

THE DEVELOPMENT OF INDIAN CORPORATE LAW VIS A VIS INDEPENDENT DIRECTORS POST THE REVELATION OF THE SATYAM SCANDAL

Written by *Dipankar Aggarwal** & *Yashovarman Chandel***

** 5th year BA LLB Student, OP Jindal Global University, Sonipat, Haryana, India*

*** 5th year BA LLB Student, OP Jindal Global University, Sonipat, Haryana, India*

BACKGROUND

One of the largest financial frauds ever to be committed in India was the Satyam scam. When it was unveiled, Satyam Computers Services Limited was the 4th largest company in India¹. This scam was committed through a combination of misrepresentation of company data, manipulation of assets and liabilities as well as the forging of bills to back such false data. The perpetrator of this scam was Mr. Ramalinga Raju, also the managing director of Satyam Computer Services Ltd. He was involved in manipulating the accounts of the company by underreporting liabilities and making up total assets for around 7-8 years before this came to light. The scam initially started with minor misrepresentations made up by the managing director and it gradually developed into a multi-billion-dollar scam. After recognizing that this scandal was becoming too large to manage, Mr. Raju decided that the only option he had to prevent himself from being caught red handed was to reduce the amount of revenues in the books and to increase the actual number of assets to a figure closer to what was depicted in the books of Satyam Computer Services Ltd. In order to do this, he made a final attempt to make Satyam buy two companies involved in business of infrastructure development as well as construction works (Maytas Properties and Maytas Infra) and make them subsidiaries of his Company. This was to be made possible because Mr. Raju along with some of this family members had a majority stake in these companies and Mr. Raju planned to buy them through

the revenue cash balance in the books which in reality did not exist and depict the assets of these two new subsidiaries on the books of Satyam Computer Services Ltd to narrow the deficit between the fabricated numbers and the real numbers. This acquisition could not materialize because the shareholders sensed something fishy as these two companies had no business relating to the Information Technology sector and the top brass of Satyam clearly had an indirect interest in this acquisition.

Thereafter, Mr. Raju decided to reveal the details of this fraud pursuant to which the Sensex crashed. This scandal revealed the numerous failures of the Indian legal framework. Among those the most obvious one was the failure of independent directors who had owed a fiduciary duty to the company and thereby had to ensure that they were well versed with the workings of the company and also ensure no illegal deeds were being committed. However, their gruesome failure is evident by the fact that the scam was one of the biggest of all times by magnitude and was going on for close to a decade and yet they could not detect it. Thereby in light of this unfortunate scam, this paper would focus on the duties that the independent directors are expected to perform in corporations and also discuss in detail the law that came to be post the discovery of the Satyam scam vis a vis the concept of independent directors.

INDEPENDENT DIRECTORS

The two most important roles that have been put forth for independent directors in corporations by academicians are that of

A Watchdog for Public Shareholders: In Indian context it is necessary to highlight that since most companies have a controlling shareholder there is a risk that this powerful shareholder may expropriate the investment of the other shareholders and behave in self-fulfilling manner without keeping the best interest of the company in mindⁱⁱ. Thus one method of dealing with this issue is by ensuring that the independent directors in the company monitor the actions of the management and especially the controlling shareholders so as to prevent them from using the assets in a manner which is motivated by self-interest and is detrimental to the firmⁱⁱⁱ. Thus

independent directors are expected to be vigilant on behalf of the minority shareholders and lookout for any self-dealing transactions between the company and the controlling shareholder as well as minority freeze out arrangement which may be proposed by such controlling shareholder^{iv}. Thus, by doing so independent directors function as watchdogs, and if they learn about any such wrongful behavior by the controlling shareholder, they can immediately bring it up with them and subsequently in public to protect the corporation.

Strategic Advisor to Controlling Shareholders: The role of independent directors can also be understood as strategic advisors who can give their guidance based on experience to the controlling shareholder, and thereby allowing the company in making better and prudent business decisions going forward^v.

However in the Satyam scandal, the notable independent directors including one who was a former cabinet secretary were unable to fulfill these roles and this could be attributed to the fact that the independent directors of a great number of firms of those times complained that they did not possess the sufficient expertise, resources or training to oversee the affairs of the firm nor were they paid enough remuneration for their roles, along with having very limited interaction with the public stakeholders of the company^{vi}. This is coupled with the belief among certain academicians that independent directors at Satyam, like in other corporates probably felt that they needed to work for those who brought them on the board rather than realizing that a healthy board is one wherein popular opinion is also coupled with expert dissenting views^{vii}.

In light of these shortcomings and a much-maligned global reputation regarding the Indian corporate law framework the Indian legislature embarked on the journey of framing a much more comprehensive company law regime in 2013 as compared to its predecessor of 1956, while focusing strongly on the post of independent directors. Thus, while Section 149^{viii} defines who is an Independent Director and lays out the provisions for his appointment, the requirement that he must not be a promoter of the company in which he is appointed but also not in a subsidiary, holding or associate company helps raise the standard of integrity of Independent Directors. Then, Schedule IV of The Companies Act 2013 gives a detailed “Code for Independent Directors” wherein guidelines of professional conduct, duties, roles, and functions

are laid out to bring transparency and accountability to the post of Independent Directors. Among many others their role includes bringing in an independent judgement on key issues of strategy, safeguard and protect interests of all shareholders, especially the ones in minority and devote sufficient time and effort to their work to be able to make informed decisions. However, surprisingly when the scam took place the listing agreement and the 1956 Act did not precisely define their roles and responsibilities nor their liabilities, which led to a great deal of uncertainty concerning their roles^{ix}.

Further another reason as to why the Satyam scam took place was because the post of these directors was not accountable enough, because of which now Independent Directors will be appointed independently of company management to ensure transparency. As per provisions under section 152^x Independent Directors will have a tenure of 5 years and can be reappointed for another 5 years if a special resolution is passed to that effect. But a 3-year buffer period has to be followed if an Independent Director has served his full term, along with selecting an Independent Director from an established data bank to ensure that Companies do not have an established connection with the Independent Directors, and Independent Directors now have to pass a certain exam with at least 60% marks to ensure that people just by virtue of being friends with the top management do not sit on the Board and that these directors are capable of handling and understanding the nuances of the company matters. These measures are believed to immensely aid in ensuring the smooth and proper functioning of the Board of Directors of a company.”.

Given that one of the core objectives of appointment of Independent Directors is to safeguard the interests of the minority shareholders, liability of Independent Directors must be fixed. “The liability of an independent director can be ascertained through the roles and responsibilities undertaken by such director during the course of his/ her appointment.”^{xi} Post Satyam scam Independent Director has a high liability, but they can only be prosecuted when it is proved that certain matters were brought to their notice, but they decided to turn a blind eye towards these matters Furthermore Section 212^{xii} was amended and the scope of liability was made broad enough to include Independent Directors in it, these are welcome changes

which are considered as necessary to pave the way for transparent and accountable corporate governance.

Analyzing the changes with regard to Independent Directors is important to better understand whether there is an actual benefit of these amendments. Appointment of Independent Directors is a two-step process, after the nomination by the board, it is the shareholders that approve the appointment and that is where the problem lies. The voting system results in favoring the choice of the controlling shareholders and the opinions of minority shareholders are left neglected, which means that a lot of independent directors end up being ‘yes men’ to the chairman^{xiii}. Though it is not expected that they develop an adversarial relationship with the management but wherein they observe that the aims of the management is not in line with those of the corporation they must be strong enough to speak for the ultimate owners and perform their fiduciary oversight duties responsibly^{xiv}. Further, even though Section 151^{xv} exists, where a “small shareholder” can appoint one director which will be considered Independent Director as per Section 149^{xvi}, it is still not enough to ensure that the rights of the minority are protected. In a country like India, majority shareholding is generally with promoters (even in public listed companies), the majority shareholder has a large influence in appointing the directors on the board, thus, one director will not be able to protect the interests of the minority.

While it is true that the above paragraph has listed genuine challenges that arise in the efficient functioning of independent directors, but it is also important to recognize that no law is infallible and so herein we must focus more on the people performing their role as independent directors rather than solely keeping ourselves engrossed in the limitations of the framework. Thus, it is imperative that within the prescribed legal framework independent directors understand their roles clearly and perform their duties ethically as they owe a fiduciary duty to the company. Thus, considering that independent directors have a majority in the Audit Committee they must involve themselves in performing essential functions such as monitoring the end use of funds raised by means of public offers, oversight and scrutiny of inter-corporate loans and investments as well as approval of related party transactions, rather than being present merely to fulfill regulatory requirements of the corporation. Similarly, they should put in efforts to review previous financial statements and call for further information where the

accounts do not show them the full picture while having necessary discussions with such matters with the auditor of the company, along with the Chief Financial Officer and internal auditors^{xvii}. Similarly, those in the nomination and Remuneration Committee should undertake the responsibility of formulating criteria to determine independence of directors and also to analyze their performance. Independent directors should also take into account available indemnity, exculpation and insurance protections being offered to them before they decide to serve on the Board. It is believed that Directors and officer liability insurance protections provide them with comfort to act in the best interests of the company, and allow them to perform their role as a watchdog efficiently^{xviii}. Similarly, among other things it is equally important that the incoming independent directors try to communicate with the existing directors, to understand their reasons for exiting (if any special reasons) and also get an idea about the working of the company and the duties that they are expected to perform in that role^{xix}.

Moreover, it is undisputed that the access to information is limited for independent directors as compared to the promoters and the key managerial personnel reporting to them given that they are not involved in the day to day functioning of the corporation but at the same time it cannot be said that the law has made them entirely toothless. Thus, we find that they are obliged to conduct one separate meeting amongst themselves per year with the aim of reviewing the performance of non-independent directors along with the Chairperson of the Board and also focus on the quality and quantity of necessary information flowing to the Board in order for the Board to perform its duties properly^{xx}. Similarly, as discussed, they also find themselves in critical roles in the capacity of being members of important committees in the company such as the audit committee, risk and compliance committee as well as the remuneration committee.

FOREIGN LAW

The Companies Act, 2013 has largely mitigated the problems and loopholes that existed previously but there are still some measures which need to be implemented for instance,

Independent Directors should be appointed for a term of three years instead of five. For reference we can look at The Corporate governance code^{xxi} issued by the UK Financial Reporting Council, which prescribes a rotation term of three years for independent directors in a company. Reducing the term would help in ensuring that an Independent Director does not get too familiar with the Board and has no vested interest in colluding with perpetrators because he is there for a short period of time. In the UK the independent directors once appointed are required to undergo on-going training to help keep them updated with the business development of the company. The report by Cadbury, Hampel and Higgs which later was included in the UK Corporate Governance Code suggest that the board should have independent directors of “sufficient calibre” meaning that they should know what objective view and understanding they are bringing on board. Another suggestion that can be borrowed from the UK is that Independent Directors should seek professional advice on Company matters and it be done at the Company's expense. If an Independent Director is giving money out of his own pocket, then it will discourage him to take professional advice. The need for advice becomes crucial at times when there is very specific and technical information which may not be comprehensively understandable to the Independent Director but is imperative for his investigation into the conduct of the affairs of the company. Similarly, there is a post of lead independent director in the USA. They are chosen by other independent directors with their primary duty as being the contact point between the board of management and other independent directors. In one of the recommendations by the Kotak committee report, 2017^{xxii} on corporate governance suggested the concept of lead independent directors in cases of non-independent chairperson. The lead Independent Director acts as a liaison between the Independent Directors and the board (consisting of executive directors), thus keeping the Independent Directors in loop with the internal matters of the company. It is true that lead Independent Directors blurs the line between an executive director and Independent Director, but this role is necessary for efficient work by Independent Directors because they should have independent knowledge regarding the internal affairs of the company to ensure the accountability of the company. The recommendation was not accepted by SEBI^{xxiii}, but they need to be adopted for better functioning and to grant access to independent directors in the

actual plans and operations of the company. The Corporate governance guidelines of Australian Securities Exchange have recommended that the majority on board must consist of independent directors. This mandatory minimum is crucial with respect to good corporate governance and shareholder confidence. India needs to adopt these changes happening in the global world of corporate governance where the focus of regulatory bodies is to safeguard the interest of the shareholders and to provide a viable business atmosphere.

CONCLUSION

Hence, at the cost of repetition it is reiterated that the most important aspect in the functioning of independent directors is that they perform their duties ethically as the law does provide them with various responsibilities, and ultimately it is up to each and every individual to ensure that they fulfil their fiduciary duty towards the company and not end up as mere puppets in the hands of the management to abide by regulatory requirements. While doing so, they must also disprove a belief held among many that a major reason for the position of independent directors being weak is due to the fact that Indians are generally not conditioned by society to express their dissent forcefully.

ENDNOTES

ⁱ Shivanna, Manoj. “The Satyam Fiasco- A Corporate Governance Disaster!” (May 2010)
<https://dx.doi.org/10.2139/ssrn.1616097>

ⁱⁱ Khanna, Vikramaditya; Mathew J, Shawn. “The Role Of Independent Directors In Controlled Firms In India: Preliminary Interview Evidencer” (October 11, 2010)
<http://docs.manupatra.in/newslines/articles/Upload/8BC687F7-9B76-4342-A173-28F598A94BE9.pdf>

ⁱⁱⁱ *ibid*

^{iv} *ibid*

^v *ibid*

^{vi} Haldea, Prithvi. “Myth of independent directors: They can only be effective if they are independent of promoters” (October 12, 2020) <https://www.financialexpress.com/opinion/myth-of-independent-directors-they-can-only-be-effective-if-they-are-independent-of-promoters/2104809/#:~:text=Advertisement,Myth%20of%20independent%20directors%3A%20They%20can%20only%20be%20effective,they%20are%20independent%20of%20promoters>

^{vii} Pandey, Payal; Rahman, Faria. “Role of Independent Directors Post Satyam Case” (August 3, 2020)
<https://dx.doi.org/10.2139/ssrn.3644619>

^{viii} Companies Act, 2013. s 149

^{ix} Verma, Bhmesh; Jain, Sara. “Independent Directors: Role, Responsibilities, Effectiveness” (July, 2019)
<https://www.sconline.com/blog/post/2019/07/12/independent-directors-role-responsibilities-effectiveness/>

^x Companies Act, 2013. s 152

^{xi} Alpha Partners, “India: Independent Directors- Roles And Liabilities” (January 4,2020)
<https://www.mondaq.com/india/directors-and-officers/877046/independent-directors-roles-and-liabilities>

^{xii} Companies Act, 2013. s 212

^{xiii} Pandey, Payal; Rahman, Faria. “Role of Independent Directors Post Satyam Case” (August 3, 2020)
<https://dx.doi.org/10.2139/ssrn.3644619>

^{xiv} *ibid*

^{xv} Companies Act, 2013. s 151

^{xvi} Companies Act, 2013. S 149

^{xvii} “Independent directors as pillars of good governance: Role and expectations” (February,2020)
<https://www.grantthornton.in/globalassets/1.-member-firms/india/assets/pdfs/independent-directors-as-pillars-of-good-governance.pdf>

^{xviii} *ibid*

^{xix} *ibid*

^{xx} Companies Act, 2013. Schedule IV

^{xxi} Bupa, “Role of the Non-Executive Director” <https://www.bupa.com/corporate/who-we-are/corporate-governance/role-of-the-non-executive-director> , accessed on 15 April 2021

^{xxii} Kotak committee report on corporate governance, 2017 https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html, accessed on 2 May 2021

^{xxiii} Securities Exchange Board of India (Listing Obligation and Disclosure Requirement) Regulation, 2015

