THE ROLE OF INDEPENDENT DIRECTORS IN CONTROLLED FIRMS IN INDIA: AN EMPIRICAL ANALYSIS OF DISPUTES INVOLVING DIRECTORS

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ABSTRACT

The role of independent directors has come under the scrutiny subsequent to the Satyam fiasco, and the bulk resignation of independent directors that succeeded. It has been argued that there is no intelligible comprehension of the function that an independent director is envisioned to be involved in the boardroom. On the top of it, they set forth the doubtful sceptical points over the aptness and suitability of criminal and civil liability laws to the independent directors. In addition, they are repeatedly a cause of concern, and it is often asserted that these issues of consideration and concern must be inscribed in the advanced change to India's company codification. In a firm, directors with shorter tenures, and directors who are more powerful or independent are more predictable to be embroiled in a dispute. This article puts a light on the establishment of the institution of the independent director as a tool of corporate governance, and evaluates its' efficacy in the Indian scenario. The issue that the independent director was framed to tackle in the US is the agency problem between the shareholders and the management stemming up from a diffused shareholding framework. However the corporate mounting in India is inked by the existence of a controlling shareholder, and therefore the major issue that arises in the corporate governance is the conflict of mind between the minority shareholders and the majority shareholders. The evolution of the concept of independent directors has taken place from the concept of US and UK and in this way the researcher can analyse that by the adopting the same in the Companies Act 2013 India too has been adaptive to the concept of independent directors by imbibing the role and functions, duties, manner of appointment of the independent directors etc. In this paper, I will dwell upon the institution of the Independent Director in the regulatory framework of India, and examine its' workability particularly in view of the wide differences in

the corporate cultures of corporations between Anglo-Saxon core of the US and the UK on the one hand, and India on the other.

PREMISE

"Citizens never support a weak company and birds do not build nests on a tree that does not bear fruits."

– Salman Khurshid

THE SATYAM SAGA

In 2009, the pendulum swung both ways for India Inc. There was much good news – corporate India came out of the global financial crisis smelling like a rose, with the Sensex outdistancing its' pre-crisis peaks and India's economic advanced development and growth rates outreaching most of the estimates.[1]It is pertinent to note that 2009 was also a climacteric year in the category of bad news, with disclosures of one of the monumental scandals in the history of Corporate India at ***Satyam Computer Servi*****ces** and the tribulation of Nimesh Kampani in regard to his account as an Independent Director at Nagarjuna Finance domineering the headlines and wearing away the confidence both overseas and in the domestic sphere in the corporate India.[2] These events attracted significant public attention to and invited the scrutiny of India's Independent Directors, and a great number of such independent directors took cognizance: In 2009, a number of independent directors (at most 620) stood down from the boards of the Companies in India– a figure that is, to our intelligibility, by far without precedent globally.[3]This diaspora of independent directors emphasized a deep inconvenience within India and within the corporations of the country with the very establishment of independent directors in the backdrop of companies dominated either indirectly or directly by such promoters and corporate founders.

[1]Satapathy & A. Bhardwaj, *Business Diary, 2009*, ZEENEWS.COM, Dec. 28, 2009, *available at* http://www.zeenews.com/news589650.html.

[2]P. Banerji, *Scandal Jolts Confidence of Global Investing Community*, THE FINANCIAL EXPRESS, Jan. 8, 2009, *available at* http://www.financialexpress.com/news/scandaljolts- confidence-of-global-investing-community/407876/. See Part II below for more detail on these events.

[3]Tabulated based on data available at http://directorsdatabase.com. For our purposes, we only counted cessations listed in the database for which the reason listed was "resignation."

EVOLUTION OF INDEPENDENT DIRECTORS IN INDIA

The greatest ill affecting Indian public life is the universal paucity of accountability and the consequent failure of institutional structures. This is a trend with some exceptions, and India Inc. is clearly not one of them. Over the last few decades, a fair bit of work has been done in both regulatory and policy circles to tackle this issue of trust deficit afflicting corporations in India. It is unsurprising, as is normal for Indian policymakers to look at the West (particularly UK and US) for inspiration, when faced with a tricky situation. At least one of the solutions that has been implemented and recommended is apparent to have been transplanted almost wholesale from existing Anglo-Saxon jurisprudence.[4] The Independent Director is technically is divorced from the internal workings of the management, but an essential part of the Board and is required to supervise the board with a sense of detachment that the executive directors would not have. There has been a consistent and nearly uncritical endorsement of the Independent Director, **from the Desirable Corporate Governance Code in 1983[5] to Chapter 11 of the Companies Act, 2013** - a conception which was conceived in the US in the mid-20th Century, and further fashioned by UK in the 1990s.[6] In contrast to British and American companies which are featured by a shareholding pattern which is widely dispersed, most large Indian companies, with a powerful controlling shareholder have concentrated shareholding structures.[7]

THE NEED OF INDEPENDENT BOARD IN ASIAN CORPORATIONS

The requirement to have an Independent Board is heightened in the case of Asian economies including India, where family members with substantial ownership and control rights occupy managerial positions with the only objective of dominating the firm and where corporations which

[4]*See*, Kumar Mangalam Birla Committee Report, *infra* note 14, ¶ 2.6 ("… to prepare a Code to suit the Indian corporate environment, as corporate governance frameworks are not exportable").
[5]*See*, http:// www.nfcgindia.org/desirable_corporate_governance_cii.pdf.
[6]*See* Varottil, *infra*, note 16, 282 **(**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, just to name a few).
[7]Shaun Matthew, *Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities*, 3 Colum. Bus. L. Rev. 800, 833 (2007).

are largely family owned belonging to business groups control the corporate landscape. When control and ownership are centralised in the same hands, the nature of the agency problem changes vis-à-vis diffused ownership structures, from conflicts between two categories of principals—the controlling inside shareholders, and minority outside shareholders (Type II or "horizontal "agency problems) to shareholder manager conflicts (Type I or "vertical" agency problems). Gaining effective influence over a corporation entitles the controlling owner to assess not just how the company is run, but also how profits are being shared among the shareholders.

CONCEPTUALISING INDEPENDENT DIRECTORS UNDER COMPANIES ACT. 2013

The foundation of the concept lay in the comprehension of the agency problems arising in diffused corporate systems can be best resolved by separating the function of monitoring of decisions by the board and ratification, from the initiation and implementation of these decisions.[8] Given this general presupposition, one of the major problems in corporate governance that academics have had to think about is the dearth of precision and clarity on the real ambit of the functions of the board and the principle of its separation from the management. The 2013 Act has defined the term 'Independent Director' u/s 2(47) which says that 'Independent Director' means an Independent Director as referred to in sub-section (5) of section 149 and has taken over many of the provisions of clause 49 of the Listing Agreement The New Act also provides the criteria for tenure, remuneration, qualifications, appointing, and liability of the Independent Directors. Section 149 of the 2013 Act is to be read with Rules 3, 4 and 5 of the Companies (Appointment and Qualification of Directors) Rules, 2014.

APPOINTMENT OF INDEPENDENT DIRECTORS BY ASSET MANAGEMENT AND TRUSTEE COMPANIES

[8]Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, Journal of Law and Economics, Vol. 26, No. 2 (Corporations and Private Property: A Conference Sponsored by the Hoover Institution, June, 1983), 322 (Fama & Jensen refer to this separation as the separation between decision control and decision management).

Reg. 16(5) of SEBI (Mutual Fund Regulations), 1996 provides that two- thirds of the Board of Directors of a trustee company shall be Independent Persons and shall not be associated with the sponsors or be associated with them in any manner.

Under Reg. 21(1) (d), at least 50% of the Board of Directors of an asset management company must be Independent Directors.

ROLE OF INDEPENDENT DIRECTORS ON THE BOARDS OF INDIAN COMPANIES

In a highly commendable move, Company Act 2013 made a remarkable improvement over its predecessor and categorically delineated duties and liabilities to independent directors in a forthright manner. **Sec. 149(8) read with Schedule IV**[9] of the Company Act 2013 comprises of a Code that describes set of professional ethics, functions, duties, appointment, resignation, remuneration and so on. This is a combination of several conventional duties and emerging expectations that have been formulated over years of experience, judicial wisdom and expectations.

In India, for listed companies, an Independent Director is a non-executive director who apart from receiving directors' 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 that may affect the director's independence as defined by **Securities and Exchange Board of India (SEBI)**, in **Clause 49 of the listing agreement**. Certain specific factors were also listed that helped determine whether or not a director is independent and while these factors dictate as to who cannot become independent directors there is an 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 a person should possess (prior to appointment) to the position so as to be able to discharge board responsibilities effectively. This was a serious deficiency in the definition of independence and it allowed companies to appoint persons who while satisfying the formal requirements of independence, were otherwise not suited for the job.

[9]Sec. 149 (*8*), the company and independent directors shall abide by the provisions specified in Schedule IV.

FUNCTIONS

Functions of the Independent Directors encompasses of (a) Real and not Tokensic involvement[10] (b) Vigilance (c) To act as a sounding board (d) Attendance to the meeting and performance appraisal[11] (e) Declaration of Independence[12] (f) Protecting the interests of shareholders (g) Oversight to Corporate Social Responsibility[13]

EXTENT OF LIABILITIES UNDER THE PRESENT LAW

Companies Act 2013 makes an improvement over its predecessor in terms of fixing up liabilities on independent directors. By way of a non-obstante clause and attributable through Board processes, and with his consent or connivance or where he had not acted diligently[14],it specifies that independent directors will be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge[15]. It accompanies as a corollary that Independent Directors cannot forgo their duties which, *a posteriori*, after a resolution which is inimical to the public interest is passed, will result in the inference that they were mere dummies on the board of directors.

[10]Schedule IV Code for Independent Directors II Role and Functions; See Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, 6 HASTINGS BUS. L. J. 281, available at http://online.wsj.com/public/resources/documents/satyam01115.pdf.
[11]VII. Separate meetings:
(1) The independent directors of the company shall hold at least one meeting in a year, without the attendance of non-independent directors and members of management;
(2) All the independent directors of the company shall strive to be present at such meeting;
(3) The meeting shall:
(a) review the performance of non-independent directors and the Board as a whole; (b) review the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors;
(c) assess the quality, quantity and timeliness of flow of information between the company management and the Board that is necessary for the Board to effectively and reasonably perform their duties
[12]Sec. 149 (*7*), Companies Act, 2013.
[13]Sec.135, Companies Act, 2013.
[14]Sec. 149 (12), Companies Act, 2013.
[15]Sec. 149 (12), Companies Act, 2013.

The court, in the case of ***Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry* v. *Griffiths***[16] has expounded the law explaining the law that collective responsibility flows from individual responsibility of the director, which he cannot escape.

It is important that independent directors assume responsibility and follow due process while undertaking the duties entrusted to them, or else they would lose the trust of the average small shareholders have in them. The court emphatically observed in ***Dovey v. Corey***[17] that:

"The business of life could not go on if people could not trust those who are put in a position of trust for the express purpose of attending to details of management."

In reference to section 291 of the Companies Act, 1956, the Delhi High Court has made an observation in the case of ***Raj Travels and Tours Ltd. and others* v *Destination of the World (Subcontinent) Private Limited***[18] in relation to the issue of liability of the director in a case regarding to section 138 of Negotiable Instruments Act, 1881, subsequently which has made the following observation on the directors' role in companies.

MEETINGS AND COMMITTEES

The Independent Directors to meet at-least once in a year as necessitated by the Companies Act, 2013. An Independent Director would also assess the performance of the chairperson of the organisation. The Act mandates an Independent Director to assess the performance of the Board and the non-independent directors as a whole of the company. These measures would ensure in the smooth and proper functioning of the Board of Directors of a company.

The Act, 2013 has also focused on the appointment of an Independent Director as a chairperson or as a member in several committees. To take an example of the Nomination and Remuneration Committees[19] which shall consist of three or more non-executive directors, ID's should not be less

[16]Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry v. Griffiths, (1998) 2 BCLC 646, Pg. 653: (1998) 2 All ER 124, Pg.130.
[17]Dovey v. Corey, (1901) AC 477, Pg. 486.
[18]Raj Travels and Tours Ltd. and others v. Destination of the World (Subcontinent) Private Limited**,** (2012) 6 Comp LJ 342 (Del).
[19]Sec. 178(1), Companies Act, 2013.

than half of the total number of members. On the same lines the Audit committee[20] which shall consist of minimum three directors, Independent Directors should form a majority.

REMUNERATION

The Act does not allow the directors from obtaining remuneration and other stock options other than reimbursement of travel expenses for attending the board meetings and other seatings. Subject to the approval of the shareholders, profit related commission may be paid to them.[21] The chief reason for limiting the remuneration was to safeguard the personal financial connect with the company and to ensure their independence.

INDEPENDENT DIRECTOR GUILTY OF INSIDER TRADING

Purchase of substantial amount of shares of the target company, by the wife of a director where funds were arranged by the director and where the director was in constant touch with the high officials of the company of which he was a director and also a member of the audit and compensation committee. The Independent Director and his wife were guilty of Insider Trading as the decision to purchase the shares of the target company was like to materially affect the price of shares of the target company and being so was unpublished price sensitive information for the insiders of the company. Such insiders are prohibited from dealing in shares of the target company till such information was made public.[22]

PROMOTER DOMINANCE IN INDIAN COMPANIES

PROMOTER DOMINANCE IN CORPORATE OWNERSHIP

The corporate sector in India is portrayed by firms with concentrated ownership and control similar to those most developing, emerging and dominating economies. Domestic private sector firms are either affiliated to non-affiliated standalone firms or business groups. Both the firms are family firms with distinguished equity holdings by family members.

[20]Sec. 177, Companies Act, 2013.
[21]Sec. 197(7), Companies Act, 2013.
[22]V.K Kaul v. SEBI, (2012) 116 SCL 24: (2012) 111 CLA 629 (SAT).

However, an assessment of the structure of ownership of a large specimen of listed firms exhibits that in India, a large majority of firms are featured by control structures and concentrated ownership and widely-held firms (where no shareholder dominates 20% votes) are an exception rather than the rule.

India stands out as an exception if one adjudges the percentage of widely held companies in the largest 20 corporates across countries —none of the top 20 listed companies, ranked either in terms of asset size or market capitalisation are widely held.

This profound influence of promoters in corporate ownership in India is mirrored in their dominance on corporate boards. A typical board in India consists of 70% non-executive or outside directors and 30% executive or inside directors. While outsider dominance might be suggested due to the existence of such a large percentage of outside directors, in reality about 20% of these outside directors are affiliated directors, many of whom are relatives or promoters who, as non- executive members will occupy board seats. Essentially, the existence and presence of promoters on company boards has in significantly increased over the years with an apparent jump in 2005—approximately around the time when there was an applicability of stricter governance regulations in virtually all listed companies. Every three out of five Indian companies had a promoter on board, by the year 2008. The increase has been much more significant for positions as inside directors, although promoters have increasingly taken up positions both as inside and outside directors. The above study points out that Indian companies (at least the large ones) are controlled virtually by promoters in terms of both managerial discretion and ownership.[23]

It has been suggested time and again that the board should comprise of a majority of independent directors. Due to promoter dominance in Indian Companies, an adequate representation of independent directors on corporate boards is an essentiality to make their decision count and voice heard. However, the Company Act has mandated that the Central Government may prescribe the minimum number of independent directors in case of any class or classes of public companies.[24] Every listed public company shall have at least one-third of the total number of directors as Independent Directors.

[23]Available at https://www.nseindia.com/research/dynaContent/CG_15.pdf.
[24]Sec. 149(4), Companies Act, 2013; Available at http://shodhganga.inflibnet.ac.in/bitstream/10603/43939/12/12_chapter%207.pdf.

BACKGROUND SCENARIO IN UNITED STATES, UNITED KINGDOM AND AUSTRALIA

ROLE AND FUNCTIONALITY ENTRUSTED TO ID's OFFICE IN UNITED STATES

The history of Independent Directors in US could be traced from 1950 to 2005.[25] Across this period corporate governance and laws contained several nomenclatures when talking about independent directors. Thus the terms outsiders, non-interested, disinterested, non-executive, non-employee and independent were frequently used interchangeably. However the modern day concept of independent director developed over this period. In the same breath if one examines the trend of inculcation of independent directors in the board, it emerges that the initial voluntary action took a mandatory turn. In the light of collapses of Enron, WorldCom, Tyco legislature and regulatory requirements were crafted in the form of the **Sarbanes- Oxley Act, 2002** (hereinafter SOA) and stock exchange rules.

Delaware laws and courts were considered to be most progressive when it came to corporate matters. A catena of decisions and judicial interpretations are helpful in the way in which courts perceived independent directors role in the overall conflict of interest issue. Interestingly, the court considered independent directors to be instrumental in resolving not only conflict of interest situation but also extended their role to protection from controlling shareholders, a concept which theoretical developed much latter. Hence, the answer to this question has been derived in a positive sense since the concept of independent directors has largely emerged in response to several agency and other related problems.

CONCEPT IN USA AND UK

The concept was developed in the US where the primary corporate governance concern is the agency problem existing between on one hand, the shareholders who in theory own the company; and on the other, the class of professional managers. The agency problem arises because although

[25]See Jeffrey N. Gordon, the Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices, 59 STAN.L.REV. 1465, 1473.

the managers run the operations nominally for the benefit of the shareholders, they in fact often have separate agendas of their own.[26]The share registers of most public companies in the UK and the US are characterised by the presence of large institutional investors who own sizeable holdings in the company, but not enough to be able to control its day-to-day operations. As these investors cumulatively hold a majority of the company's share capital amongst themselves, the companies do not have a controlling shareholder. Also as the institutional investors view the investee company shares primarily as financial investments, there are fewer incentives for the shareholders to take part in the management.

Given this skewed power dynamics, these companies are essentially run at the level of board meetings with the general meetings serving merely as a rubber stamp on key issues. If the board meetings are left to be driven by the management, the shareholders will not have much of a say in the running of the company at all. As can be expected, the managers of such companies come to accumulate significant clout and authority, and often pursue their own agendas which are not necessarily aligned with those of the investors. It was in the backdrop of this agency problem that the idea of having non-management directors germinated, with the expectation that these directors who are not beholden to the management will check managerial excesses and protect the interests of the shareholders. This idea has gone through various phases of evolution with consequent changes in terminology.[27] However at its heart, the independent director by whatever name called, remains an institution designed to protect the interests of a dispersed body of investors from the excesses of a self-serving management.

COMPARISON: BRITISH AND AMERICAN COMPANIES WITH INDIAN COMPANIES

In contrast to the American and British companies, the shareholding patterns of Indian companies are fundamentally different. Indian companies have traditionally been and still are, largely

[26]Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034. (1993). *Also see Id*., Urtiaga & Saez, 4.
[27]Donald C. Clarke, *Setting the Record Straight: Three Concepts of the Independent Director*, 4 (The George Washington University Law School Public Law and Legal Theory, Working Paper No. 199).

dominated by family promoters or controlling shareholders.[28]In that regard, most Indian companies share similarities with companies in Continental Europe and also in other emerging markets. Several of the large Indian listed companies had their origins in modest family owned private companies or even sole proprietorships. As their operations grew, these enterprises felt the need to tap more capital and outside expertise; this road eventually leading to their shares being offered to the general public and institutional investors.[29] However the promoter families have mostly retained a substantial shareholding, and often rather zealously (and even publicly) consider the listed company as an extension of the family heirloom.

Given their large stakes, these controlling shareholders can easily control the board and the management; indeed several Indian listed companies have had a history of only having family representatives in senior managerial positions.[30]Apart from family controlled companies, several Indian listed companies have the state as the major shareholder which poses a set of problems that English and American companies do not often have to deal with. Hence, it is evident that the prime corporate governance concern in India is not manager versus shareholder agency problem, but the protection of the minority shareholders from the excesses of the majority. In light of this, it is worth asking the question as to whether the institution of the independent director can serve its intended purpose in the Indian context at all, given the many local variables the original model would have never needed to contend with. Although there are some Indian companies which have diffused shareholding patterns, most large companies have a controlling shareholder. Any corporate governance regime would need to build in the flexibility to accommodate such variations.

AUSTRALIAN INVESTMENT MANAGERS' ASSOCIATION

AUSTRALIA

[28]Paul L Davies, *The Board of Directors: Composition, Structure, Duties and Powers*, Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends, December 7–8 2000, 3.
[29]*See*, Reliance Industries Limited, *Major Milestones*, available at http://www.ril.com/html/aboutus/major_milestones.html (Last visited on 28 July 2013).
[30]*See*, *My Son Will Never Become CEO of Wipro, Azim Premji Says*, Times of India January 23, 2013, available at http://articles.timesofindia.indiatimes.com/2013-01-23/strategy/36504457_1_rishad-azim-premji-ceo-tk-kurien (Last visited on 28 July 2013).

The board of directors of a listed company should prominently and clearly disclose, in a separate section of its annual report, its approach to corporate governance. This should include an analysis of the corporate governance issues specific to the company so that public investors understand how the company deals with those issues.

The Chairperson should be an independent director. If the Chairperson is not an Independent Director, then the independent directors must appoint a lead director who serves as an acting non-executive Chairperson. The board must consist of a majority of independent directors and annually report its required mix of competencies.

Independence: Independent directors are those who are not major shareholders; have not been employed by the company in an executive capacity for the three previous years; are not a professional adviser to the company; are not a significant supplier or customer; have no significant contractual relationship with the company or company subsidiary; and are free from any other business or relationship that could interfere with the individual's capacity to act in an independent manner.

Board committees should be comprised of a majority of independent directors and be free to obtain its requirement of information and resources, both internally and externally, at company expense.

• The board should appoint audit, nomination and remuneration committees.

• Audit Committee Audit committees should be composed only of non-executive directors, a majority of whom are independent, with written terms of reference and should enjoy direct communication with both internal and external auditors.

HOW INDEPENDENT ARE INDEPENDENT DIRECTPRS ON THE BOARDS OF INDIAN COMPANIES EVEN AFTER THE RECENT REGULATORY CHANGES?

In January 2013, SEBI's consultative paper was issues. Several amendments have been made to address the challenges of corporate governance springing up from the existence of dominating shareholders in Indian business organizations. It suggests that independent directors should be approved and appointed by minority shareholders that such directors should be trained formally to be on the board of a company and should be regularly assessed on the basis of their performance. Emphasizing on the need to have a more independent, transparent and professional approach for appointing independent directors, with due representation from the minority shareholders, the

paper issued by SEBI in January 2013 regards to the practices followed in other jurisdictions, for instance the UK, where the regulator has proposed a dual voting structure whereby independent directors of premium listed companies or Italy, that have specific provisions for appointment of Independent Directors by minority shareholders. However, in the Indian scenario that requires one-third or half of the member of the board to comprise of independent directors, the consultative paper points out that in case, if all the independent directors are to be appointed by "majority of minority", it may result in "abuse by minority".

As per the rules framed under the **Companies Act, 2013** a listed company may suo moto or upon receiving notice of not less than five hundred or one-tenth of the total number of small shareholders, whichever is lower, elect a small shareholders' director from amongst the small shareholders. Such director shall be considered as an independent director subject to his giving a declaration of his independence in accordance with **sub-section (7) of section 149** of the Act. While the consultative paper issued by SEBI expresses the view that the provisions of **section 151** may be workable in Indian context, it also suggested that it may be explored as to whether listed companies beyond a market cap need to be mandated to have at least one small shareholder director, SEBI (2013).

At present, despite the new enactments, given the numerical majority that the dominating shareholders exercise over the company's voting strength, nothing prevents them from appointing their nominee as a shareholder director by following the process prescribed in the Companies Act and the Rules framed there under and the expectation of genuine small shareholder representation on company boards remains an illusory expectation.

TATA- MISTRY SHAREHOLDERS v. BOARD BATTLE FOR SUPREMACY

Conflict between shareholders and managers is asymmetric warfare, with shareholders in no position to prevail

EXECUTIVE SUMMARY

- Decision to remove Mr. Cyrus Mistry from position of chairman of Tata Sons has created some sort of a crisis and has threatened the perceived ethically *numero uno* position

savoured by house of Hitherto Tatas (Tata in India Inc.).It has been observed as no nonsense business house and ethical. **The stature is at risk.**

- The activity with immediate effect of removal is inordinate to the account of reasons mentioned, elevating enormous number of questions and doubts. The issue of non-performance, if true, admittedly has been continuing for long time and hence, instantaneous removal does not make any sense.
- Letter war between two different sides is not aiding the element of cause of stakeholders. While on one hand, an E-Mail of Mr. Mistry raises some critical issue, which is required to be effectively clarified or addressed or labelled. On the other hand, it questions the decisions of the board to which the Independent Directors and/or he himself were a party.
- The Board battle has kept the primary role of Independent directors in the leading position. Without cross- examining their right and their decision, the body raises some real essential questions on the issue. On what grounds, the Independent Directors of Tata Chemicals and IHCL have decided to back Mr. Mistry? Do they have the knowledge of the truth? If affirmative, do the Investors know if that? If negative, can they determine the two sides based on letters? Are they competent enough for adjudication? In one aspect, they are guilty of same fast decision, which is being questioned at by Mr. Mistry.
- Independent Directors on the Board of IHCL have unanimously rested faith in Mr. Mistry. However, a serious question springs up here. Amongst many issues, the IHCL issues are notable and of a serious nature. However, due to the collective responsibility of the Boards, these Directors along with Mr. Mistry are responsible equally for mis-governance as well. Mr. Cyrus Mistry accredits all the issues as legacy hotspots and problems. It is pertinent to note that the stakeholders are confused and asking questions why these directors had kept mum for all these years and permitted all such problems to continue.
- Does the decision of IDs to aid Mr. Mistry completes the primary objective of good governance? Is their action shielding the value of shareholders? The body finds that somewhere, in the anxiety to prove and project the independent mind, Independent Directors have forgotten about the interest of the stakeholders. Here, we have a situation where **form has won over substance.**

- These IDs have been associated with the Board(s) of Tata companies for very long; all allegations of Mr. Cyrus Mistry relate to past. Therefore, suddenly how come uprightness of governance and independence which were not in the picture till now have been ignited?
- It of the view that in order to base a ground of high morality that these directors have taken to lay foundation of their independent behaviour, probably they have ignored that their key responsibility is to shield stakeholder value. By supporting an individual, howsoever right it may be, they have created a divided board which is surely going to lead to erosion of value.

SES (Stakeholders Empowerment Services) VIEW:

It is of a strong view that in a dynamic changing state where shareholders keep on changing continuously, there is a requirement for someone to issue directions to the Board and keep an eye on both Board and management. In cases where the representative of is not there, it is achieved mostly in non-transparent manner. It is of the viewpoint that SEBI must start public discussion on the same and devise an effective framework so that none of SEBI Regulations i.e. For example, LODR, Insider Trading and PFUTP are in violation, yet the framework is made effective and functional.

STATEMENT OF INDEPENDENT DIRECTORS

Tata Chemicals- Independent Directors

They recalled and reaffirmed their earlier assessment and evaluation carried out in the year 2015 & 2016 of the Chairman, the Board, and its functioning. The Independent Directors referred to the minutes of the above meetings outcome of which was with the entire Board at that time.[31]

[31]Available at http://corporates.bseindia.com/xmldata/corpfiling/AttachLive/CAD179E8_ED7B_4513_9430_5A8D8B9A5078_175959.pdf.

WHY INDEPENDENT DIRECTORS ARE SUPPORTING MR. MISTRY?

Independent Directors of TATA and IHCL, have praised Mr. Mistry in complete administration for his contribution. The aid of Independent Directors of Indian Hotels to Mr. Mistry was just a result of a situation where most of the Independent Directors were pushed to the wall and where their independence was put to question. **These directors had two choices**

A: In view of questions being raised, if they had opposed Mr. Mistry, they would have faced the same questions as are being faced by Tata Sons IDs, even if that decision was based on solid reasons. In addition, probably their independence would have been questioned.

B: An easy option, although not the best choice was to support Mr. Mistry. It protects their image and they appear to be independent optically. Further, they were of the knowledge that it is only an interim step. This way both Tata and IDs would be winner.

WHAT SHOULD GUIDE INDEPENDENT DIRECTORS?

The guide to the conduct of all directors and not only of IDs is the best interest of the stakeholders. The second measure is that truth should be guiding principle. It is of the view that the full picture has not mostly been seen by the Investors. Independent Directors do not have the mandate to establish and pronounce right or wrong. A divided board is like a vehicle with driver at both end, each trying to move in his own direction. Division at board level unlike dissent, which reflects a healthy board, is counterproductive and destroys shareholder value.[32]

INDEPENDENT DIRECTORS IN INDIA- A WRONG MEDICINE?

Despite its many inadequacies, and vague findings on the impact that Independent Directors have on the performance of the Board and the monitoring quality, it has maintained itself as an

[32]Available at http://www.sesgovernance.com/pdf/home-reports/Tata-Mistry-Shareholders%20vs%20Board-Battle%20for%20supremacy.pdf.

unquestioned characteristic in the framework of corporate governance of several jurisdictions which also encompasses India. When choosing it for implementation in India, the experiences in other jurisdictions like the US and the UK were apparently guiding factors. As observed, the institution was created in the US as a solution to a very specific problem, i.e., the agency problem between the shareholders and the management. However in India, the problem in corporate governance which is given primacy is not the shareholder- manager agency problem but the minority- majority issue.

It is highly believed that the problems might get resolved if the institution is customised adequately to deal with the majority-minority problem. Moreover, the ways in which this customisation may be brought about shall be viewed at.

CHANGING THE ELECTION SYSTEM

One potential curative would be to pioneer proportional representation as the mandatory system for election of directors. In contrast to the simple majority voting system in which the shareholders can vote the number of shares, he owns for each candidate standing for election; each shareholder gets a block of votes equal to the number of shares he owns multiplied by the number of directors to be elected under cumulative voting. The shareholder can then either distribute them among any number of candidates or cast all his votes in favour of one candidate.[33] This particular voting method is usually sanctioned by the minority shareholders because it gives them the option to elect some members of the board if they can unite behind a few candidates. Director election by proportional representation is an option **both under § 265 of the Companies Act, 1956 and § 163 of the Companies Act, 2013**, that may be included in the company's articles. The minority shareholders would have a better chance of getting their nominees on board despite resistance from the majority and hence, it can potentially lead to a more equitable voting system for directors if the company chooses to implement it. Apart from the introduction of mandatory proportional representation, the preferential treatment to the minority may also be enlarged in other ways. One suggestion is to modify the nomination process by necessitating that independent directors should be nominated exclusively by the existing independent directors. This would discard the

[33]See Richard S. Dalebout, *Cumulative Voting for Corporation Directors: Majority Shareholders in the Role of a Fox Guarding a Hen House*, 1989 BYU Law Rev. 1199, 1200.

overbearing and overarching influence of the management and the controlling shareholders from the nomination process, although their power of influence will still be felt in the process of election.

SAFEGUARDING THE INDEPENDENT DIRECTORS

RETHINKING THE REMOVAL PROCEDURE

It is to be considered whether for a better security of tenure, the same protection that the Companies Act, 2013 gives to the statutory auditors should also be extended to the Independent Directors, permitting them the freedom to carry on their mandate without having to worry about the consequences of engaging with the displeasure of powerful people in the company.

LEAD INDEPENDENT DIRECTOR/ NON EXECUTIVE DIRECTOR

Another proposal is the origination of the concept of a lead Independent Director or a non-executive director. This practice is mandated by the UK Corporate Governance Code for FTSE 350 companies, and necessitates that the offices of the Chief Executive Officer and the Chairman should be kept separate.[34] The Chairman is required to be chosen from amongst the Independent Directors on the board.[35] Although there is no requirement for the offices of the CEO and the Chairman to vest in different persons, the position of the lead independent director in American boards occupies a similar position. There is curiously no such requirement in India, although Clause 49 of the Listing Agreement diagnosis the benefit of having a non-executive chairman and allows some relaxation on that basis. Whilst some Indian companies have started having lead independent directors or non- executive directors, it has not become a common practice yet. A non-executive chairman or a lead independent director can alter the dominance of the executive members of the board, and can make the independent directors more efficient and effective.

[34]UK Corporate Governance Code, *supra* note 75, ¶A.2.1: The roles of chairman and chief executive should not be exercised by the same individual.

[35]UK Corporate Governance Code, *supra* note 75, ¶A.3.1: The chairman should on appointment meet the independence criteria set out in B.1.1 below. A chief executive should not go on to be chairman of the same company.

CONCLUSION

In this article, it has been discussed how the establishment of the independent director as it exists, is ill fitted to deal with the majority-minority issue in Indian corporate boards. The rationale behind this, perhaps is that the root of this institution lay in a corporate setting that is fundamentally distinct from that in India. This fact has been explicitly under-theorised. However, there has been more critical examination of this concerned issue recently. For this however, it is important that there must be a formal recognition that the main function that the Independent Directors will play is to operate as the guardian of the minority shareholders against excesses of the majority. Furthermore, definite fundamental legal provisions must be modified so that the nomination and election procedure gives primary importance to the minority shareholders. Also, the functioning styles of corporate boards should be amended to permit the Independent Directors to be able to keep an eye on the executive directors more efficiently. Apart from these, the quality of independent directors has been a concern in this paper and whether they have the skills required for the job. To deal with this issue, there must be a greater weightage on training and orientation.[36]There has even been a proposal to introduce a cadre of professional directors and/or a certification process similar to that for other professions like auditors, accountants etc. be. The Companies Act, 2013 envisions the creation of a central database of independent directors, which may be the primary footstep towards formal regulation of the institution.[37]

[36]Khanna & Mathew, *supra* note 49, 39 (Some interviewees contacted by Khanna & Mathew reported that the training material for independent directors in India were inadequate).
[37]§150, Companies Act 2013.