In this context, noncompliance of even the formal requirements by a large number of companies indicates the lack of all-round corporate will to follow more stringent governance norms in India. Even where companies do meet the minimum number of independent directors, a large number of them are appointed principally to satisfy compliance requirements.

   Balasubramanian, Black and Khanna also find that in 59 percent of the surveyed companies, there was a separate CEO and chairman. At first blush, these statistics appear to be impressive. However, interview evidence suggests that several companies maintained separate CEO and chair positions so as to be able to comply with Clause 49 by appointing one-third of their board as independent directors rather than one-half, because if the positions of CEO and chairman were held by the same person the more onerous requirement of appointing one half of the board as

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217. Supra note 172 and accompanying text.
218. Balasubramanian, Black & Khanna, supra note 150, at 14.
219. Id.
220. This finding is supported by the practitioner interviews that I conducted as well as Balasubramanian, Black & Khanna, supra note 150 at 14.
221. The KPMG Report shows that 64 percent of its respondents believe independent directors merely contribute towards satisfying a regulatory requirement, although empowering them would enhance their performance significantly. KPMG Report, supra note 216, at 6.
222. Balasubramanian, Black & Khanna, supra note 150, at 14.
independent directors would apply instead of the one-third requirement. This way, management and controlling shareholders can keep the influence of independent directors on boards at a minimum.

3. Nomination and Appointment

While the analysis of Clause 49 in Part IV.B.3 of this Article identifies controlling shareholder influence as a key shortcoming, the empirical survey of board practices reflects the perpetuation of the problem in practice. Controlling shareholders in fact do exercise significant control over appointment of independent directors as they have in the case of other directors too. The FICCI GT Report observes as follows:

The survey shows that majority of the respondents (56%) do not have a nomination committee to lead the process of identifying and appointing directors. Possibly, the general practice has been for the promoters to identify people known to them or with whom they have comfort levels or otherwise people who are known personalities and can thus enhance the visible creditability of the board. This naturally restricts the choice to a relatively small segment and explains why the second most populated country in the world has been voicing a problem with numbers when it comes to finding independent directors.

In a similar vein, the AT Kearney, AZB & Partners, and Hunt Partners Report ("AAH Report") finds that a "good 90 percent of the non-executive independent directors were appointed using CEO/chairperson’s personal network/referrals, and the remaining 10 percent through executive search firms." These findings are also overwhelmingly supported by interviews with practitioners. Most practitioners were of the view that the involvement of promoters in director nomination and appointment is

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223. Interview with a corporate lawyer, who is also an independent director on companies, in New Delhi, India (July 3, 2008).
224. It must be noted, however, that when Balasubramanian, Black and Khanna conducted their survey in 2006, the one-third requirement could be satisfied by merely separating the positions of the CEO and chairman. At that stage, it was quite common for companies to appoint promoters (who were not in any executive capacity) as the chairman of the company. This effectively ensured that the chairmanship as well as the key managerial responsibilities remained with the family. It is for this reason that an additional requirement was introduced in April 2008 requiring companies to avail of the one-third independent director requirement, i.e., that the chairman should also not be related to the promoter. See also supra notes 174 and accompanying text. This will ensure that boards are structured such that either the chairman is truly independent or that at least one half of the board consists of independent directors. It is possible that any survey over a period following April 2008 may yield different results.
225. Issues are compounded because it is not mandatory under Clause 49 to have independent nomination committees that would handle the process of selection, nomination and appointment of independent directors.
226. FICCI-GT Report, supra note 216 at 11.
227. AAH Report, supra note 216, at 33. This study also finds that only "39.1% followed a formal process for the selection of board of directors in 2005-2006." Id.
"huge." Interestingly, some practitioners opined that such involvement is not necessarily objectionable, primarily because promoters themselves gain when high quality individuals are enlisted onto corporate boards as independent directors as their contribution would be immensely useful to the companies. Apart from that, bringing in independent directors who can work with promoters and the management will enable collegiality on the board. While the practitioner view will enable seamless board activity, it is not clear if that would result in proper monitoring so as to ensure that the interests of all constituencies involved are appropriately protected. However, most practitioners were of the view that nomination committees ought to be made mandatory as that will introduce objectivity in the independent director selection process.

4. Competence

Balasubramanian, Black and Khanna report their findings on backgrounds of independent directors. They find that 39 percent of the firms surveyed had a scholar on their board. The other prominent categories of individuals for independent directorship are lawyers (in 38 percent of companies) and former governmental officials or politicians (30 percent). The study by Balasubramanian, Black and Khanna does not track executives from other companies as independent directors. However, it appears from a sample survey of large reputed Indian companies and also interviews with practitioners that the category of business executives is becoming increasingly prominent. Practitioner interviews also suggests the emergence of a cadre of professional directors, although they are few and far between compared to the other categories.

As regards the dominant categories of academics, professionals (such as lawyers), retired governmental officials and politicians, it is not clear if they do possess requisite qualities to perform monitoring activities in the required manner.

228. Interview with a former senior corporate executive, chairman and independent director on several Indian companies, in Mumbai, India (June 13, 2008).
229. One practitioner even observed that boards should not become "debating societies" and that constructive decisionmaking is essential. Interview with a corporate lawyer, independent director on Indian companies, in New Delhi, India (July 3, 2008).
230. Some of the surveys also call for reform by way of mandating a nomination committee. See FICCI-GT Report, supra note 216, at 11; KPMG Report, supra note 216, at 6.
231. Balasubramanian, Black and Khanna, supra note 150, at 16. They find that scholars are an attractive choice for companies as they are formally independent.
232. Id., at 16.
233. This is similar to the category recommended by Professors Gilson and Kraakman whereby the primary occupation of such individuals is independent directorships on the boards of a few companies. See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863 (1991).
5. Incentives and Disincentives

Remuneration of independent directors in India is fairly low compared to international standards. Independent directors are paid a sitting fee or a commission (as a share of profits)\(^{234}\) or are awarded stock options in the company.\(^{235}\) Further, committee members are paid additional compensation for their enhanced efforts in performing specific functions. The quantum of remuneration has been on the upswing in recent years. The AAH Report found that the “average annual compensation increased from Rs. 397,000 in 2004-05 to Rs. 606,000 in 2005-06, an increase of 52.5%”\(^{236}\) and the “average annual sitting fee increased by 39%, from Rs. 112,000 in 2004-05 to Rs. 155,000 in 2005-06.”\(^{237}\) Although the numbers are increasing, they may not be sufficient to attract high quality talent.

From an empirical standpoint, the key question relates to whether increase in compensation would compromise independence, especially if the independent director’s principal source of income were to come from such directorship. During interviews, most respondents seem to believe that increased compensation by itself will not impinge upon independence, particularly if individuals are independent directors on multiple boards.

There are several disincentives to individuals for acting as independent directors. The principal among them relates to potential liability and loss of reputation, primarily in case of breach of law by the company or any other types of malfeasance. Furthermore, companies are not in a position to indemnify independent directors except in certain circumstances.\(^{238}\) As regards D&O insurance policies in favor of independent directors, they are not as popular as they are in developed economies, although the Indian market for such policies is on the rise.\(^{239}\)

Following the corporate governance scandal at Satyam, SEBI is actively considering the imposition of a mandatory requirement that all public listed companies obtain D&O insurance policies for their directors.\(^{240}\) However,

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234. As regards sitting fees and commissions, there are limits on the amounts payable. While the sitting fee is a small amount, the commission is determined on the basis of profitability of the company.
235. The trend of awarding stock options to independent directors is of recent vintage and is yet not entirely common. AAH Report, supra note 216, at 50.
236. Id. at 49.
237. Id. at 49.
238. Section 201 of the Companies Act provides that any such indemnification provision in favour of a director (including an independent director) that holds such person harmless “against any negligence, default, misfeasance, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void.” Moreover, any expenses incurred in defending proceedings can be reimbursed by the company only when the independent directors have been acquitted or discharged or when relief is granted to them. The Companies Act, supra note 40, § 201.
239. D&O insurance policies market picking up, THE HINDU BUSINESS LINE (India), Nov. 10, 2005.
240. Aman Dhall, SEBI may make D&O liability insurance must for listed cos, ECONOMIC TIMES (India), Apr. 19, 2009.
there are certain practical difficulties in the wide acceptance of D&O insurance policies. While the large and more reputed companies, particularly those that are cross-listed on international stock exchanges, do obtain large amounts of D&O insurance policies, most of the other companies find it prohibitively expensive to obtain meaningful policies. Indian insurance companies have only recently begun offering these types of insurance policies and there are bound to be difficulties in successfully invoking such policies.

There appears to be no empirical survey that tracks the manner in which such disincentives operate in the minds of independent directors in India. However, there are some cases which provide an indication in this regard, which will be examined in the next section.

6. Role of Independent Directors

As we have seen in the previous Part, Clause 49 is altogether silent when it comes to the roles and responsibilities of independent directors. It is not clear if they are to be involved in strategic advisory functions or monitoring functions. It is also not clear if they are to owe their allegiance to the shareholder body as a whole, to the minority shareholders specifically, or to other stakeholders. It is somewhat surprising, therefore, to find that survey results report a great level of confidence among independent directors about knowledge of their own roles. The AAH Report states that 62.5 percent of the respondents “believe that the roles and responsibilities of the non-executive directors are clearly defined and documented.” In the FICCI GT Report, a slightly larger proportion of 69 percent expressed satisfaction with the outline of the current role and responsibility of the board members in general. If participants in the corporate sector seem quite conscious of their own role, what exactly is that role—strategic advisory or monitoring? This is an important question which the surveys do not readily answer. The only guidance available is that 59 percent of respondents to one survey believe that independent director involvement in annual planning and strategy development of the company of the company is moderate, while 22 percent believe it to be substantial and 13 percent minimal. But, the monitoring function, which has been the focus of the independent director’s evolution in the U.S. and the U.K., appears not yet to be a key part of an independent director’s role in India. While the surveys themselves do not track the monitoring

241. Interview with a corporate lawyer, independent director on Indian companies, In Mumbai (June 12, 2008).
243. FICCI-GT Report, supra note 216, at 15. Note that this report, unlike the AAH Report, surveys the role of the board as a whole as opposed to the specific roles of independent directors.
244. FICCI GT Report, supra note 216, at 17.
function, interviews with practitioners suggest a greater involvement of independent directors in business strategy formulation than in monitoring.\footnote{245}

In the context of the majority-minority agency problem's persistence, there is no general tendency on the part of independent directors to bear in mind the interests of minority shareholders. One survey finds that “[o]ver 20 percent of firms have a director who explicitly represents minority shareholders or institutional investors.”\footnote{246} However, the survey does not identify the types of minority investors. Based on practitioner interviews and a broad overview of minority investors in Indian companies, it appears that these independent directors are usually appointed by institutional investors who take significant shareholdings in public listed companies.\footnote{247}

The investors enter into contractual arrangements (though subscription and shareholders’ agreements) with the company and the controlling shareholders to identify the inter se rights among the parties. The so-called independent directors, who are otherwise nominees of the investors, are appointed to oversee the interests of the investors appointing them and do not have any explicit mandate to cater to the interests of minority shareholders as a whole. Such an independent director selectively takes into account the interests of one minority shareholder, and cannot be said to aid in the resolution of the majority-minority shareholder problem in general.\footnote{248}

Finally, independent directors can play an impactful role only when board systems and practices enable such role. One of the key obstacles to the proper functioning of independent directors relates to availability of information. Although the amount of information being shared with independent directors has been increasing over the years, surveys find that there is a need for drastic improvement both in terms of the timeliness and

\footnote{245}{Many practitioners believed that their role is not meant to be one of “policing” individuals within the company, and that with their minimal involvement in the company’s affairs it was impossible for them unearth all goings-on in the company.}

\footnote{246}{Balasubramanian, Black & Khanna, supra note 150, at 16.}

\footnote{247}{These institutional investors are private equity funds, venture capital funds and similar institutional investors who take up a stake in public listed companies through PIPE (private investment in public equity) transactions or are investors who came into the company prior to its listing, but have remained even thereafter. These types of investors rely extensively on additional rights provided under contractual documentation, including the right to nominate directors on the boards of the companies. Practice reveals that several companies treat such nominees as independent directors. This is because such directors tend to satisfy the formal definition of independence in Clause 49 and there is no further clarity regarding the status of such nominee directors. Other companies, however, adopt a more conservative approach and refuse to treat such nominees as independent directors. The practice is dichotomous.}

\footnote{248}{The KPMG Report generally notes that “75 percent of the respondents believe that significant efforts need to be made to address the concerns of minority shareholders” and that “12 percent of the respondents say that minority shareholders’ concerns are sometimes addressed but not in the best interests of the company.” KPMG Report, supra note 216, at 7.}
quality of information provided.\textsuperscript{249} Furthermore, independent directors can be effective only if they are provided adequate training and their performance is properly evaluated. As far as training is concerned, although there is no mandatory training requirement in Clause 49,\textsuperscript{250} one survey suggests that 57 percent of the respondents are taking steps to provide training to their directors.\textsuperscript{251} Independent directors will have an incentive to carry out their roles diligently if their performance is periodically evaluated.\textsuperscript{252} However, performance evaluation of independent directors has not evolved sufficiently in India as a common practice. One survey indicates that only a quarter of responding firms have an evaluation system for non-executive directors,\textsuperscript{253} while another survey indicates that about 39 percent companies surveyed had a formal board evaluation process\textsuperscript{254} (which perhaps covers the entire board rather than just the independent non-executive directors). This suggests that independent directors are often brought on boards merely to comply with the legal requirement rather than with a view of obtaining any significant contribution (either in terms of strategic value-add or monitoring).\textsuperscript{255}

In conclusion, the empirical surveys reemphasize the shortcomings not only of the concept of the independent director itself but its current form as contained in Clause 49. Although respondents are generally optimistic about greater effectiveness of the independent directors once appropriate conditions are created, the current situation is far from the desired.\textsuperscript{256} To a

\begin{itemize}
\item \textsuperscript{249} AAH Report, supra note 216, at 30-31; FICCI GT Report, supra note 216, at 13; KPMG Report, supra note 216, at 10.
\item \textsuperscript{250} This is unlike China where independent director training is mandatory. China Independent Director Opinion, supra note 190.
\item \textsuperscript{251} FICCI GT Report, supra note 216, at 24. This is also consistent with practitioner interviews indicating that companies do provide opportunities to directors for training programmes. However, these are provided only on a voluntary basis and directors do avail of them depending on their need for the training and the availability of time.
\item \textsuperscript{252} Under Clause 49, evaluation of the performance of non-executive directors is only a non-mandatory requirement. Listing Agreement, supra note 156, cl. 49 Annexure IC, § 6.
\item \textsuperscript{253} Balasubramanian, Black & Khanna, supra note 150, at 18.
\item \textsuperscript{254} AAH Report, supra note 216, at 33.
\item \textsuperscript{255} In a practitioner interview, one respondent remarked that often individuals are often brought in as independent directors just to ”keep the seat warm.” Interview with a CEO of a listed company, in Bangalore, India (June 23, 2008). This is also consistent with the inadequacies pointed out in the nomination and appointments process. If there is a serious evaluation process, controlling shareholders and managers would be compelled to nominate competent and strong-willed individuals as independent directors with the ability to sustain serious scrutiny, and who may not necessarily adhere to the policies and aspirations of their nominators.
\item \textsuperscript{256} One survey summarizes the deficiencies in the current position:
   According to directors, the greatest impediments in changing board structure include limited pool of independent directors, and lack of willingness on part of existing board members to change. Absence of a structured process to select capable independent directors was also perceived to be an impediment to a certain extent.
\end{itemize}

AAH Report, supra note 216, at 23. The survey also noted that “[r]elatively few directors believe that adding more independent directors could add further value to the board.” Id. at 23.
large extent, the claims made in this Article about the inadequacies of the
independent director regime in India stand supported by empirical
evidence.

Before concluding on the empirical front, it is necessary to highlight
one heartening trend. During practitioner interviews, the study revealed
that in a handful of leading Indian companies (the so called “blue-chip”
companies), the corporate governance norms and practices identified were
far superior to what is prescribed by Clause 49 and were also comparable
to, and perhaps more stringently followed than, practices around the world,
particularly in developing countries. In these companies, only competent
individuals who are truly independent are appointed following a rigorous
appointment process. Further, the companies (management and controlling
shareholders) themselves are highly demanding of the time and attention of
the independent directors. They seek independent advice of such directors
(on strategy, compliance, monitoring and other issues), rely substantially
on their inputs and even impose an onerous evaluation system. However,
these are only honorable exceptions that seem to flow against the tide.

B. INDEPENDENT DIRECTORS IN INDIA: CASE STUDIES

In addition to empirical evidence, there is also a fair amount of
anecdotal evidence represented by case studies (with the prominent ones
being most recent) that help analyze the effectiveness of independent
directors in Indian corporate governance. The case studies are divided into
three categories and discussed below.

1. Compliance with Clause 49

Even assuming that independent directors are not believed to be
effective, it would be right to presume that companies would nevertheless
appoint independent directors in order to comply with the minimum
requirements of Clause 49, at least as a means of “checking the box.”
However, as we have seen, nearly 13 percent companies were yet to
appoint the minimum number of independent directors as of 2006.
Surprisingly, the principal offenders are not the medium- and small-scale
companies or lesser known businesses, but the government itself in the case
of public sector undertakings.

In a string of cases, SEBI initiated action in 2007 against several

\[257. \text{See supra Part IV.B.}\]
\[258. \text{Interview with an executive director and the company secretary of a technology services company, in Bangalore, India (June 23, 2008).}\]
\[259. \text{Supra Part V.A.2 and accompanying notes.}\]
government companies for non-compliance of Clause 49. These actions were initiated on the specific count that these government companies had failed to appoint the requisite number of independent directors as required by Clause 49. However, the actions were subsequently dropped by SEBI. The principal ground for dropping the action is that, in the case of the government companies involved, the articles of association provide for the appointment of directors by the President of India (as the controlling shareholder), acting through the relevant administrative Ministry. SEBI found that despite continuous follow up by the government companies, the appointments did not take effect due to the need to follow the requisite process and hence the failure by those companies to comply with Clause 49 was not deliberate or intentional.

This episode may likely have deleterious consequences on corporate governance reforms in India. Compliance or otherwise of corporate governance norms by government companies has an important signaling effect. Strict adherence to these norms by government companies may persuade others to follow as well. But, when government companies violate the norms with impunity, it is bound to trigger negative consequences in the marketplace thereby making implementation of corporate governance norms a more arduous task. Furthermore, such implementation failures raise important questions as to the acceptability of transplanted concepts of corporate governance in the Indian context.

2. Effectiveness of Independent Directors: The Satyam Episode

Even where there is a stellar independent board of directors, it may not be possible for them to perform their role effectively if the conditions that facilitate proper performance do not exist. The Satyam episode demonstrates some of the reasons why the effectiveness of independent directors in India may continue to be in doubt.

a. Satyam: the company and its board

Satyam Computer Services Limited (recently renamed Mahindra Satyam) is a leading information technology services company incorporated in India. Satyam’s promoters, represented by Mr.

Business Line (India), Sept. 12, 2007.

261. SEBI repeatedly made public statements through its Chairman indicating its intention to ensure that government companies too strictly comply with Clause 49. See PSUs Must Meet Clause 49 Norms, Rediff Money (India), Jan. 3, 2008.

262. During October and November 2008, SEBI passed a series of orders involving several government companies, viz. NTPC Ltd. (October 8, 2008), GAIL (India) Ltd. (October 27, 2008), Indian Oil Corporation Ltd. (October 31, 2008) and Oil & Natural Gas Corporation Ltd. (November 3, 2008), available at http://www.sebi.gov.in.

263. It is paradoxical that the expression “Satyam” stands for “truth” in Sanskrit.
Ramalinga Raju and his family, held about 8 percent shares in the company at the end of 2008, while the remaining shareholding in the company was diffused. Its securities are listed on the Bombay Stock Exchange and the National Stock Exchange. Furthermore, the company’s securities are cross-listed on the NYSE. This required Satyam to comply not only with Clause 49 but also the requirements of the Sarbanes-Oxley Act as well as the NYSE Manual. Satyam took immense pride in its corporate governance practices.

At the relevant time (end 2008), Satyam had a majority independent board, thus over-complying with the requirements of Clause 49. Its board consisted of the following:

**Executive Directors**
- B. Ramalinga Raju, Chairman;
- B. Rama Raju, Managing Director and Chief Executive Officer;
- Ram Mynampati, Whole Time Director;

**Non-Executive, Non-Independent Directors**
- Prof. Krishna G. Palepu, Ross Graham Walker Professor of Business Administration at the Harvard Business School;

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264. It has been reported that the promoters’ percentage shareholding in Satyam declined over a period of time:

Though the precise numbers quoted vary, according to observers the stake of the promoters fell sharply after 2001 when they held 25.60 per cent of equity in the company. This fell to 22.26 per cent by the end of March, 2002, 20.74 per cent in 2003, 17.35 per cent in 2004, 15.67 per cent in 2005, 14.02 per cent in 2006, 8.79 in 2007, 8.65 at the end of September 2008, and 5.13 per cent in January 2009. The most recent decline is attributed to the decision of lenders from whom the family had borrowed to sell the shares that were pledged with them. But the earlier declines must have been the result either of sale of shares by promoters or of sale of new shares to investors.

C.P. Chandrasekhar, *The Satyam Scam: Separating Truth from Lies*, THE HINDU (India), Jan. 14, 2009 (internal citations omitted). It would be cumbersome to obtain the exact amount of voting shares held by the promoters as large parts of those shares were pledged to lenders and those pledges were enforced by the lenders, thereby bringing the promoter holdings down to negligible levels.

265. In Satyam’s case, institutional shareholders held a total of 60 percent of shares as of December 31, 2008; the highest individual shareholding of an institutional shareholder, however, was only 3.76 percent. Satyam Computer Services, Ltd., Shareholding Pattern (Dec. 31, 2008), available at http://www.bseindia.com/shareholding/shareholdingPattern.asp?scripcd=500376&qrid=60.


267. Id. at 43. The securities listed on the NYSE in the form of American Depositary Receipts (ADRs) are derivative securities issued to holders by a global depository that holds underlying equity shares of Satyam.

268. It is also ironic that the company was awarded the Golden Peacock Award for Corporate Governance by the World Council for Corporate Governance as late as September 2008. Satyam receives Golden Peacock Global Award for Excellence in Corporate Governance, FINANCIAL EXPRESS (India), Sept. 23, 2008.

269. Satyam Annual Report, supra note 266; Satyam Computer Services Ltd., Annual Report (Form 20-F) (Aug. 8, 2008) [hereinafter Satyam Form 20-F].

270. Although Professor Palepu was initially appointed as an independent director, he ceased to be so formally, in view of the special remuneration of $200,000 that he received from the company
Independent
Dr. Mangalam Srinivasan, management consultant and a visiting professor at several U.S. universities;
Vinod K. Dham, Vice President and General Manager, Carrier Access Business Unit, of Broadcom Corporation;
Prof. M. Rammohan Rao, Dean, Indian School of Business;
T. R. Prasad, former Cabinet Secretary, Government of India; and
V. S. Raju, Chairman, Naval Research Board and former Director, Indian Institute of Technology, Madras.

The board consisted of three executive directors, five independent directors and one grey (or affiliated) director. Amongst the non-executives, four were academics, one was from government service and the last was a business executive. At a broad level, it can be said that very few Indian boards can lay claim to such an impressive array of independent directors.

b. The Maytas transaction

On December 16, 2008, a meeting of Satyam’s board was convened to consider a proposal for acquisition of two companies, Maytas Infra Limited and Maytas Properties Limited. Two sets of facts gain immense relevance to the transaction. One is that the Maytas pair of companies was predominantly owned in excess of 30 percent each by the Raju family, thereby making the proposed acquisition deal a related party transaction. The other is that the Maytas companies were in the businesses of real estate and infrastructure development, both unrelated to the core business of Satyam. The transactions were also significant as the total purchase consideration for the acquisition was Rs. 7,914.10 crores (US$1.6 billion). It is important to note that, if effected, the transaction would have resulted in a significant amount of cash flowing from Satyam, a publicly listed company, to its individual promoters, the Raju family.

The board meeting on December 16, 2008, was attended by all directors, except for Palepu and Dham who participated by audio conference. On account of the related party situation and unrelated towards professional consulting services rendered. Satyam Annual Report, supra note 266, at 64.

271. Vinod Dham is a seasoned technocrat who is also referred to as the “father of the Pentium chip.” Scandal at Satyam: Truth, Lies and Corporate Governance, INDIA KNOWLEDGE@WHARTON, Jan. 9, 2009, available at http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344.


275. Satyam Board Minutes, supra note 272, at 4.

276. Under the Companies Act, participation by audio conference is not recognized and hence there
business diversification, it is natural to expect a significant amount of resistance from the independent directors to the Maytas transactions. After the company’s officers made a presentation to the board regarding the transactions, the independent directors did raise some concerns. For example, “Dr. Mangalam Srinivasan, Director enquired if there are any particular reasons either external or internal for this initiative and timing of the proposal” and “suggested to involve the Board members right from the beginning of the process to avoid the impression that the Board is used as a rubber stamp to affirm the consequent or decisions already reached.”

Other independent directors such as a Rao and Dham were concerned about the risks in a diversifying strategy as the company was venturing into a completely unrelated business. Yet others opined that “since the transactions are among related parties, it is important to demonstrate as to how the acquisition would benefit the shareholders of the company and enhance their value” and that there should be “complete justification” regarding the valuation methodology adopted, which “should be communicated to all the concerned stakeholders.”

The independent directors cannot be criticized for failing to identify the issues or to raising their concerns at the board meeting, for that is precisely what they did. Surprisingly, however, the final outcome of the meeting was a “unanimous” resolution of the board to proceed with the Maytas transaction, without any dissent whatsoever. As required by the listing agreement, Satyam notified the stock exchanges about the board approval immediately following the board meeting. This information was not at all accepted kindly by the investors. The stock price of Satyam’s American Depositary Receipts collapsed during a single trading session by over 50 percent due to massive selling, and the company was compelled to withdraw the Maytas proposal within eight hours of its announcement.

This episode gives rise to a number of questions regarding the role of

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277. As a technical matter, however, this board meeting was chaired by Rao (an independent director) rather than the Chairman, Raju, as the latter was interested in the Maytas transactions. Satyam Board Minutes, supra note 272, at 1.

278. Id. at 4. Her suggestions were for “the management to take Board’s guidance at appropriate stages for all acquisitions.”

279. Id.

280. Id. at 5.

281. Id. at 7.

282. Id. at 8-10.

283. Id. at 8. The announcements to the stock markets were made after the close of trading hours in India, but before the commencement of trading on the NYSE (resulting in some disparity in information between the markets due to the time difference between India and the U.S.).

284. Somasekhar Sundaresan, Year of All-Pervasive Poor Governance, BUSINESS STANDARD (India), Dec. 29, 2008; S. Nagesh Kumar, Independent Directors Put Tough Questions. But Gave Blank Cheque, THE HINDU (India), Jan. 14, 2009 (noting that the drastic collapse of Satyam’s stock price following the board meeting signalled “the start of Satyam’s downhill journey”).
the independent directors. If the transactions were riddled with issues, why were they approved “unanimously” by the independent directors even though they voiced their concerns quite forcefully? Why were the interests of the minority public (institutional and individual) shareholders not borne in mind by the independent directors when the transaction involved a blatant transfer of funds from the company (which was owned more than 90 percent by public shareholders) to the individual promoters that is tantamount to siphoning of funds of a company by its controlling shareholders to the detriment of all other stakeholders? Why were the independent directors unable to judge the drastic loss in value to the shareholders by virtue of the transactions and stop them or even defer the decision to a further date by seeking more information on the transactions? How was it the case that the investors directly blocked the transaction when the independent directors were themselves unable to do so? These questions do not bear easy answers, but it is clear from this episode that shareholder activism (exhibited through the “Wall Street walk”) performed a more significant role in decrying a poor management decision than independent directors. If independent directors are to be the guardians of minority shareholders’ interests, Satyam’s directors arguably failed in their endeavors.

In the ensuing furor that this episode generated, four of the non-executive directors resigned from Satyam’s board. However, most independent directors defended themselves stating that they had raised their objections to the Maytas transactions as independent directors should. While the markets were still recovering from the purported corporate governance failures at Satyam, evidence of a bigger scandal emerged during the first week of 2009 raising further questions about the role of independent directors.

c. Fraud in financial statements

On January 7, 2009, the Chairman of the company, Mr. Ramalinga Raju, confessed to having falsified the financial statements of the company, including by showing fictitious cash assets of over US$1 billion on its books. The confession also revealed that the proposed Maytas buy-outs

285. The directors who resigned are Dr. Mangalam Srinivasan, Prof. Krishna Palepu, Mr. Vinod Dham and Prof. Ramnohan Rao. Corporate Lawyers, CAs Hit Out at Satyam’s Independent Directors for Quitting, THE MINT (India), Dec. 30, 2008; Sundaresan, supra note 284.
286. Satyam’s Independent Directors Had Raised Concerns Over the Deal, BUSINESS LINE (India), Dec. 19, 2008.
287. Letter from B. Ramalinga Raju, Chairman, Satyam Computer Services Ltd., to the Board of Directors, Satyam Computer Services Ltd. (Jan. 7, 2009), available at http://www.hindu.com/nic/satyam-chairman-statement.pdf [hereinafter Chairman’s Confession]. In his confession addressed to Satyam’s board, Raju wrote:

It is with deep regret, and tremendous burden that I am carrying on my conscience, that
were just illusory transactions intended to manipulate the balance sheet of Satyam and to wipe out inconsistencies therein. The stock price of the company reacted adversely to this information and fell more than 70 percent thereby wiping out the wealth of its shareholders, some of whom are employees with stock options. Minority shareholders were significantly affected as they were unaware of the veracity (or otherwise) of the financial statements of Satyam, and hence this exacerbated the majority-minority agency problem.

This episode invoked fervent reaction from the Indian government. Several regulatory authorities such as the Ministry of Company Affairs, Government of India and SEBI initiated investigations into the matter.

would like to bring the following factors to your notice:

1. The Balance Sheet carries as of September 30, 2008
   A. Inflated (non-existent) cash and bank balances of Rs. 50.40 billion (as against Rs. 53.61 billion reflected in the books)
   B. An accrued interest of Rs. 3.76 billion which is non-existent
   C. An understated liability of Rs. 12.30 billion on account of funds arranged by me
   D. An over stated debtors position of Rs. 4.90 billion (as against Rs. 26.51 billion reflected in the books)

2. For the September quarter (Q2) we reported a revenue of Rs. 27 billion and an operating margin of Rs. 6.49 billion (24% of revenues) as against the actual revenues of Rs. 21.12 billion and an actual operating margin of Rs. 610 million (3% of revenues). This has resulted in artificial cash and bank balances going up by Rs. 5.88 billion in Q2 alone. The gap in the Balance Sheet has arisen purely on account of inflated profits over a period of last several years... What started as a marginal gap between actual operating profit and the one reflected in the books continued to grow over the years. It has attained unmanageable proportions as the size of the company operations grew significantly...

Id.

288. Id. Raju’s letter further goes on to state:
   The aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with real ones. Maytas’ investors were convinced that this is a good investment opportunity and a strategic fit. Once Satyam’s problem was solved, it was hoped that Maytas’ payments can be delayed. But that was not to be. What followed in the last several days is common knowledge”

Id.


291. The magnitude of the financial loss caused to unwitting minority shareholders is unimaginable. As one column notes:
   Shareholders have lost Rs. 136 billion in Satyam shares in less than a month. The market capitalisation fell to Rs. 16.07 billion on January 9, 2008, from Rs. 152.62 billion at the end of trade on December 16, 2008, the day when Satyam had announced the Rs. 80 billion acquisition deal of two firms promoted by the kin of the IT firm’s former chairman Ramalinga Raju.


292. Souvik Sanyal, Government Refers Satyam Case to Serious Frauds Investigation Office,
While several independent directors of the company had resigned, the remaining directors were substituted with persons nominated by the Government. Certain key officers of Satyam, being the chairman, the managing director and the chief financial officer were arrested by the police within a few days following the confession, while two partners of PriceWaterhouseCoopers, Satyam’s auditor, were arrested thereafter. The investigations by the various authorities, which are likely to be time-consuming, are ongoing and it is expected that their outcome will be available only in due course. The only significant investigation that has been completed is that of the Ministry of Company Affairs conducted through the Serious Frauds (Investigation) Office. At a broader level, the Satyam episode has triggered renewed calls for corporate governance reforms in India, and some of the reforms are already underway.

As for the company itself, it witnessed a remarkable turnaround of fortunes under the leadership of its new government-nominated board of directors. The new board and their advisors took charge of the affairs of

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293. Oomen A. Ninan, Satyam Episode: SEBI Enquiries Will Focus on Three Areas, HINDU BUSINESS LINE (India), Jan. 16, 2009.
294. See supra note 285 and accompanying text.
296. Satyam’s Raju Brothers Arrested by AP Police, ECONOMIC TIMES (India), Jan. 9, 2009; Satyam Fraud: Raju Sent to Central Prison; CFO Vadlamani Arrested, ECONOMIC TIMES (India), Jan. 10, 2009.
299. Some of the immediate developments towards:
   (i) Within days of the Satyam episode coming to light, the CII set up a special task force on corporate governance to examine issues arising out of the Satyam episode and to make suitable recommendations. CII Sets Up Task Force on Corporate Governance, BUSINESS STANDARD (India), Jan. 12, 2009.
   (ii) The National Association of Software and Services Companies (NASSCOM), the premier trade body representing the Indian IT-BPO industry announced that it will be forming a Corporate Governance and Ethics Committee to be chaired by Mr. N. R. Narayana Murthy, Chairman and Chief Mentor, Infosys Technologies Ltd. This signifies NASSCOM’s efforts to strengthen corporate governance practices in the Indian IT-BPO industry. NASSCOM Announces Formation of Corporate Governance and Ethics Committee, BUSINESS STANDARD (India), Feb. 11, 2009.
   (iii) The Minister for Corporate Affairs, Government of India announced that the Ministry will consider changes to the Companies Bill, 2008 (that is pending in Parliament) in the light of events surrounding Satyam. Satyam Scam: Provisions of New Companies Bill to be Reviewed, HINDU BUSINESS LINE (India), Jan. 8, 2009.
300. These reforms are discussed in Part V.C below.
301. A six-member board was appointed pursuant to orders passed by the Company Law Board. The board (as of May 18, 2009) consisted of industrialists, representative of business associations, professional bodies and a former government officer. They were: Deepak Parekh, Kiran Karnik, C. Achutan, Tarun Das, T.N. Manoharan and S.B. Mainak. Satyam.com, http://www.satyam.com/about/board_members.asp.
the company, appointed a new chief executive, and undertook tireless efforts to retain clients and employees. Finally, the company itself was sold through a global bidding process to Tech Mahindra, another Indian IT player in a transaction that received uniform adulation for the alacrity with which the various players (particularly the new board of Satyam) acted to resuscitate the company and protect the interests of its stakeholders.

d. Lessons from Satyam

It is necessary to examine to how misstatements in Satyam's financials were made possible in the first place despite the applicability not only of Clause 49 (as Satyam was listed on Indian stock exchanges), but also of the Sarbanes-Oxley Act (as the company was also listed on the NYSE). Satyam had seemingly complied with all the onerous requirements imposed by Clause 49 and the Sarbanes-Oxley Act, such as the appointment of an impressive array of independent directors, an audit committee, and the audit of its financial statements by a "Big Four" audit firm, but these corporate governance failures nevertheless occurred. This episode raises serious questions about implementation of corporate governance norms in India, and points towards the lack of success of transplanted concepts.

More specifically, several key questions arise with reference to the role of independent directors in such situations. Satyam's independent directors were unable to prevent the falsification of financial statements.


303. See Pratip Kar, Enron? Parmalat? Lehman? No, no, it’s Satyam, BUSINESS STANDARD (India), Jan. 9, 2009; Salil Tripathi, India Faces an ‘Enron Moment’, WALL ST. J., Jan. 9, 2009. An additional question that has baffled observers pertains to how Satyam was able to circumvent the onerous provisions of the Sarbanes-Oxley Act that were applicable to it by virtue of its cross-listing on NYSE. For an explanation regarding specific characteristics that arise out of cross-listings, see Amir N. Licht, Cross-Listing and Corporate Governance: Bonding or Avoiding?, 4 CHI. J. INT’L L. 141, 142 (2003). He refers to the cross-listing feature of companies as the “bonding thesis” and notes that “cross-listing on a foreign stock market can serve as a bonding mechanism for corporate insiders to commit credibly to a better governance regime.” However, there are some challenges to the bonding thesis as its role has been greatly overstated. He adds:

A large body of evidence, using various research methodologies, indicates that the bonding theory is unfounded. Indeed, the evidence supports an alternative theory, which may be called “the avoiding hypothesis.” To the extent that corporate governance issues play a role in the cross-listing decision, it is a negative role. The dominant factors in the choice of cross-listing destination markets are access to cheaper finance and enhancing issuer visibility. Corporate governance is a second-order consideration whose effect is either to deter issuers from accessing better-regulated markets or to induce securities regulators to allow foreign issuers to avoid some of the more exacting domestic regulations. Overall, the global picture of cross-listing patterns is best described as a model of informational distance, which comprises elements of geographical and cultural distance.”

Id.
Various reasons can be attributed to this failure. No doubt, the Satyam board was largely independent and also comprised distinguished and reputable individuals. But, independent directors cannot generally be expected to uncover frauds in companies as the decisions they make are generally based on information provided to them by management.\textsuperscript{304} Even in Satyam’s own case, the Chairman’s Confession itself concedes that “[n]one of the board members, past or present, had any knowledge of the situation in which the company is placed.”\textsuperscript{305} Since independent directors do not get involved in the day-to-day management of the company, it is virtually impossible for them to unearth such frauds.\textsuperscript{306} Hence, even when monitoring functions are imposed on independent boards, it is impractical to expect independent directors to exercise watchdog functions as their role is necessarily limited. In addition, independent directors are busy individuals who spend little time each year tending to matters pertaining to each company on whose boards they serve. This also limits their ability to delve deeper into financial, business and other matters involving the companies.

At a structural level, as discussed earlier, independent directors are subject to nomination, appointment and removal, all at the hands of the controlling shareholders,\textsuperscript{307} and hence may be subject to influence by the controlling shareholders.\textsuperscript{308} Although Satyam was subject to the listing requirements of NYSE,\textsuperscript{309} it did not have an independent nomination committee\textsuperscript{310} that could have potentially brought the appointment of directors outside the purview of the controlling shareholders. In the present

\textsuperscript{304} The management or controlling shareholders control the “amount, quality and structure” of information that is provided to the board, and this “kind of power over information flow is virtually equivalent to power over decision.” EISENBERG, supra note 72, at 144, 172. Added to that is the complexity of the information based on which directors are required to decide. Often, directors’ roles are “predicated on a detailed knowledge of a company and its business.” JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA’S CORPORATE BOARDS 57 (1989).

\textsuperscript{305} Chairman’s Confession, supra note 287.

\textsuperscript{306} It has been noted that “by their nature, the directors on the board largely rely on information from the management and auditors, with their capacity to independently verify financial information being quite limited . . . .” D. Murali, Truly Independent Director, A Rarity, HINDU BUSINESS LINE (India), Jan. 22, 2009.

\textsuperscript{307} See supra Part IV.B.3 and supra Part V.A.3.

\textsuperscript{308} To be sure, this is not to suggest any malfeasance on the part of Satyam’s independent directors. The independent directors may act well-intentioned and bona fide, but due to the operation of several constraints on time, information, as well as on business, financial and legal expertise, they may not be in a position to challenge management or controlling shareholders when required. An observation made several years ago by a leading commentator on board behavior continues to be apt today: “‘Professional courtesy’ and ‘corporate manners’ were phrases used to explain the lack of challenging questions.” MYLES L. MACE, DIRECTORS: MYTH AND REALITY 54 (1971).

\textsuperscript{309} Satyam’s ADRs are listed on the NYSE, symbol: SAY. New York Stock Exchange, http://www.nyse.com/about/listed/say.html.

\textsuperscript{310} Satyam did not constitute a nomination committee even though one is mandated by the corporate governance requirements of the NYSE. Satyam Form 20-F, supra note 269, at 70. See also NYSE Manual, supra note 3, § 303A.04 (2003).
case, it is evident that the independent directors were not willing to fiercely oppose the proposals of the management and promoters, as they may have implicitly owed allegiance to the promoters of the company who were in a position to influence their appointment and continuance on the board.\textsuperscript{311}

Independent directors are said to be in a position to exchange their views more frankly if they meet separately from the management (or the controlling shareholders). This would ensure that they are not inhibited by the presence of the management or their possible reaction to the views of the independent directors. This would help independent directors take a more unbiased position. However, Indian corporate governance norms do not require such executive sessions without the presence of management, and hence independent directors’ views tend to be equivocal even when they are not convinced of the merits of any proposals that are before them for consideration. The Satyam episode presents evidence of this difficulty.

Furthermore, Indian corporate governance norms do not specify the roles of independent directors. Such lack of clarity in their roles could result in less desirable outcomes from independent director action as we have witnessed in Satyam’s case. More importantly, there is no special role for independent directors in related party transactions with the controlling shareholders. For instance, if there is a requirement that all such related party transactions are to be approved by a vote of independent directors only, then such office bearers are likely to take on greater responsibility for their decisions.\textsuperscript{312} Again, there is no such specific role envisaged for independent directors in the Indian corporate governance norms.

Lastly, the Satyam episode is also symptomatic of a signaling problem with the role of independent directors. That is, the corporate governance norms bestow too much (and somewhat misplaced) importance on the role of independent directors than is justified. 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.\textsuperscript{313} However, as the Satyam episode has demonstrated, the independent directors are constrained in the

\textsuperscript{311} As one observer quite directly notes:
If the board is in awe of the family executive, it makes it difficult for the board sometimes to ask tough questions or at other times the right questions at the right time in order to serve the interests of the shareholders better. As a result truly independent directors are rarely found in India companies. D. Murali, supra note 306. In the Satyam case, although the independent directors did ask pointed questions, they seemed willing to accept answers which may not have been altogether convincing (because the investors voted thumbs down as they did not seem convinced with the proposals).

\textsuperscript{312} For such provisions in the laws of Delaware, see supra Part III.B.3.a and accompanying text.

\textsuperscript{313} It has been observed that an "independent director is a myth in India." Virendra Varma & Rachna Monga, Cry Freedom! Investor Activism More Than Independent Directors Can Keep Managements in Check, BUSINESS TODAY (India), Jan. 25, 2009.
extent to which they can be effective in unearthing frauds, even when they exercise a fair amount of diligence in their action.

There also exists the larger issue of promoter control in Indian companies that affects the functioning of independent directors. Promoters (who are controlling shareholders) exercise significant influence on matters involving their companies, even though such companies are listed on stock exchanges and hence have public shareholders. Indian law confers some distinct roles for promoters. This largely holds good even for companies that have controlling shareholders with small percentage holdings in companies. For instance, the Raju family who were the promoters of Satyam held only about 5 percent shares around the time when the Chairman’s confession was made on January 7, 2009. A company with a 5 percent promoter shareholding will usually be considered as belonging to the outsider model in terms of diffused shareholding, and hence requiring the correction of agency problems between shareholders and managers. However, the gradual decrease in controlling shareholders’ percentage holdings coupled with the concept of “promoter” under Indian regulations makes the distinction between an insider-type company and outsider-type company somewhat hazy in the Indian context. The Raju family, as promoters, continued to wield significant powers in the management of the company despite a drastic drop in their shareholdings over the last few years. This was aided by the diffused nature of the remaining shareholding within the company. The Satyam episode illustrates that a company with

314. The importance of the position originates in the context of public offerings of securities, where the role of key persons involved in control of the company is material information that is to be disclosed to investors to enable them to take an informed investment decision. Apart from that, promoters are required to hold minimum number of shares in the company at the time of listing (also known as minimum promoter contribution) and they are subject to lock-in on their shares. It has been argued that “[a]ny requirement that statutorily forces a promoter to bring in specific investment amounts or maintain specific shareholding would necessarily perpetrate the unfortunate reality of keeping our listed companies in the hands of the promoters.” Somasekhar Sundaresan, SEBI Should Phase Out ‘Promoter’ Concept, BUSINESS STANDARD (India), Oct. 8, 2007. This would arguably inhibit any transition from controlling shareholding in companies (i.e., the insider system) to diffused shareholding (i.e., the outsider system) so as to engender board-driven professionally managed companies. Id.


316. Although institutional shareholders (particularly foreign institutional investors) are beginning to hold significant numbers of shares in Indian listed companies, they have refrained from exercising significant influence over corporate decisionmaking. Collective action problems continue to operate and, over a period of time, “the culture of institutional shareholders always blindly voting with the promoter was established.” Ajay Shah, Getting the Right Architecture for Corporate Governance, FINANCIAL EXPRESS (India), Jan. 13, 2009.

In the U.S., hedge funds and other institutional shareholders effectively monitor and sometimes agitate against inefficient boards and management and also help shape general corporate governance norms. Geis, supra note 36. They are ably aided by proxy consultants such as RiskMetrics to build coalitions of institutional investors to adopt an “activist” role in companies. Id. The absence of these checks and balances in the Indian context confers unhindered powers to controlling shareholders or promoters (including those with limited shareholding percentages) to wield significant influence over corporate decisionmaking. Id. The “transplantation” of investor activism from developed markets such
minimal promoter shareholding could still be subject to considerable influence by the promoters, thereby requiring a resolution of the agency problems between controlling shareholders and minority shareholders even at those shareholding levels. The transition of companies from the insider model to the outsider model through constant dilution of shareholding by controlling shareholders can be difficult, as Satyam demonstrates. Corporate governance regimes in emerging markets such as India which are likely to witness such transition from insider to outsider regimes through dilution of controlling shareholding need to provide mechanisms to tackle undue control by promoters with limited shareholding.

The Satyam case clearly demonstrates the inability of the existing corporate governance norms in India to deal with corporate governance failures in family-controlled companies, even where the level of promoter shareholding is relatively low. Reforms to the independent director regime that spring from this case ought to take into account the vulnerability of minority shareholders in such companies that lie at the cusp of insider and outsider systems.

3. Legal Liability

If the Satyam episode exhibits the lack of appropriate institutions and incentives that enable independent directors to act effectively, certain other recent cases demonstrate the operation of several disincentives that impede otherwise competent individuals from taking up independent director position. The case of Nagarjuna Finance is symptomatic of potential criminal liability that could be foisted upon independent directors.

Nagarjuna Finance, located in Hyderabad, State of Andhra Pradesh, is a non-banking financial company that had raised deposits worth Rs. 938 as the U.S. and yet to find an entrenched position in the Indian corporate milieu, although signs of activist investors in India are slowing beginning to emerge. This tepid involvement of investors in corporate governance of Indian companies has also been a subject matter of empirical studies.

Observers believe that companies with controlling shareholders holding limited stakes can be particularly vulnerable to corporate governance failures. As Ajay Shah, a noted Indian economist states: "The incentive for theft [in such cases] is the greatest: there is a great temptation for a CEO who owns 8% of a company to make a grab for 100% of the cashflow." Shah, supra note 316. Further, promoters who are in the twilight zone of control, i.e., where they hold shares less than that required to comfortably exercise control over the company, have perverse incentives to keep the corporate performance and stock price of the company at high levels so as to thwart any attempted takeover of the company. The following statement by Ramalinga Raju is emblematic of how this incentive operates: "As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten." Chairman’s Confession, supra note 287.

There is an argument that if there is to be a smooth transition towards an outsider regime and "[i]f SEBI truly desires the Indian market to have board-driven professionally-managed companies, it should begin by considering a roadmap to do away with the 'promoter' concept over time." Sundaresan, supra note 314. See also Brian Cheffins, Current Trends in Corporate Governance: Going from London to Milan to Toronto, 10 DUKE J. COMP. & INT’L L. 5, 7 (2000).
million from the public (about 85,000 depositors) during the years 1997 and 1998.\(^{319}\) During the period when the deposits were raised, the company’s board included prominent individuals such as Nimesh Kampani, one of India’s leading investment bankers, Minoo Shroff, a former industrialist, A.P. Kurien, a prominent finance professional and L.V.V. lyer, a corporate lawyer. As they were independent directors, they were not involved in the day-to-day management of the company. Reports indicate that at the time the deposits were obtained, the company had an unblemished track record of repaying its deposits.\(^{320}\) This continued until 2000.\(^{321}\) In the meanwhile, the independent directors ceased to hold office in the company.\(^{322}\) Subsequently, from the year 2000, the company began defaulting on its deposits, and a large number of depositors suffered severe financial loss on that count.

In terms of Section 5 of the Andhra Pradesh Protection of Depositors of Financial Establishments Act, 1999, which is a state legislation and not a central or federal legislation, it is a criminal offence if the company is unable to repay its depositors, due to which “every person responsible for the management of the affairs of the financial establishment including the promoter, manager or member of the financial establishment shall be punished with up to 10 years’ imprisonment and with up to Rs. 100,000 fine.”\(^{323}\) Based on this provision, the Andhra Pradesh state police issued arrest warrants against a number of persons involved with Nagarjuna Finance, including those who were independent directors of the company when it raised deposits.\(^{324}\) It did not matter that these persons ceased to be independent directors by the time the deposits became matured for repayment, i.e., when the default in fact occurred. Fearing persecution by the police, at least two independent directors, Kampani and Shroff remained in Dubai and London respectively for several months.\(^{325}\)

The recent events involving Satyam and Nagarjuna have resulted in a mass exodus of independent directors from Indian corporate boards. In Satyam’s case, there has been no liability (either civil or criminal) yet imposed on the independent directors. However, Satyam’s directors suffered a grave loss of reputation as all of them were individuals of great standing. In Nagarjuna’s case, it is more than just reputation, i.e., the actual fear of arrest. Due to the alarming effect of these instances, more

\(^{319} \) The Common-Sense View: The Supreme Court’s Decision Not to Grant Anticipatory Bail, BUSINESS STANDARD (India), May 11, 2009.


\(^{321} \) Id.

\(^{322} \) Id.

\(^{323} \) Id.

\(^{324} \) Professionals Turn Fall Guys of Boards, FINANCIAL EXPRESS (India), Jan. 5, 2009.

\(^{325} \) Sucheta Dalal, Scared Speechless, MONEY LIFE (India), Apr. 9, 2009. In October 2009, Kampani received relief from the Andhra Pradesh High Court which stayed charges against him. C.R. Sukumar, Kampani Gets Relief from Andhra Court, THE MINT (India), Oct. 15, 2009.
than 500 independent directors resigned from companies listed on the Bombay Stock Exchanges during the first three months of 2009 itself.\(^\text{326}\)

This adds to the issues pertaining to the availability of competent individuals to act as independent directors on Indian companies.

Finally, even where indemnification provisions and D&O insurance policies are available to directors to protect themselves against liability, there is no past track-record in India as to how such claims have been handled. In the recent instance involving Satyam, although the company is said to have taken a D&O policy cover in the range of US$75 million to US$100 million,\(^\text{327}\) the insurance company has disputed the claims of the independent directors in connection with expenses incurred by them in defending various actions, including class actions filed in the U.S. courts.\(^\text{328}\)

Although it is somewhat premature to conclude on the outcome of the claim, existing evidence does not point to the effectiveness of protective provisions such as indemnity and D&O policies in favour of independent directors in India yet.

**C. EVALUATING RECENT REFORMS**

Before concluding this Part, it is appropriate to consider the round of regulatory reforms to corporate governance norms that have been propelled by the recent events. Although there was great anticipation of radical reforms immediately following the Satyam and Nagarjuna episodes, the Government chose to adopt a more careful approach by avoiding any knee-jerk reactions. There was some level of consternation when no firm announcements were forthcoming on regulatory policy in the months that followed these events. Moreover, the Companies Bill, 2009 was presented in Parliament on August 3, 2009, in the same form as contained in its previous version presented in 2008 before the occurrence of these episodes.\(^\text{329}\)

However, during late 2009, a series of policy reforms were announced, which I shall now consider briefly.

In November 2009, the Task Force constituted by CII\(^\text{330}\) made recommendations to modify corporate governance norms in India.\(^\text{331}\)

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\(^{326}\) Abha Bakaya, *Independent Directors on Quitting Spree*, *ECONOMIC TIMES* (India), Apr. 20, 2009; Ranju Sarkar, *Why Independent Directors are Quitting in Drones*, *BUSINESS STANDARD* (India), May 14, 2009; Candice Mak, *Corporate Structures are Frightening Independent Directors*, *ASIA LAW*, Apr. 9, 2009.


\(^{328}\) *Tata AIG Disputes Satyam’s D&O Claim*, *ECONOMIC TIMES* (India), June 10, 2009.


\(^{330}\) See supra note 299.

Pending formal legal changes, the Task Force also called upon companies in India to voluntarily adopt the revised regime. Shortly thereafter, the Institute of Company Secretaries of India ("ICSI") too provided its own set of recommendations for altering corporate governance regulations. Based on these and other proposals received, the Ministry of Corporate Affairs, Government of India has published the Corporate Governance Voluntary Guidelines, 2009 which provide a set of best practices for public companies to follow. Rather than impose mandatory requirements, such as by adding to Clause 49, the Government has chosen to adopt the "comply-or-explain" regime on this occasion.

From a substantive standpoint, the Voluntary Guidelines do address some of the concerns that recently emerged. First, the appointment of independent directors is provided a greater element of formality. The company is required to execute a letter of appointment with the independent director that captures various details such as the term of appointment, duties of the director, remuneration, D&O insurance and list of prohibitions against directors. Second, there is recognition of discrepancies in the nomination and appointment of independent directors due to the influence of controlling shareholders. Companies are to have a nomination committee comprising a majority of independent directors. Some guidance is also provided regarding the process of nomination.

Third, specific positive attributes have been prescribed for independent directors. These include "integrity, experience and expertise, foresight, managerial qualities and ability to read and understand financial statements." Fourth, a maximum tenure of six years is fixed for an independent director. Fifth, in order to ensure time and attention of the independent directors, a cap has been imposed on the number of

NareshChandra_CII.pdf.


334. This is contrary to the approach adopted in 2000, following the Birla Report, where it was felt that corporate governance norms should be made mandatory. See supra note 154.

335. Voluntary Guidelines, supra note 333, ¶ I.A.1. Such a formal letter of appointment is also required to be included as part of disclosures to shareholders. Id.

336. Id., ¶ I.A.3 (providing that nomination should be "based on an objective and transparent set of guidelines which should be disclosed").

337. Id., ¶ I.B.1. Independent directors are also required to provide a certificate of independence. All of this signifies progress from the position under Clause 49 wherein "independence" is defined with reference to a set of negative factors. For further discussion, see supra notes 176-80 and accompanying text.

338. Id.

Sixth, the Voluntary Guidelines also lay down some basic principles for remunerating independent directors. They are required to be paid sitting fees depending upon the “twin criteria of net worth and turnover of companies.” Finally, several suggestions have been made to enhance the quality of decision-making on boards, particularly by independent directors. These include training of directors, provision of information in a timely manner, access to company management for information, and a formal and rigorous evaluation of directors.

However, such an approach arguably fails to evoke a great sense of optimism. As we have seen earlier, a large number of companies have failed to comply with even the formal requirements of corporate governance that are prescribed under the Listing Agreement with fairly significant consequences in law. It is not clear, therefore, whether compliance with such voluntary guidelines is bound to be met with much success. Moreover, as they signify government actions in the aftermath of a corporate governance crisis, the Voluntary Guidelines amount to mere rhetoric in certain areas. To take one example, requirements such as training of directors and board evaluations were already non-mandatory recommendations in Clause 49 of the listing agreement. By including them again in another exercise that only exhorts companies to voluntarily adopt these practices, no real purpose appears to be served. In all, while the current reforms do highlight the importance of these measures to address existing inadequacies, there exists considerable agnosticism about their ability to bring about significant changes in practice. That can be empirically verified only in due course after implementation of the Voluntary Guidelines.

Previous parts of this Article laid down the hypothesis that the functioning of independent directors in India would be different from that in the outsider economies of the U.S. and the U.K. from where they were transplanted. Further, the preceding part identified shortcomings in the legal provisions that dictate the roles and other aspects pertaining to independent directors. In this Part, these shortcomings were verified

340. Id., ¶ 1.A.4. For reckoning the number of directorships, two types of companies are included: (i) public limited companies; and (ii) private companies that are either holding or subsidiary companies of public companies.
341. Id., ¶ 1.C.1.4.
342. Id., ¶ 1.B.1.
343. Id., ¶ 1.B.2.
344. Id., ¶ 1.B.3
345. Id., ¶ 1.D.
346. See supra Part V.B.1.
347. That is not to suggest that there would be large-scale non-compliance. Several reputable blue-chip companies would follow these voluntary guidelines, and some of them may have already set up the required mechanisms even prior to the regulatory exhortation. But, based on current evidence, such voluntary compliance is likely to be limited to a few of the large companies.
empirically, in terms of quantitative measures (to a limited extent), but more by way of qualitative assessments of board practices as well as through case studies. This exercise establishes through available evidence that the institution of independent directors that was devised in the outsider economies to resolve the manager-shareholder agency problem may not be effective in that very form in the insider economies such as India (to which it was transplanted) in order to resolve the majority-minority agency problem that is predominant in these economies.

VI. FUTURE PROSPECTS FOR INDEPENDENT DIRECTORS IN INDIA

In this Part, I approach the question from a normative standpoint. What does the future hold for independent directors in India? Is it time to consider jettisoning the concept altogether in that country? Alternatively, is there merit in retaining the concept and, if so, what are the changes required to be introduced to embolden independent directors in India such that they are able to perform the monitoring role and protect the interests of minority shareholders, the basic constituency that requires the independent directors' allegiance? This Part seeks to address these questions.

Here, I confine myself to a discussion of reforms required to some of the key legal considerations that emerge from the analysis in the previous Part. For example, it has been found that issues relating to the nomination and appointment of independent directors and their exact role and constituencies they are required to protect are matters of grave doubt in the insider systems such as India. Hence, this Part seeks to provide some options for future reforms on these fronts. On the other hand, there are also several practical issues relating to independent directors: their competence levels, availability of adequate information, ability to commit adequate time for the job and other matters pertaining to their performance of the role in practice. Many of these issues are common both in the outsider systems as well as insider systems like India. Hence, I do not propose to delve into details regarding some of these practical issues from a normative standpoint, but only to list them with some basic discussion so as to constitute an exhaustive guidance of factors to be taken into account by regulators in India while reforming their independent director norms.

A. REVISITING THE CONCEPT

If the independent director concept in India is mired in conceptual and practical problems, the obvious question that arises is whether the concept adds any value at all and hence whether it should be done away with altogether. Of course, independent directors may add value to companies from an advisory standpoint, but that can be a matter left to determination
by parties voluntarily. For instance, if companies wish to bring experts on to their boards, they could do so without the existence of any law that mandates the same. It is only the monitoring aspect that requires regulatory oversight or mandate by law, and if that aspect is not being fulfilled by independent directors, it may be argued that there is no merit in retaining independent directors as a mandatory requirement by law. At one level, it may seem outrageous to approach the issue from such an angle, but it might be worthwhile to ask that question anyway, considering that the present study seeks to strike at fundamental issues pertaining to the role of independent directors in India.

At the same time, the analysis in this Article does not support a radical proposal such as elimination of independent directors altogether in India. These questions have arisen previously in the outsider systems as well, where also there has been no empirical evidence of success of the concept, but scholars have repeatedly avoided the path of calling for extinction of independent directors. For example, it has been observed that "it is hard to oppose more independent directors;"\textsuperscript{348} even more, "[t]o oppose the institution of the independent director almost amounts to heresy;"\textsuperscript{349} and "[a]ny jurisdiction that does not stipulate the need for independent directors may find itself unable to attract capital to its securities markets."\textsuperscript{350} The outcome of the present research is to advocate a similar position.

Merely because the concept has not been fully effective, it is not prudent to follow the radical approach of doing away with independent directors.\textsuperscript{351} Independent directors do bring significant value to corporate governance not only in their advisory role, but also in their monitoring role. If the requirement of mandating independent directors is done away with, that would mean a loss of even the currently available (albeit minimal) monitoring efforts on corporate boards in insider systems. Hence, what is required is revamping of the structure of the institution and the support systems available to independent directors to carry on their role more effectively.

However, it is equally important not to be over-optimistic about independent directors even within a reinforced set up. For reasons that have perhaps been belabored at length earlier in this Article, it is not possible for independent directors to perform any wondrous role that ensures complete protection to minority shareholders, for example by


\textsuperscript{349} Rodrigues, \textit{supra} note 85, at 457.


\textsuperscript{351} Commentators have noted that since it is a "universally acclaimed regulation" [sic], it ought to be retained, and that any other approach would question its introduction in the first place as a misjudged policy choice in these countries. Prithvi Haldea, \textit{The Naked Truth About Independent Directors} (2009), http://www.directorsdatabase.com/IDs_Myth_PH.pdf.
preventing frauds in companies on whose boards they sit. That simply cannot be expected. Hence, it is incumbent upon the governments and regulatory authorities in insider systems, and particularly emerging economies such as India, to first comprehend the extent of utility of independent directors and to devise a corporate governance regime with that in mind, so that any over-optimism bias is eliminated. Similarly, the regulatory authorities must moderate the expectation of the corporate players in order to ensure that there is no over-reliance on independent directors and that they are not seen as a solution to all corporate governance ills that plague those economies. In other words, it is important that the perceptional constraints that currently operate in India are carefully addressed so that corporate actors obtain clarity on the role of the independent directors and the extent to which they can make a difference to corporate governance.

B. ALTERNATE STRUCTURES FOR APPOINTMENT OF INDEPENDENT DIRECTORS

One of the significant weaknesses in the current structure for independent directors in India relates to their nomination and appointments process. Since controlling shareholders (who are to be monitored) have a strong influence on the nomination and election process, the independent director institution fails to have any bite to begin with. As we have seen, independent directors tend to toe the line of the controlling shareholders as the latter category of persons nominates, appoints, remunerations, renews the term and can even remove the independent directors. This process obstructs the efficacy of independent directors in protecting the interests of minority shareholders. In terms of the way forward, one of the key areas for reforms relates to the process of nomination and appointment of independent directors. In this section, I propose to explore several alternate structures for the appointment of directors (other than straightforward election by shareholders) that may diminish the influence of controlling shareholders and thereby instill greater independent in fact in such directors. The details of each structure and a discussion of their advantages and disadvantages precede the recommendations for an optimal structure.

1. Nomination Committee

Nomination committees consisting of independent directors are mandatory in the U.S., as required by the leading stock exchanges, and

352. As one commentator in India has observed: "If almost the entire foundation of corporate governance rests on the shoulders of the independent directors (IDs), it is not beyond debate that the foundation indeed is extremely fragile." Id. (emphasis in original).

353. See supra note 119 and accompanying text. Both the NYSE and the NASDAQ require the
they have also been called for in the U.K. The role of the nomination committee is to consider various candidates for appointment as independent directors and to make recommendations to the full board. There are various methods that nomination committees utilize before they make their choice. These include consideration of candidates identified by external consultants (e.g., recruitment firms), through recommendations from other industry players, and quite often through names put forth by the management itself. In many cases, nomination committees are required to follow strict procedures and maintain utmost transparency in their functioning. It has become almost customary for independent directors to be nominated by nomination committees in outsider systems. However, the requirement of nomination committees has only been recently introduced in India, and that too in a non-mandatory form. It is therefore necessary to consider whether such nomination committees in India, even if followed by a large number of companies, will adequately deal with the problem of controlling shareholder influence in the appointment of independent directors.

As far as outsider systems such as the U.S. and the U.K. are concerned, nomination committees do serve a purpose. Since it is the manager-shareholder agency problem that dominates the corporate governance arena, the nomination committee moves the independent director nomination process outside the purview of the management.

The strands of this approach can be seen in the Cadbury Report. See supra note 135 and accompanying text. The key recommendations of the Cadbury Report have been adopted in the U.K.'s Combined Code for Corporate Governance, which requires the majority of nomination committees to consist of independent directors. Combined Code 2008, supra note 146, \textsection{} A.4.1. There is a similar requirement in other Commonwealth countries. See e.g., in Australia, as recommended by the Bosch Committee. FORD, AUSTIN & RAMSAY, supra note 130, at 16.


For example, one observer notes elaborate mechanisms to be followed by a nomination committee:

The [nomination committee requirement] significantly expands the disclosures relating to the director nomination process. A company is ... also required to: make the nominating committee's charter publicly available, disclose whether the nominating committee members meet ... independence requirements, disclose whether the committee has a policy regarding considering nominees recommended by shareholders, describe the minimum qualifications for nominees recommended by the committee, describe the qualities and skills that the nominating committee believes are necessary or desirable for board members, describe the nominating committee's process for identifying and evaluating candidates and whether fees are paid in connection therewith, disclose who recommended the nominee, and disclose the identity of any candidate nominated by a holder of more than five percent of the voting common stock, regardless of whether the nominating committee chose to nominate that candidate.


See Voluntary Guidelines, supra note 333.
an independent nomination committee picks candidates for independent directorship, it presents the candidate to the shareholders for their vote. Since the shareholders are dispersed in the outsider system and given the existence of collective actions problems, it is conceivable that they would vote for the candidate presented by the independent nomination committee, and they are unlikely to come together to vote against a candidate (unless, of course, there are some extraordinary circumstances). This process effectively keeps the management outside the nomination and election process. 359

However, if this system is replicated in an insider system like India, the outcome is likely to be different by quite a wide margin. Even if an independent nomination committee were to nominate candidates without the influence of the controlling shareholders or management, those candidates would ultimately have to be voted at a shareholders’ meeting, where the controlling shareholders would wield significant influence. While nomination and election are virtually seamless in the outsider systems (due to lack of significant shareholder input), they are two different processes in the insider systems. The nomination committee tackles the first process, but it does not touch upon the second. Controlling shareholders will continue to have the ability to sway the shareholder decision on whether the candidate nominated by the nomination committee should be appointed on not. Hence, nomination committees are compelled to function in the shadow of an ultimate shareholder decision (with controlling shareholder influence). For this reason, nomination committees are unlikely to pick a candidate who does not have the tacit acceptance of a controlling shareholder. It would be an embarrassment after all if the person nominated by the nomination committee fails to muster enough votes at a shareholders’ meeting due to opposition from the controlling shareholders. Implicitly, therefore, independent nomination committees are likely to consult controlling shareholders before putting up names for election.

Such a process is unlikely to effectively deal with the majority-minority agency problem in India as independent director appointments continue to be within the de facto control of the controlling shareholders. Nevertheless, a nomination committee process is superior to the current system of direct elections (without an independent nomination process). A rigorous and transparent nomination process 360 could minimize the

359. It is a different matter that criticisms have been levelled that management continues to play an important role in the manner in which nomination committees select their candidates. For example, quite often, nomination committees tend to rely extensively on candidates that have been identified by management. ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 202 (3rd ed., 2004); ANDERSON & ANTHONY, supra note 355, at 94.

360. For a brief description of such a process, see supra Part VI.B.1.
influence of controlling shareholders.\textsuperscript{361}

The following proposals involve a change in the voting process for election of independent directors and also in the constituencies that elect them.

2. \textit{Minority Shareholder Participation in Independent Director Elections}

Currently, independent directors in India are elected by shareholders through the "straight voting" system, whereby a majority of the shareholders present and voting for a resolution can determine whether or not a candidate for independent directorship is appointed.\textsuperscript{362} It is the straight voting system that confers dominance on controlling shareholders in the appointment of independent directors, as minority shareholders do not have any say at all. My proposal deals with the enhancement of minority shareholder involvement in independent director elections. This would make independent directors accountable to the shareholder body as a whole (including the minority shareholders) as opposed to the sole allegiance to controlling shareholders as currently practiced in India.

Minority shareholder participation can be introduced through two principal methods: (i) cumulative voting by shareholders,\textsuperscript{363} and (ii) election of independent directors by a "majority of the minority."\textsuperscript{364} At this stage, it is imperative to discuss the rationale for minority shareholder involvement in independent director elections before dealing with the details of each of the two options.\textsuperscript{365}

Minority shareholder involvement in director elections as a mandatory matter is almost a rarity. However, historical accounts of cumulative

\textsuperscript{361} When independent nomination committees select candidates in a manner that is transparent to all shareholders (and other stakeholders), controlling shareholders may find it difficult to veto the appointment of such nominee as that would send negative signals about the company and its corporate governance principles to the market, which could also impact the company's stock performance.

\textsuperscript{362} Bhagat and Brickley provide a simple description:

In most corporations board members are elected through "straight voting." In straight voting each shareholder is entitled to cast votes equal to the number of shares held for each director position. If a group controls 51 percent of the vote, it can elect the entire board of directors by casting all of its votes for the candidate that it favors for each position.

Sanjai Bhagat & James A. Brickley, \textit{Cumulative Voting: The Value of Minority Shareholder Voting Rights}, 27 J.L. & ECON. 339, 339 (1984). Note, however, that in straight voting any shareholding above 50 percent, i.e., one vote more than 50 percent, is sufficient to guarantee appointment of all directors. It is not necessary to have "51 percent" as the authors suggest above.

\textsuperscript{363} For an introduction to the concept of cumulative voting, see supra note 188.

\textsuperscript{364} In this method, controlling shareholders will not be permitted to vote for the election of independent directors. The independent directors will be elected by a majority of votes that are cast by all the non-controlling shareholders. Hence the expression "majority of the minority."

\textsuperscript{365} Note, however, that the literature concerning the role of minority shareholders in director elections is largely embedded in the context of cumulative voting rather than "majority of the minority," and hence any reference to cumulative voting in this rationale discussion will apply equally to the "majority of the minority" even though no explicit reference is made to the latter.
voting (including one by Professor Gordon) indicate that it was a prevalent practice in the early part of the 20th century, and was even a mandatory provision for director elections in some states in the U.S. This practice witnessed its demise first in the 1950s and thereafter in the 1980s due to pressure from the managerialist forces. Managers sought to ensure complete prominence in director elections without shareholder influence, thereby perpetuating the manager-shareholder agency problem. The nearly eliminated concept of cumulative voting (as a measure of minority shareholder involvement in director elections) has found its resurrection recently the form of a mandatory requirement in Russia.

Minority shareholder participation in elections of directors in general and independent directors in particular carries with it significant advantages. First, minority shareholders obtain representation on the board of directors, as they are unable to do so in the straight voting process. Second, independent directors elected by minority shareholders will obtain knowledge about various policy decisions that are being discussed on the board. Knowledge itself is a significant advantage, and it is of special significance where public disclosure of company information is not advanced in the relevant jurisdiction. This bears significance to jurisdictions like India where the availability of company information is yet not as wide as it is in the outsider economies. Third, independent directors will be truly independent (of management and controlling shareholders) and hence accountable to the minority shareholders as such directors have been elected by that constituency. Fourth, the minority shareholders’ voice will be heard on the board through independent

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367. Id. at 144. Professor Gordon further notes:

I have looked at salient historical factors operating during the two periods of rapid movement away from mandatory cumulative voting, the 1950s and the 1980s. The evidence suggests that at both times managerialist motives activated the process of legislative change: in the 1950s, managers wanted to reduce the threat of proxy contests which, among other characteristics, seemed to jeopardize senior management tenure; in the 1980s, they wanted to reduce the threat of hostile takeovers by eliminating a particular route to board representation. Id. at 148.

368. Currently, only the company law that was adopted in Russia over a decade ago contains a mandatory provision for cumulative voting for director elections. KRAAKMAN, ET AL., supra note 43, at 55. See also Black & Kraakman, supra note 19.
371. However, it must be noted that SEBI in India has taken significant steps in recent times to improve disclosure of financial and other information by companies by prescribing detailed disclosure norms, both in the primary markets as well as secondary markets.
directors elected by them.\textsuperscript{373} Fifth, independent directors elected by minority shareholders will have incentives to monitor the activities of management and controlling shareholders against transactions that create conflicts of interest.\textsuperscript{374} Finally, there is fairly unequivocal empirical evidence that supports minority shareholder participation in director elections through cumulative voting.\textsuperscript{375}

On the other hand, minority shareholder representation on corporate boards brings with it certain disadvantages. First, minority shareholder representation could impede constructive decision-making on corporate boards as it is likely to create frictions causing disruption in boardroom activity. Second, due to the diversity of interests represented on the board, it is argued that “minority representation schemes expose the firm to an uncompensated risk of making inconsistent or illogical decisions.”\textsuperscript{376} Third, it may be a device for certain minority shareholders to extract rents out of management or controlling shareholders—a kind of blackmail, by which the process can be subjected to abuse.\textsuperscript{377} Fourth, it could provide avenues for competitors to put forth candidates as independent directors so as to obtain information about the company and derive undue competitive advantage.\textsuperscript{378}

Having considered the advantages and disadvantages of minority shareholder representation on corporate boards, I argue that the benefits of this method of director election far outweigh its costs. Of course, minority shareholder representation is likely to denude the collegiality on corporate boards, but that is a small price to pay for the lack of effective monitoring that exists on corporate boards currently in India where independent directors are effectively the nominees of the controlling shareholders. There may be complexities in the decision-making process, but the benefit is effective monitoring that protects all shareholders (including the

\textsuperscript{373} Campbell, supra note 369, at 13. Another commentator observes: 
... while criticism [of management and controlling shareholders] may be painful, it often acts as an oven to refine out impurities or expose weaknesses. A board of directors' meeting should be a place for hard work and clear thinking. It should not be run like a social club where a person with unpopular ideas can be "blackballed" by those who don't like him. A famous statesman is reported to have said: "If you can't stand the heat, get out of the kitchen."


\textsuperscript{374} Gordon, Cumulative Voting, supra note 366, at 170.

\textsuperscript{375} Bhagat & Brickley, supra note 362, at 364 (finding that the inclusion of a provision for cumulative voting rights in charters of companies enhanced share values of such companies); Peter Dodd & Jerold B. Warner, On Corporate Governance: The Impact of Proxy Contests, 11 J. FIN. ECON. 401 (1983) (concluding that cumulative voting tends to benefit shareholders). The empirical studies in this area may be limited, but they are at least consistent.


\textsuperscript{377} Ralph E. Axley, The Case Against Cumulative Voting, 1950 WIS. L. REV. 278, 283. See also Campbell, supra note 369, at 13; Gordon, Cumulative Voting, supra note 366, at 169.

\textsuperscript{378} Axley, supra note 377, at 283.
Objections such as rent-seeking behavior and exposure to competition can also be carefully addressed. Rent-seeking by minority shareholders can be avoided through a careful nomination process of independent directors by an independent nomination committee. Furthermore, as a matter of law, allegiance of independent directors to competition could result in breach of duties by independent directors that could expose them to potential liability under company law. In essence, the perceived disadvantages of minority shareholder representation cannot preclude the introduction of an otherwise beneficial method of independent director election.

On a more theoretical plane, it is interesting to note that the arguments against minority shareholder representation carry greater acceptability in the context of outsider systems and that the concept is more attuned towards an insider system like India. For instance, Professor Gordon notes that the decline of cumulative voting is associated with the movement among U.S. corporate structures from concentrated ownership to diffused ownership. Such a view finds overwhelming support. In the context of the theoretical analysis adopted in this Article, this only boils down to one conclusion. Minority shareholder representation may not be necessary (and may even be undesirable) where there is diffused shareholding, and hence it is not seen as a mechanism for addressing the manager-shareholder

379. See infra Part VI.B.2.c.ii.
380. Gordon, Cumulative Voting, supra note 366, at 169. He states:
In the large public corporation there was no face-off between majority and minority interests; rather, management was the party on the other side. Thus the potential role of cumulative voting changed, from giving a minority a voice in a majority-dominated firm to giving a minority a voice in a management-dominated firm. This led to a significant problem. Management's control, because it rested only on the proxy machinery and on the majority's apathy, seemed at risk in such a confrontation. Because a tenacious minority could do real damage to management's position, management would face the temptation to accede to various rent extraction proposals that a minority might present. In short, in the absence of a majority check on minority power and without adequate monitoring of management by the majority, the minority's power under a cumulative voting regime made the firm vulnerable to hold-up.

Id.
The preceding case histories and comments deal principally with close corporations which usually have an unchanging majority. About the only escape for the minority whose interests are being abused is to be bought out in one way or another. Publicly held corporations are, on the other hand, quite different in many respects. In the first place there is probably a market in which the shares of a minority may be sold. Furthermore there is no fixed majority so that one who is in the majority today may be in the minority tomorrow and vice versa. Because shares are available to anyone on the market, and because of the fluidity of the majority position, and because of the necessity of dealing with many proxies, it is in the publicly held corporation that the results of mandatory cumulative voting can be seen at their worst.

Id. In this context, it is necessary to note that the liquidity in stock markets and the availability of free-float stock (i.e., that which is not held by the controlling shareholders) in insider systems is considerably low making them similar to the kind of close corporation referred to by Sturdy.
agency problem. However, where there is concentrated shareholding, with a long-term controlling shareholder, minority shareholder participation can make all the difference in being able to protect the interests of minority shareholders. Contextually, therefore, minority shareholder participation in director elections (especially of independent directors) is an important tool in the hands of minority shareholders in insider systems, and its benefits significantly exceed its costs in these systems, thereby providing the requisite justification for introduction of such a voting method in these jurisdictions.

In the backdrop of this discussion, it is now necessary to consider some proposals for the specific application of minority shareholder participation in independent director elections in India.

a. Cumulative voting

Cumulative voting will ensure that minority shareholders will have the ability to elect such number of independent directors as is proportionate to their shareholding in the company, thereby reducing the dominance of controlling shareholders in the process. In this structure, each shareholder gets to exercise such number of votes determined as the product of the number of shares held by the shareholder and the number of independent directors to be elected. A shareholder can exercise all votes in favor of a single candidate or can split the votes among different candidates. In case all votes are cast in favor of a single candidate, then that candidate may have a chance of being elected depending on the total number of candidates that are in the fray.

The formula that is used for this purpose is:

$$N = \frac{(x-1)(d+1)}{v}$$

where:

- $N$ = number of directors who can be elected
- $x$ = number of votes exercised by a shareholder
- $d$ = number of independent directors to be elected
- $v$ = total number of votes exercised in the independent director election

The key variables here are the number of votes available to a shareholder (relative to the total shareholding of the company) as well as the number of directors to be elected. Any change in either variable can alter the possibility of minority shareholders effectively being able to influence the

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382. This perhaps explains why cumulative voting was eliminated as a mandatory requirement in the U.S., in addition to manager influence in the policymaking process.
384. Id. (explaining through an illustration that “if a corporation is to elect seven directors and it is estimated that one thousand shares will be voted, a group controlling 126 shares can expect to elect one director (if it cumulates its votes and votes for only one director).”
overall outcome of the election. Therefore, the higher the number of independent directors, the greater the chance that shareholders with smaller stakes will be able to elect independent directors through cumulative voting. The reverse holds good equally. Hence, the concept of cumulative voting works only if the board of the company is large, which therefore needs a larger body of independent directors that is mandatorily stipulated.

The advantage of cumulative voting is that it allows both controlling shareholders as well as minority shareholders to elect independent directors depending on the proportion of their respective shareholding. This creates a suitable mix of persons who are acceptable to controlling shareholders (and management) as well as truly independent directors. In that sense, the interests of all parties (including minority shareholders) are likely to be well-protected. Furthermore, the management and controlling shareholders may also benefit from the guidance and counsel of independent directors that each of them may nominate. Such an election process may create three distinct classes of directors: (i) executive or promoter (non-independent directors), (ii) independent directors elected through votes of controlling shareholders, and (iii) independent directors elected by minority shareholders. This process will create a diverse board representing varying interests, and hence it cannot be claimed that any shareholder interest is left unprotected.

Apart from cumulative voting, the result of proportional representation of minority shareholders can be achieved through the system of single transferable vote. This is provided, for example, as an option for director elections in India. See Indian Companies Act, supra note 189. A scheme involving a single transferable vote is explained below:

Single transferable ("STV") vote is a preference voting system for a multi-seat election. . . . With STV, however, the voters are allowed to indicate more than simply their first choice among the candidates. Voters may also, if they wish, rank order candidates to reflect their relative preferences among them. . . . Ranking candidates in order of preference in an STV election enables votes that would be "wasted" on one candidate to be transferred to another candidate. A vote is wasted in either of two ways. It could be cast in support of a losing candidate, or it could be a "surplus" vote cast in support of a candidate who would win without it. Rather than waste a vote in such situations, STV allows a vote to be transferred to another candidate, provided the voter has specified a subsequent preference. STV is a voting system designed to increase the proportion of voters in an election whose vote will ultimately contribute to the election of a candidate.

Richard L. Engstrom, The Single Transferable Vote: An Alternative Remedy for Minority Vote Dilution, 27 U.S.F. L. REV. 779, 788 (1993). While STV helps achieve the same result for minority shareholders as cumulative voting, it is somewhat more complex as it requires voters to make multiple choices in order of preference.

The second category of persons, i.e., those independent directors elected by controlling shareholders may have an important role to perform as well, in terms of mediating the various interests on the board. On the one hand they are elected by controlling shareholders, but on the other hand they are independent (at least in form) as they will still be required to satisfy the definition of "independence" under the relevant corporate governance norms applicable in the insider jurisdiction. Their role will be akin to the 'mediating director' described by Professor Langevoort:

Such persons may not, for reasons often emphasized in the literature, be the best external
The interests of minority shareholders will be truly protected in this scheme only if the total number of independent directors is significant, but not otherwise. In this context, there may be a question as to what is the minimum number of independent directors for whose election the cumulative voting method can be employed. Here, the present research does not propose to identify any magical figure and to impose the same as a criterion for the applicability of the rule. That would depend on a number of factors such as broad shareholding patterns in companies in India, usual board size, the minimum number of independent directors to be appointed and the like. It would be best left to the discretion of regulatory authorities based on further empirical analysis to crystallize that minimum number of independent directors. Similarly, cumulative voting is effective only when the minority shareholders (at least as a collective) hold a meaningful number of shares, but even the determination of that number is best left for determination on a case-by-case basis, without hazarding any guess as to a magic number. Lastly, it is also necessary to provide that all independent directors will have a concurrent term that runs for a pre-determined period. In that case, all independent directors will be elected for the same term thereby providing a robust number for an election that makes

monitors. But they may well make up for this shortcoming as advisers to the management and as emissaries to the true outsiders on the board. The same may be true of the so-called "gray" directors. But again, whatever their limits as monitors, their knowledge of, and ties to, the senior managers put them in a good position to earn trust inside. They can then build on this trust to work with the outsiders to reduce the level of cognitive diversity and allow the board to function more efficiently. We have put forward two sets of less conventional reasons why firms with "mixed" boards may be more productive than super-independent ones. The first is that giving insiders a significant political presence on the board may help both de-bias the outsiders and bolster the perceived quality and stability. The second reason is that overloading the board with true monitors may create too stark a dilemma for the senior managers, forcing them to engage in impression management tactics at the expenses of seeking needed advice and assistance in strategy formulation and resource gathering.

Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797, 815-16 (2001). This discussion in the context of the manager-shareholder agency problem has its parallel in the majority-minority agency problem as well.

Whenever there is a small number of independent directors, it is recommended that they be appointed by the "majority of the minority" voting method discussed below. See infra Part VI.B.2.b.

Even here, where shareholding of the minority shareholders is minimal, the appointment of some, if not all, independent directors can be determined by a "majority of the minority." This can be illustrated by certain companies in India, e.g., Wipro, which are listed on stock exchange both in India and the U.S., but where the controlling shareholder holds in excess of 80 percent with very little possibility of any minority representation on the board through the election of even a single independent director.

For example, a three-year term would be customary and desirable, although there is no hard and fast rule in that behalf.

In case any independent director's term comes to an end in the interim for any reason (such as resignation, death, removal or the like), then it can be provided that the term of all independent directors will come to an end at the ensuing annual general meeting where fresh elections are to be held.
cumulative voting more meaningful. This is to guard against a situation where minority shareholders do not have much power in cumulative voting. For example, in a staggered board, only a small number of independent directors will come up for elections each year, in which case cumulative voting will not provide any meaningful role to minority shareholders for reasons discussed earlier. If minority shareholders do not have a meaningful role at repeated elections due to the slender number of independent directors being elected, then the controlling shareholders enjoy similar powers as they have in the case of straight voting. Hence, it is important that all independent directors are elected together at the same time, and not on a staggered basis.

b. Voting by ‘majority of the minority’

In this schema, only the minority shareholders are entitled to vote for the election of independent directors. Each independent director will be elected so long as the candidate enjoys majority support within the constituency comprising the minority shareholders. In this approach, neither the controlling shareholder nor the management can influence the appointment as they have no role at all. The controlling shareholders will not be permitted to vote in independent director elections under this proposal. Furthermore, this is useful where the number of independent directors to be appointed is small whereby the system of cumulative voting would render itself ineffective. This will result in true representation of minority shareholders on corporate boards and instill accountability in the minds of the independent directors towards minority shareholders.

The principal drawback of this proposal is that it could become subject to “capture” by the minority shareholders. For example, minority shareholders who may have an axe to grind with management or controlling shareholders could put up candidates who may denude constructive decision-making on the board. Moreover, it could also provide avenues to competitors to gain entry into corporate boards. The disadvantages of minority shareholder participation on corporate boards will be greatly accentuated in the “majority of the minority” scheme than in the cumulative voting scheme. Despite these drawbacks, this proposal gives significant rights to minority shareholders so as to ameliorate the majority-minority agency problem.

c. Evaluation of options for minority shareholder representation

Having considered the two types of minority shareholder participation in independent director elections, it would be necessary to evaluate some

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392. In addition to these two methods, there is another method sometimes employed to provide
concrete proposals in the context of the issues identified in this Article.

i. Is there an optimal option?

For the reasons discussed in this section, minority shareholder participation is the recommended option for election of independent directors. However, as between the two options of cumulative voting and "majority of the minority" as methods of such participation, this Article would stop short of recommending one option over the other. That is because the optimality of the option would depend on a number of circumstances, such as the normal board size (including any minimum number of directors required) and the number of independent directors to be elected, the broad shareholding pattern of companies, and the like. It should, therefore, be necessary to analyze these issues further to determine which of the options suits the Indian corporate governance system in the best possible way, given the operability of these factors. Nevertheless, as a thumb rule, it is appropriate to say that cumulative voting would serve the purpose in the case of large boards while the "majority of the minority" would do so in the case of small boards.

ii. How to deal with the collective action problem

At this stage, an important question may arise in the reader's mind. If powers of selection of independent directors are to be conferred on minority shareholders, can there be an assurance that those powers will be exercised in fact? Will the minority shareholders not suffer from the collective action problem, thereby resulting in sub-optimal choices for independent directors? These are valid questions indeed and need to be addressed. At the outset, it is to be noted that the collective action problem is more severe in the straight voting process than voting with minority shareholder participation. In straight voting, it is almost certain that the controlling shareholder will be able to influence the outcome of the election, and hence minority shareholders rarely take part in the elections as their votes do not affect the final outcome. The collective action problem among minority shareholders is at its highest intensity because
there is no benefit in forming any coalitions due to their inability to affect the result. However, where the election process guarantees some level of influence to minority shareholders (either through cumulative voting or “majority of the minority”), they are likely to be incentivized to exercise their ballot. Each vote could make a difference to the outcome. Hence, the collective action problem among minority shareholders is likely to be far lesser in voting with minority shareholder participation than in straight voting.

But, such reasoning may not be adequate on its own. It is also necessary to inculcate a greater sense of investor activism in India. The process of activism, which has generated great interest even in the developed nations only about a decade ago, has found its way into India as well. The concepts of relational investing by institutional investors such as private equity funds and venture capital funds as well as the increase of participation by investors such as CalPERS and activist hedge funds into India will raise levels of investor activism. Regulatory authorities too can encourage investor activism through establishment of investor associations that can take up causes on behalf of minority shareholders, including by encouraging them to exercise their rights in the corporate democracy. Such measures would ensure that shareholder participation is achieved not just as a legal matter, but in practice as well.

iii. How to prevent rent-seeking by minority shareholders

In order to ensure that the disadvantages of minority shareholder representation are neutralized, it is necessary to adopt a stringent nomination process that results in the selection of competent, committed and impartial candidates who are put up for election by minority shareholders. Such a nomination process can be accomplished by the mandatory requirement of a nomination committee that carries on its process with regard for due transparency. This would ensure that minority shareholders (and other stakeholders) have adequate information about candidates that stand for the post of independent directors as also their competence levels and an understanding about the broad constituencies

393. See e.g., Gilson & Kraakman, supra note 233.
394. For example, in the Satyam case, it was activism in the form of excessive sale of stocks that raised crucial questions regarding related party transactions with the Maytas companies. See supra Part V.B.2.b.
395. In this arrangement, “institutions see themselves as long term investors in the firm-owners-rather than as short term traders or arbitrageurs.” Gordon, Cumulative Voting, supra note 366, at 127.
396. For example, in India, SEBI already encourages and regulates the operation of investors’ associations. See SECURITIES AND EXCHANGE BOARD OF INDIA, Investor Association Operations, http://Investor.sebi.gov.in/InvAssOperations.html. SEBI has also devised a scheme for funding such associations that may initiate litigation against errant companies. Anindita Dey, SEBI Proposes to Fund Class Action Suits, BUSINESS STANDARD (India), June 1, 2009.
they are likely to represent. This would act as an effective deterrence against rent-seeking (including by competitors and alleged blackmailers). Therefore, it is clear that minority shareholder participation would act as an effective method of independent director election only if it is accompanied by an unimpeachable nomination process that is truly independent.

iv. Renewal and removal of independent directors

The procedure for renewal of the term of independent directors ought to be the same as that for a fresh appointment, i.e., through selection by an independent nomination committee and election through minority shareholder participation. As far as removal is concerned, there are some key issues to be borne in mind. There is no benefit in having a carefully considered election process for independent director if that can be undone in one stroke by a straightforward removal process. For example, if independent directors can be removed by a simple majority of shareholders, then the controlling shareholders can reverse the effect of appointing independent directors by removing them through exercise of their influence. In order to obviate such a reversal, along with minority shareholder participation in independent director elections, it is necessary to impose stringent removal requirements. Either independent directors can be removed by shareholders only for "cause" or they can be removed with a supermajority that requires a higher threshold (of say 3/4 or 2/3 majority of shareholders voting for the resolution). This would ensure that independent directors are capable of being removed only in extreme circumstances, and not simply because such directors no longer enjoy the trust of the controlling shareholders. Such a requirement is essential to ensure that independent directors remain outside the influence of controlling shareholders.

To conclude the discussion on selection of independent directors, the recommended course of action is the nomination of such directors by an independent nomination committee through a transparent process and the election of such directors by way of minority shareholder participation (either through cumulative voting or "majority of the minority").

C. Crystallizing the Role of Independent Directors

In addition to the appointment process, this Article identifies the lack

397. This could result in disastrous consequences that exacerbate the majority-minority agency problem. For instance, one of the shortcomings of the revised company law in Russia is that although it provided for director elections through mandatory cumulative voting, it continued to retain a straightforward removal process (albeit with some differences) whereby controlling shareholders can wipe out the effect of the cumulative voting process. See Yevgeniy V. Nikulin, The New Self-Enforcing Model of Corporate Law: Myth or Reality, 6 J. INT'L L. & PRACT. 347, 371 (1997).
of a clear role for independent directors as a key shortcoming of the corporate governance norms in India. That leads to the question as to what the role of the independent director ought to be.

It is recommended that the role consist of two parts: (i) advisory; and (ii) monitoring. Independent directors need to bring value to the company in terms of their ability to provide inputs on strategy, business, marketing, legal, compliance or other relevant aspects and also carry out monitoring functions (by acting as watchdogs) in order to protect the interests of shareholders in general and minority shareholders in particular. The corporate governance norms ought to clearly outline these rules so that independent directors are not subject to any uncertainty on this front. Admittedly, it may be too much to require every independent director to perform both advisory and monitoring functions, and that may not be practicable to begin with. However, the board could be comprised of independent directors with different capabilities so that the board as a whole may be in a position to perform both these functions effectively.

More specifically, the monitoring aspects can be carried out by independent directors only if they are conferred specific powers. It is not sufficient if independent directors merely record any transaction or express their opinion on the suitability thereof whenever that comes up for consideration before the board, particularly where such transaction involves self-dealing or other related party transaction between the company on the one hand and the management or controlling shareholders on the other. Currently, the powers conferred on independent directors are insufficient. For example, in India the audit committee is required only to verify disclosures pertaining to related party transactions. They have no approval rights whatsoever even though related party transactions may significantly enrich the controlling shareholders and erode the value of the minority shareholders. Such a situation can be remedied if independent directors are provided the exclusive right to approve certain types of transactions involving related parties that reduce the value of the minority shareholders. In such transactions, it is the minority shareholders who are entirely under-protected under the current dispensation. It is not proposed in this Article to list out the items that require the approval of the independent directors. That would be a matter of detail to be suitably tailored by the regulators in India, but the guiding principle to defining a related party transaction is that it should include any transaction that involves self-dealing with management or controlling shareholders, being

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398. This aspect has been emphasized by Nolan, supra note 62, at 438.
399. See supra note 198 and accompanying text.
400. Even in the Satyam case, we find that in the discussions pertaining to a significant related party transaction, independent directors only raised questions, but in the end unanimously approved the transactions as they were voting along with the non-independent directors, although the directors representing the related parties themselves abstained. See supra note 277-82.
any transaction that benefits management or controlling shareholders to the
detriment of the other (minority) shareholders.\textsuperscript{401}

As a matter of procedure, it is necessary to ensure that such matters
for approval of independent directors are taken up at a separate meeting of
independent directors without the presence of management or controlling
shareholder representatives (i.e., in executive sessions). This is essential to
ensure that independent directors are able to freely exchange views among
themselves, adopt a proper position and make an impartial judgment. The
presence of management or controlling shareholder will negatively
influence the decision-making by the independent directors. Such an
approach may seem largely procedural, but it has enormous implications.
This procedure will help independent directors overcome several cultural
constraints that inhibit impartial decision-making by independent directors
in countries like India.

Identification of clear roles and functions by regulatory authorities
will not only introduce certainty in the minds of the independent directors
as to their tasks on corporate boards, but it will also manage the
expectations of shareholders and other stakeholders as to the level of
monitoring they can expect from independent directors. Regulators too
will be in a position to structure other corporate governance protections
around the clearly defined role of independent directors.

The next key issue pertains to the constituencies that deserve the
attention of independent directors. At the outset, it must be clarified that
independent directors are required to owe their duties to the company as the
separate legal entity.\textsuperscript{402} In that sense, all shareholders (whether controlling
or minority) will be the beneficiaries of directors’ duties. Any breach of
such duties would be met with consequences that are normally provided
under law.

In addition to duties of directors generally, independent directors must
have a special duty to protect the interests of minority shareholders where
those rights are expected to come in conflict with those of the controlling
shareholder.\textsuperscript{403} In such circumstances, controlling shareholders do not
require any protection as they virtually dominate the affairs of the company
through their voting power. It is the minority shareholders who deserve

\textsuperscript{401} Guidance can be obtained from the relevant accounting standards that deal with related party
transactions. For example, clause 32 of the Listing Agreement incorporates concepts from the
Accounting Standards on “Related Party Disclosures” (AS-18) issued by the Institute of Chartered
Accountants of India. Listing Agreement, supra note 156, cl. 32.

\textsuperscript{402} Directors’ duties are not statutorily enumerated in India, and they are adopted from common
law. Under those principles, duties are owed to the company and not individually to shareholders.
Since the company itself is an abstraction, courts have recognized that its interests equate to that of the
shareholders when the company is a going concern and also that of creditors when a company becomes
insolvent. See PAUL L. DAVIES, GOWER AND DAVIES’ PRINCIPLES OF MODERN COMPANY LAW 391-79
(2003).

\textsuperscript{403} No such duty exists at all under current Indian law.
protection through monitoring by independent directors. In case of a breach of these duties, appropriate remedies need to be devised depending on the types of shareholder remedies available in India. In that sense, minority shareholders are a key constituency whose interests are to be protected by independent directors.

By way of analogy, even where directors owe duties to the company as a legal entity, the shield of separate legal personality breaks down in certain circumstances such as where the company falls into insolvency. Similarly, it should be made possible to break down the legal personality when directors decide on specific transactions such as related-party transactions involving the controlling shareholders, where the specific consideration by independent directors of minority shareholder interests ought to educate or inform their decision-making and discharge of their duties owed to the company.

D. Other Relevant Considerations

In order to engender a workable institution of independent directors in India, it is necessary to create an appropriate environment, both in terms of legal requirements as well as other practical considerations. In this section, I propose to highlight some of these key considerations. The intention here is only to set out the broad principles in terms of recommendations without insisting on specific changes or formulations. It is for regulators in India to consider these principles and devise specific policies as may be appropriate.

I. Defining Independence

In India, independence is currently defined with respect to the existence of pecuniary or business relationships and family relationships. These are quite narrow, and in India where the cultural backgrounds create other forms of social relationships between individuals (such as extended familial relationships and friendships and bonds between business families that transcend generations), it is necessary for definitions of independence to capture such relationships as well. The importance of social institutions cannot be undermined. Admittedly, it is an onerous task for legal definitions to capture such fluid relationships, but guiding principles can nevertheless be set out without attempting very specific definitions. On this count, I advocate a principles-based approach rather than a rule-based approach. The latter is fraught with difficulties because bright lines always


405. This issue has not been entirely resolved even in the outsider systems, although it has received attention in rare cases. In re Oracle Corp. Derivative Litig., 824 A.2d 917, 938-39 (Del. Ch. 2003).
lead to noncompliance in spirit as parties would tend to arrange their affairs in such a manner as to stay out of the bite of the regulation with impunity. Any such principles-based definition ought to capture the objective of independence and the problems that are sought to be addressed through the system of independent directors.

2. Competence and Qualifications

Current definitions of independence largely rely on the lack of relationships between the director and the company, management or controlling shareholder. It does not matter if the person is otherwise ill-suited for the job. That leads to the appointments of persons who may not possess any business acumen or other skills that are required of a director on corporate boards. It is therefore necessary to introduce positive qualities that individuals are required to display before they can occupy an independent director's board seat. This can be knowledge or experience in the particularly industry in which the company operates, or even general business and managerial skills, or other allied skills in areas such as accounting, marketing, strategy, law and the like that the individual can bring to bear on corporate boards. Any such skills would also enhance monitoring on corporate boards. More importantly, at least one director should have significant expertise in accounting and financial matters because accounting fraud, manipulation and non-transparent disclosures has been found to be a key corporate governance failure in insider systems.

Other "soft" factors ought to be kept in mind while appointing independent directors. For example, there are often complaints that the average age of independent directors is very high and that it is usually male-dominated. These issues are to be addressed so that the element of board diversity is maintained. This would bring persons with varied skills, experience and backgrounds on to boards as independent directors.

3. Commitment

One universal concern in the insider systems is the lack of availability of competent individuals suitable to don the mantle of independent directors. The ones who have the necessary qualification and competence are required to serve various boards, and hence find it difficult to commit ample time to each board. One solution would be to specify that an independent director shall spend a certain number of hours or days each year for every company on whose board he or she serves. However, that would be difficult to enforce or even effectively monitor. The other would...
be to specify the maximum number of companies on which independent directors may serve and to keep that at a low number so that they can justify their role on each board. While that would be a necessary requirement, it may not command a "one size fits all solution." It would depend on the competence levels of the directors, time available on their hands (which would vary on the basis of whether they are gainfully employed elsewhere) and the amount of work required on each board. Hence, it is not appropriate to mandate the maximum number of boards on which independent directors would serve, but to leave it to the independent directors and the companies themselves to determine the specifics. However, there ought to be a clear understanding under law that some level of minimum commitment is essential.

One idea that is extremely attractive in the context of several of the practical issues discussed in this Article (but one that is yet to find its way into practice in a common way) relates to the appointment of professional directors. Such directors' principal vocation is to serve on a handful of corporate boards, from which they earn their living. The ability of such directors to commit their time and attention as independent directors would be tremendous, as they are not distracted by any other principal vocation or profession. In practice, it is found that the concept of professional directors is gradually finding its way into the corporate governance sphere in India. However, this system needs to take on a more sustainable form, and there is enormous opportunity for such a system of professional directors to enhance the role of independence on corporate boards.

4. Cadre of Independent Directors

Professionalization can be taken to the next level through additional steps. The first is training for independent directors. Introducing mandatory training at the time of induction as well as continual training on a periodic basis would ensure that independent directors are aware of their roles and responsibilities. Apart from formal training, informal briefings and caucuses would work as well. For example, forums where independent directors get together and share their experiences would help in improving best practices in the field. The learning from these trainings and forums can be put to use by independent directors across all boards that they serve.

In addition, it is necessary for policymakers to explore the possibility

407. While there are caps on the number of boards that directors in India can serve, they are arguably too high to be meaningful. Even the limit of seven boards introduced by the Voluntary Guidelines appears excessive.
408. The concept of professional directors has been advocated notably by Professors Gilson and Kraakman. Gilson & Kraakman, supra note 233.
409. Practitioner interviews affirm the gradual emergence of this type of directorship in India.
410. Practitioner interviews indicate the existence of at least one such forum in India.
of creating a cadre for independent directors through a certification process. In this proposal, a regulatory authority or peer body would register individuals as independent directors upon satisfaction of certain conditions, including qualifications, experience, competence levels, training, and so on. Such a certification would not only ensure uniform standards in independent directors, but would also make such directors accountable to their peers. This is similar to certification of lawyers, chartered accountants, architects and other professionals. It may be premature at this stage in the evolution of corporate governance in India to insist on certification as a mandatory requirement, but it is an aspect which should be attained eventually and policymaking efforts ought to clearly bear that in mind.

5. Incentives

Independent directors need to be provided sufficient incentives to carry out their functions effectively. Of course, compensation of independent directors in monetary terms is the most measurable of the incentives. Currently, monetary compensation of independent directors in India is far from satisfactory, as we have seen in Part V.A.5. Therefore, it is necessary to appropriately remunerate the independent directors so that they take their job seriously, in a responsive and accountable manner. At the same time, there is a risk of over-compensating directors that may cause them to lose their independence. The monetary compensation should not be so high that the independent director begins to rely heavily on the board position, which will impinge on the impartial decision-making faculties of such directors. It is critical that the line is drawn very carefully. It would not be appropriate to fix specific limits and caps on independent director remuneration, as that would be counterproductive. However, it is possible to lay down some rules of thumb. The guiding factor should not be the relevance of the remuneration with reference to the financial size of the company itself. Rather, it should bear relevance to the overall earnings of the independent director. In other words, any limit should be placed as a percentage of the director’s overall earnings, as that would determine whether the director will place greater reliance on the board position that is a necessary means of earning and hence not act entirely dependent. Even here, a principles-based approach would augur well.

One of the significant forms of independent director compensation is through stock options. The advantage of stock options is that it provides the independent directors with a stake in the fortune of the company and its business. In that sense, it motivates independent directors to act in a

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411. Stock options for independent directors is beginning to take on an important form of compensation in India.
manner that preserves shareholder value. However, adequate care is to be taken to ensure that some of the perverse incentives that operate in stock options do not flow over to independent directors as well. First, holders of stock options are motivated to increase the short-term earnings of companies so that they are able to encash on their options.\textsuperscript{412} This is often at the cost of long-term performance of the company. Second, any stake in a company obtained by independent directors ought not to exceed predetermined maximum limits. For example, in case independent directors obtain a controlling position (more likely \textit{de facto} in nature) in a company, such director is perhaps likely to act as any controlling shareholder would do rather than in the interests of the minority shareholders. That would defeat the very purpose of appointment of independent directors in insider systems. These perverse incentives of stock options must always be guarded against.

Finally, there are certain non-monetary incentives that would propel independent directors to perform well. Reputation of independent directors is primary among them. A reputable independent director can be assured of directorships in a greater number of companies. This reputation effect in turn creates a market for independent directors, thereby enhancing the importance of that institution. However, it is important to ensure that such a reputation market for independent director is correlated only to his or her performance (in the interests of the shareholders, particularly the minority) and not with reference to allegiance shown towards management or controlling shareholders. Performance in such a market is to be determined with reference to identified criteria that is justified in the context of such a role.\textsuperscript{413}

6. \textit{Disincentives}

One of the significant disincentives that drives competent individuals away from independent directors is personal liability for non-compliance of law by the company. This, as we have seen, is a crucial issue in India,\textsuperscript{414} due to which individuals are not only reluctant to take up independent director positions, but even existing independent directors have been resigning in droves. This issue needs to be addressed.

First, the liability regime ought to take into account the fact that independent directors are not involved in the day-to-day management of the company. Hence, they cannot be held liable for matters that are not


\textsuperscript{413} For details of such performance evaluation criteria, \textit{see infra} Part VI.D.8.

\textsuperscript{414} The case involving the directors of Nagarjuna Finance highlights this issue in the Indian context. \textit{See supra} Part V.B.3.
within their knowledge, or those that they were not capable of identifying on their own.\textsuperscript{415} In that sense, all directors (whether independent or otherwise) will be subject to a basic minimum duty of care. However, executive directors may be subjected to a higher standard as they not only possess business expertise but also greater knowledge regarding the affairs of the company. Independent directors cannot bear such higher burden. Such a regime must be made clear.

Further, independent directors need to be provided the benefit of indemnities by the company and also D&O insurance policies. In case independent directors take actions genuinely that result in potential liabilities, such as for simple negligence, these protective provisions are to be attracted. Companies should be required mandatorily to provide such indemnities and D&O insurance policies. These requirements must be applied as a matter of practice each time an independent director is appointed to a company’s board.

Legislatures and courts must be educated about the precarious position with reference to independent directors and their liability. For example, criminal legislation should not be utilized by the state or the courts to harass independent directors in a manner that extracts benefits from the companies.\textsuperscript{416} Even if such criminal actions may not ultimately succeed, it causes significant hardships to the independent directors as they are required to devote time and attention to defend themselves, leading them to forego their primary professional commitments thereby raising the opportunity costs. More importantly, it causes severe reputational hardships to such independent directors. All these problems tend to be compounded in insider systems such as India where courts are prone to delays in resolution of disputes. The pendency of such disputes for a prolonged period of time enhances direct costs and reputational losses significantly.

7. Other Supporting Factors

Independent directors cannot function effectively without a conducive environment. At the outset, it is necessary to ensure that independent directors obtain all relevant information that enables them to make considered decisions on matters. There needs to be a regular flow of information from management (and controlling shareholders) to independent directors. Furthermore, independent directors should have

\textsuperscript{415} This refers to the concept of “red flags” whereby directors are expected to identify and raise questions regarding issues that are quite obvious on their face without having to make any in-depth enquiries. For a more detailed discussion on “red flags,” see In re WorldCom, Inc. Securities Litig., 346 F.Supp.2d 628 (S.D.N.Y. 2004).

\textsuperscript{416} The Nagarjuna Finance case is a classic example of what appears to be the victimisation of the independent directors.
direct access to key company officials without going through management (or controlling shareholders), as it is important to make sure they receive information that is not filtered at any level.

If independent directors are to decide impartially, they should be allowed to meet without management in executive sessions. This should be a requirement of the corporate governance norms. If this is not made mandatory, independent directors may not convene such separate meetings for fear of showing mistrust of the controllers. However, when it is made mandatory, independent directors can do so without any such fears. This is an important step as boards in India may tend to be more collegial showing reverence (sometimes misguided) to the person in control, all of which act as an obstacle to the impartial thought process of independent directors. Executive sessions will permit issues to come to the fore and for issues to be dealt with threadbare.

Independent directors must also be provided the option to engage experts and consultants on specific matter. These include forensic auditors (in case of suspected fraud), chartered valuers (in case of sale or purchase of business), lawyers (in case of a serious litigation or compliance issue) and the like, all at the cost of the company. This is so that independent directors obtain the benefit of expert advice on specific or complex matters. This is even more important in light of the proposal that independent directors should separately approve related party transactions.

8. Performance Evaluation

Independent directors will be made more accountable if their performance is evaluated periodically—at least once a year. Currently, only very few companies in the insider systems follow such performance evaluation of independent directors. It is important to determine the factors and metrics on the basis of which the independent directors are evaluated. Those should be consistent with the roles and responsibilities of the independent directors and also to the extent to which the interests of the relevant constituencies (such as minority shareholders) have been protected. Of course, this cannot be a purely quantitative exercise, as it involves subjective factors. However, it is possible for companies to appoint external consultants (such as human resources management firms) to carry out such performance evaluation. Ultimately, it is for the chairman of the company as well as the nomination committee to determine the performance of independent directors (based on relevant reports) and decide whether the term of such director should be renewed or not. Such a process of constant evaluation of independent directors would motivate them to perform effectively in a manner that fulfills their roles and functions.
E. ROLE OF THE LAW AND OTHER FACTORS

While a number of recommendations have been made in this Part, not all of them require legislation to implement. Certain aspects require a legislative framework before they can be effective. These include the definition of independence, voting systems for election of independent directors, clarity regarding the duties, role and allegiance of independent, mechanisms for compensating directors and fixation of liability. However, various other aspects such as commitment in terms of time, procedures for receipt of information and conduct of board and independent director meetings are matters for which the legal regime needs to provide for some basic principles, but the detailed working are to be left to the various corporate players to devise. These matters will vary among companies and hence some level of flexibility is called for. Moreover, these matters will need to be developed in the form of standard practices, and in that behalf, various business associations and director forums could play a more significant role than legislation. Regulators in India therefore need to fine-tune items of regulation that required the mandate of the law and other matters that need to be developed as good practices. Both are essential to engender a workable institution of independent directors in the insider systems.

Finally, it is necessary to reiterate that the independent director institution is only one of the mechanisms that would enhance corporate governance in India. That institution, as we have seen, cannot work by itself. It requires to support, and be supported by, a whole host of other attributes such as a stringent accounting and financial disclosure regime, whistle blowing mechanisms, a code of ethics, and even perhaps an open market for corporate control, just to name a few. The role of independent directors should also be supported by other gatekeeper functionaries such as accountants, investment bankers, corporate and securities lawyers, securities analysts, rating agencies and even the business press. The effectiveness of the independent directors also depends on other systemic factors. For example, it even requires courts in India to be in a position to rule efficaciously on corporate and securities law aspects, set precedents for lower courts to follow and create a set of principles that imbue certainty in the functioning of independent directors as emissaries of enhanced corporate governance. Lastly, independence is not something that can entirely be ordained by the law. It is a matter involving ethics and integrity whereby independent directors have to put before themselves the interests of those that they are to protect. That is a characteristic that should permeate into the corporate ecosystem in India if enhanced corporate

417. To that extent, the coverage of some of these aspects in the Voluntary Guidelines is noteworthy.
governance is to be achieved. While law does play an important role in creating the conditions for institutions like independent directors to carry out their functions, the success of that institution also depends to a large extent on the individuals that occupy that position and the cultures and practices that are prevalent in India.

In this Part, I suggested various reforms to strengthen the institution, specifically given the majority-minority agency problem that is prevalent in India. I also found that while some of the requirements can be mandated through law, other matters must be left for the various corporate actors and peer review bodies to determine on the basis of given circumstances, as a “one size fits all” approach may fail. It is necessary to mention a word of caution. The effect of strengthening the position of independent directors in the insider systems should not mean that such directors adopt a confrontational attitude towards management and controlling shareholders. That would result in disastrous consequences. Constant deadlocks in the boardroom would result in sub-optimal business performance, and in the end it will be the shareholders (minority included) who are likely to suffer adversely. The enhanced powers require individuals in the position to act rationally and perhaps even empathetically to the insiders who are responsible for running the business of the company. Such individuals ought to act independently and impartially without opposing every proposal put forth by the insiders. The availability of extensive powers at hand, however, is important as they may be required to be exercised, albeit sparingly, if there are transactions that may likely benefit the insiders at the expense of the minority shareholders. Unless the legal regime confers sufficient powers, independent directors will be left immobilized. But, those powers are required to be exercised in the overall interest of the company. Ultimately, in the end analysis, all directors (including independent) have to strive to create value to the shareholders having regard to the interests of the other stakeholders as well. That basic objective cannot be compromised.

VII. CONCLUSION

This Article examined a key question: what is the effect of transplanting a corporate governance norm, specifically the independent director, from the outsider systems (where it has originated) to an insider system such as India? The theoretical foundations of independent directors and the rationale for their emergence in outsider systems are inextricably linked to the manager-shareholder agency problem in those systems. There has been a selective transplantation of various independent director norms from those outsider systems to insider systems such as India (where the majority-minority agency problem is prevalent), which was driven by the forces of globalization and with possible convergence towards the outsider
A review of the empirical studies and the anecdotal evidence does not instill confidence in the effectiveness of independent director functioning in India. What is required therefore is an overhaul of the corporate governance norms so as to embolden India independent directors.

While this Article dealt with the transplant effect of independent directors from the outsider systems of the U.S. and the U.K. to the insider system of India, it also sought to provide general guidance on the types of issues that may arise in the implementation of the concept in other insider systems, particularly those that are emerging economies. China, Brazil, and Russia immediately come to mind, but there are other countries similarly situated in the evolution of corporate governance norms within their systems. Further research will help verify whether the conclusions in this Article are universal across all insider systems or whether they are due to factors that specifically at play in India.

418. These countries, along with India, are referred to as the BRICs. Goldman Sachs, *Dreaming With BRICs: The Path to 2050* (Global Economics Paper No. 99, 2003), available at http://www2.goldmansachs.com/ideas/brics/book/99-dreaming.pdf (predicting that, if things go right, in less than 40 years, the BRICs economies together could be larger than the G6 in US dollar terms; currently they are worth less than 15 percent).