Independence of Independent Directors

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Abstract

INTRODUCTION

A company is a legal entity of its own, but being an artificial person, they also constitute a body for controlling their affairs, which are the board of directors. A board of directors is the governing body of a company, whose members are elected by shareholders (in the case of public companies) to set strategy, oversee management, and protect the interests of shareholders and stakeholders. Every public company must have a board of directors. The independent director—also known as an outside director—is a member of a board of directors who brings a unique, unbiased perspective. The term "independent director" is commonly used to denote a director who's not an employee of the firm or organization where they serve on a board.

OBJECTIVE OF RESEARCH

There are mainly two controlling bodies present in a company; Shareholders and the Board of Directors. The difference between the shareholders and directors is based on the formation and setup of the company. It is the basis of corporate governance where there is a separation of duties and responsibilities. Mainly the shareholders are the owners of the company or business they are they provide funds to the business in the form of capital. While the directors are the managers of the business, they are the decision-makers in the daily running of the business. While the shareholders have rights to their investments, the directors have responsibilities towards the shareholders and all the stakeholders. The significance of Independent directors is that they don't have a conflict of interest with the companies where they serve. They bring unique expertise, perspective, and background to the boardroom table. And most importantly, they help maintain an objective viewpoint during decision-making. This paper tries to highlight the the importance of the unbiased outlook of the independent directors and how if that outlook is dismayed, the entire purpose gets defeated.

The independent directors' main duties and responsibilities typically include: Protect the interests of all stakeholders, Balance the interests of all stakeholders while making deliberations.

The directors have fiduciary relationship with the shareholders and not the management. There are instances where the objectives of management differ from those of the wide body of shareholders. The non-executive directors must be able to speak up in the interest of the ultimate owners and discharge their fiduciary oversight functions. this is the reason that the independence has become such a critical issue in determining the composition of any Board.

CONCLUSION

This paper aims at critically examining the flaws in the functioning of the independent directors and how it affects the purpose of their creation through case studies and decided case laws.

Keywords: Directors, Independent, Non - Executive, Shareholders, Management

INTRODUCTION:

A company is a legal entity of its own, but being an artificial person, they also constitute a body for controlling their affairs, which are the board of directors. A board of directors is the governing body of a company, whose members are elected by shareholders (in the case of public companies) to set strategy, oversee management, and protect the interests of shareholders and stakeholders. Every public company must have a board of directors. The independent director—also known as an outside director—is a member of a board of directors who brings a unique, unbiased perspective. The term "independent director" is commonly used to denote a director who's not an employee of the firm or organization where they serve on a board.

The corporate governance code adjudicates the use of non-executive directors who are usually independent of management. The non-executive director is a member of the board who does not have any executive management role. Thus, he is not involved in the day to day running of the business and has no contract of employment other than that by which he is appointed as a director hence he is referred to as an 'outside director'. Independence broadly connotes the absence of interest in the enterprise which could affect the bias or exercise of objective judgement.

APPOINTMENT AND QUALIFICATIONS:

Chapter IX of the companies act of 2013, section 149(6) in particular sets out the provisions for the appointment of an independent director. It clearly lays down as to who can be the independent director and their qualifications. The clause specifies that an independent director within a company is an individual distinct from the managing director, a whole-time director, or a nominee director. To qualify, this individual must exhibit integrity and possess relevant expertise and experience as determined by the board.

Additionally, they must not be affiliated with the company's promoters, its subsidiaries, holdings, or associate companies. They should have no relations with the company's promoters or directors, including those of its subsidiaries, holdings, or associate companies. Furthermore, they should not have had any financial ties with the company (including its holdings, subsidiaries, or associates) in the preceding two financial years, with the exception of director's remuneration or transactions not surpassing ten percent of their total income.

Moreover, neither the individual nor their relatives should have any financial or transactional connections with the company (including its holdings, subsidiaries, or associates) in the current or the last two financial years. Specifically, they or their relatives should not have held securities or interests exceeding fifty lakhs or two percent of the company's paid-up capital, been indebted, or provided guarantees or security for a third party's debts.

The individual or their relatives should not have held significant managerial positions or been employed by the company (including its holdings, subsidiaries, or associates) in the last three financial years. They should not have been associated with specific firms such as auditors, company secretaries, cost auditors, or legal firms conducting more than ten percent of the company's gross turnover on behalf of the company or its affiliates.

Additionally, they should not hold two percent or more of the company's voting power alongside their relatives, nor serve as the head of a non-profit organization receiving twenty-five percent or more of its funds from the company, its holdings, subsidiaries, or associate companies.

Finally, the individual must possess the qualifications as prescribed. The qualifications so prescribed are elaborate and detailed to serve the purpose and objective of the existence of independent directors.

The criteria for independent directors as outlined in the Companies Act serve various essential functions:

Ensuring Neutrality: Independent directors are entrusted with providing an impartial and fair viewpoint in the decision-making processes within a company. These rigorous criteria are in place to ensure that these directors remain free from personal biases or affiliations that could compromise their autonomy.

Boosting Corporate Governance: Independent directors play a vital role in upholding robust corporate governance. Their duties often involve supervising stakeholders' interests, scrutinizing management choices, and offering strategic advice. The qualifications exist to guarantee that these individuals possess the necessary expertise and background to effectively carry out these responsibilities.

Avoiding Conflicting Interests: By specifying that independent directors should have no financial ties or associations with the company, its promoters, or its subsidiaries, the Act aims to avert potential conflicts of interest that could emerge from such connections.

Upholding Ethical and Professional Standards: The qualifications establish a benchmark for ethical conduct, professionalism, and proficiency within a company's board. They aim to ensure that individuals serving as independent directors are of high standing and bring valuable insights and experience to the boardroom.

Safeguarding Shareholder Interests: Independent directors are responsible for representing shareholder interests and acting in the company's best interest. These qualifications aim to protect shareholder interests by ensuring the presence of individuals who can effectively oversee these responsibilities.

Compliance and Regulatory Needs: These criteria align with legal requirements and compliance measures set by regulatory bodies to ensure that companies adhere to governance norms and criteria established by the Companies Act.

Although the criteria may appear extensive, they are crafted to uphold a high level of professionalism, integrity, and autonomy within the board. These elements are pivotal for a company's effective operation and sustained development.

THE QUESTION OF INDEPENDENCE:

Aside from receiving director compensation, independent directors are not involved in any significant financial transactions or relationships with the company, its promoters, its directors, senior management, its holding company, subsidiaries, or associates that could compromise their independence.

However, in practise, who chooses these Directors? Without a doubt, the independent director is chosen by the shareholders. However, if we look at the procedure for choosing an independent director, the current directors are the ones who suggest independent candidates, and they do so after consulting with the promoters and the shareholders accept the nomination on the basis of the recommendation of the Board.

In a major scenario, the promoter owns the majority of the company's shares and controls the makeup of the board. Even shareholders have the ability to vote on who becomes a director; the majority's dominance guarantees that their preferred candidate will be chosen. Since an independent director's tenure is dependent on the other directors, it is practically impossible to accept that an independent director will act impartially against the wishes of the majority shareholder.

ACCOUNTABILITY AND CREDIBILITY:

The position of Independent directors in a company is such that, their accountability and credibility is very important to the company. Schedule 4 of the Companies Act, 2013 discusses the independent director's duties and code of behaviour under Section 149.

Simply said, accountability is the same as "responsibility." The phrase in this instance relates to the director's duties, or alternatively, "for what an independent director be questioned off." The seriousness of the issue and the director's part in the wrongdoing are reflected in the director's responsibilities. Directors with larger financial responsibilities within the organisation are likely to face higher scrutiny from investors. Since they determine the company's financial structure and bear the responsibility for any significant costs.

Accountability and credibility are mutually exclusive. If one of them falters, questions are raised about the other. A credible individual will be the only one given the task; if there is any irregularity, he will only be held accountable after that.

The idea that the independent director is dependable, trustworthy, and capable of carrying out the duties assigned to him is known as credibility. A director must carry out all of the tasks entrusted to him and adhere to the Act's code of conduct in order to retain credibility.

We have learned from previous scams, such as the 2G Spectrum Scam[1], that independent directors, bureaucrats, and politicians are interested insiders who are accountable for the scam, that independent directors must be screened and verified regardless of whether they are warranted or not. A probe was later launched against them. Although the precise amount of the scandal is still unknown to the CAG, it is likely to be around Rs 1.76 lakh crore. The Manmohan Singh-led government's demise in 2014 was ultimately due to this scandal.

It is necessary to verify the independent directors' reliability. Periodically verifying their sources, contacts, communications, linkages, confidentiality, and vetting them for insider trading will help to prevent problems. The corporation, IT authorities, the CBI, etc., perform these scans on the directors. If the director's privacy is compromised by scanning, no one would be prepared to serve as an independent director. It must be remembered that there ought to be some form of a monitoring system that protects the directors' privacy; The scan ought to be carried out legally and shouldn't interfere with the director's privacy; The Central Government must specify precisely when intervention is permitted. Additionally, their office must not be subjected to needless interference, nor should covert cables be put for the purpose of monitoring.

A probe of the actions of the company's directors may be warranted for a variety of reasons, including the following: Insider trading: Independent directors possess important information about the company that they can utilise to their advantage and make a disproportionate profit.

Lack of knowledge: Independent directors are expected to be experts in the areas in which they oversee; in the event that a director is ignorant or inexperienced, this could lead to the directors making poor decisions and possibly put them in legal hot water.

Violation of corporate governance guidelines: It is expected of independent directors to adhere to corporate governance. A director may be subject to an investigation if he disregards the guidelines outlined in various acts that govern Indian corporations and is unable to carry out his responsibilities.

[1] https://www.thehindu.com/topic/2G_Spectrum_Scandal/

Personal interest: An investigation may be ordered against an independent director if he has a personal stake in the company's operations.

The Various instances where questions regarding the independence of directors has been listed as follows:

Scandal surrounding Satyam: "Satyam Computers" was a gem in the Indian IT industry. At the time of the scam, it was India's fourth-biggest IT company. The CEO of Satyam, Mr. Ramalingam Raju, accepted responsibility for the fraud and admitted to inflating the company's revenue and financial records. In an effort to attract investors, he further stated that he had exaggerated all of the company's financial figures. When the Independent directors were put into question, it was found that they were handicapped in performing their duties, they lacked the expertise to discharge their functions, on the basis of which they were appointed. [2]

Crisis at Yes Bank 2020: In March 2020, the RBI took over management of India's top financial institution due to a crisis. All of Yes Bank's independent directors were called into question because they were unable to carry out their responsibilities and could not order the company's management to follow the required procedures. The RBI then assembled a new management team. All of its senior executives, including Mr. Rana Kapoor, the company's founder, were taken into custody. This crisis served as a reminder of how crucial it is for independent directors to carry out their responsibilities and monitor the company's financial irregularities; if they are unable to perform their duties, then a large chunk of the masses would be impacted by it.[3]

The Nirav Modi scandal involves the issuance of a fictitious Letter of Undertaking (LOU) by Punjab National Bank staff members to Nirav Modi and his business in order to obtain a loan from foreign banks. The LOUs were given out without any security. The estimated value of the scam was Rs. 14,000 crore. The incompetence and incapacity of the independent director were questioned since they failed to spot the financial scam that had been going on for years until a foreign bank questioned the legitimacy of the bank's LOUs. They were careless and incapable of carrying out their responsibility to carefully examine the company's finances and failed to see the significant financial error. This had led to a probe against the independent directors of the company and the removal of most of them.[4]

Regarding Pyramid Saimara Theatre Limited (PSTL), on March 11, 2011, SEBI issued an order barring three of its independent directors—Mrs. K.S. Kasiraman, Mr. K. Natarahjan, and Mr. G. Ramakrishnan—from serving as independent directors or audit committee members of any listed company for a two-year period beginning on that date.

The order was issued on the grounds that PSTL's independent directors disregarded their duty to prevent the company from making false and deceptive disclosures in its financial statements, which were later discovered to contain fictitious entries that artificially inflated profits and revenues. The independent directors contended that they were not in charge of the day-to-day operations of the company and that they attended board meetings where only general policy issues were discussed, but SEBI rejected their claims.

More than a week after Cyrus Mistry was removed from the top position in the Tata Group, the seven independent directors of Indian Hotels Company (IHCL) firmly supported the company's chairman. Mistry was the chairman of the Tata Group. The choice made by independent directors will make Tata Sons' attempt to remove Mistry as chairman of Tata Group companies more difficult.

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[2] https://www.hindustantimes.com/business/satyam-scam-all-you-need-to-know-about-india-s-biggest-accounting-fraud/story-YTfHTZy9K6NvsW8PxIEEYL.html (Last visited on 3rd November, 2023)

[3] https://www.business-standard.com/about/what-is-yes-bank-crisis (Last visited on 3rd November, 2023)

[4] https://www.business-standard.com/about/what-is-pnb-scam (Last visited on 3rd November, 2023)

The independent directors of THCL, which operates the Taj hotel chain, said in a statement to stock exchanges that they "take into account board assessments and performance evaluations carried out over the years, the independent directors unanimously expressed their full confidence in the chairman, Cyrus Mistry, and praised the steps taken by him in providing strategic direction and leadership to the company." Deepak Parekh, Keki Dadiseth, Ireena Vittal, Nadir Godrej, Vibha Paul Rishi, Jagdish Capoor, and Gautam Banerjee are the independent directors on the IHCL board. "After deliberations, the independent directors came to a view that being a listed company, it was imperative for the independent directors to state their views to the investors and public at large, such that those who trade in securities of the company make an informed decision," stated the statement sent to the BSE.
After all of this, the question regarding the credibility of independence directors arise and their purpose vanishes.

REVIEW OF LITERATURE:
The concept of "independence" is central to the independent director system's vitality and efficient operation, serving as its cornerstone and essence. The number of independent directors on the board was first used in the literature as a proxy variable to measure the independence of the directors (Cotter et al., 1997][5]; Weisbach, 1988[6]; Bhagat and Black, 2002[7]
Researchers Yiming Hu and Songlian Tang examined the relationship between independent directors and the accuracy of financial reporting in publicly traded firms. Their results showed that better earnings information was linked to independent directors, especially those with significant presence on the board and backgrounds in finance or accounting. Over time, there has been a shift in how independent directors are measured. Using information from Chinese listed companies, Kangtao Ye and Jigao Zhu investigated the autonomy of independent directors in their managerial oversight capacity. They noted that while independent directors generally refrained from directly challenging management, this tendency increased during times of subpar business performance. Furthermore, independent directors who had served for longer periods of time prior to the chairman's appointment, had better reputations, stronger financial backgrounds, and were more likely to challenge management choices. When there was a disagreement between the company and an independent director, Quanxi Liang and Haijian Zeng discovered a significant risk of stock price collapse. They were examining the impact of independent directors' independence on management.
Some studies have examined the relationship between independent directors and both internal and external factors, in addition to closely examining the supervisory role of independent directors. Changwen Zhao emphasised the increasingly proactive involvement of independent directors in family-owned businesses' corporate governance. After studying how the independent director system interacts with other corporate systems, Zhigang Zheng and Xiuhua Lu came to the conclusion that governance mechanisms like major shareholder supervision and management compensation incentives, as well as the effects of board independence, reinforce each other. They also pointed out a different connection between equity checks

[5] Cotter, J.F., Shivdasani, A. and Zenner, M. (1997) Do Independent Directors Enhance Target Shareholder Wealth during Tender Offers? Journal of Financial Economics, 43, 195-218.
https://doi.org/10.1016/S0304-405X(96)00886-0
[6] Weisbach, M.S. (1988) Outside Directors and CEO Turnover. Journal of Financial Economics, 20, 431-460.
https://doi.org/10.1016/0304-405X(88)90053-0
[7] Bhagat, S. and Black, B. (2002) Non-Correlation between Board Independence and Long-Term Firm. Journal of Corporation Law, 27, 231-273.

and balances and safeguards for investor power. It was discovered that the establishment of China's independent director system strengthened the governance impact of significant shareholder oversight and management pay incentives, but it may have diminished the influence of improved legal frameworks and equity checks and balances. Through its interactions with other governance mechanisms, board independence has an indirect impact on corporate governance.

Based on their professional backgrounds in accounting, Xi Wu, Chunfei Wang, and Zhengfei Lu investigated three distinct models of independent directors and auditors. The models included the following: hiring former firm employees as independent directors ("pre-peer" model), hiring independent directors from within the company but not from the chief audit firm ("peer" model), and hiring employees from the chief audit firm as independent directors ("same door" model). The effects of each model on independent directors' independence were different. Furthermore, Rui Chen and Zhi Wang talked about what happened when independent directors voiced disagreements. They discovered a "reverse elimination" effect in which there was a greater chance of independent directors quitting and a lower degree of independence and reputation among their successors.

Some studies have attempted to ascertain whether the independent director system can mitigate agency problems by directly examining the correlation between the proportion of independent directors and company performance, owing to a limited understanding of the decision-making process of the board of directors. However, because of possible correlations with missing variables, this approach is prone to endogenous issues. When attempting to directly correlate the percentage of independent directors with the performance of the company without first obtaining concrete proof of the decision-making process, Pettigrew (1992) [8] advised against making overly sweeping assumptions. This paper measures the independence of re-elected directors through objections raised by independent directors, using China's unique mandatory disclosure data, namely independent directors' opinions and voting results on board resolutions.

Comprehensive theoretical insights into the ownership and control dynamics within a company are provided by Fama and Jensen (1983). They contend that agency issues can be lessened by giving the board of directors managerial decision-making authority and control. But if a manager also has control over the board at the same time, there could be collusion between them to take advantage of dispersed shareholders. In order to oversee and protect shareholders' rights from possible violations by management, independent directors are added to the board.

The primary focus of research is on the oversight and advisory functions of independent directors in governance. The subject of corporate governance studies continues to be the efficacy of independent directors in protecting investor interests and improving company performance. There is disagreement, though, as some research indicates a favourable relationship between the performance of businesses and the presence of independent directors, while other studies reject this relationship.

According to Adams et al. (2010)[9], independent directors have a supervisory role that includes choosing, assessing, and firing management in order to cut agency expenses. According to Weisbach (1988), independent directors may be able to strengthen the connection between CEO turnover and business

[8] Pettigrew, A.M. (1992) On Studying Managerial Elites. Strategic Management Journal, 13, 163-182. https://doi.org/10.1002/smj.4250130911

[9] Adams, R.B., Hermalin, B.E. and Weisbach, M.S. (2010) The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey. Journal of Economic Literature, 48, 58-107.

success. According to Core et al. (1999)[10], independent directors have the power to prevent CEOs from being paid excessively. However, developed markets and the conflict of interest between shareholders and management are the main subjects of these findings.

The role of independent directors in emerging markets, especially in China, has shifted to preventing large shareholders from encroaching on minority shareholders. Dewu Zhao provides empirical evidence that shows the beneficial effect of independent directors' supervisory authority on the stability of earnings. According to other research, the supervisory role is measured by corporate infractions, and the presence of independent directors raises the probability of rule violations.

Studies explore the relationship between the personal attributes of independent directors and the performance of the company, taking into account variables like tenure, gender, education, work experience, and network location. Studies on the role of independent directors with administrative backgrounds have been prompted by the "resignation tide" of official directors in China, which suggests that their supervisory function is weaker.

Through advisory and supervision mechanisms, the effectiveness of the independent director system is examined in two lines of literature. The majority of independent directors support the advisory function, offering their professional judgement on matters such as project selection and company strategy. But too much independence could make it more difficult to share information, which would undermine the advisory role. According to some studies, independent directors with a background in banking tend to have a more prominent advisory role.

The phenomenon of independent directors being re-elected is not well studied, despite the fact that existing literature covers many aspects of independent director roles in great detail. Although studies on personal characteristics sometimes refer to the term of office, theoretical analyses of reappointment and the phenomenon of re-election are rarely discussed. Sustained theoretical reasoning and empirical testing are necessary to explain and direct the practical development of independent director practises in listed companies as China's independent director system changes.

WAY FORWARD:

When the purpose and credibility of independent directors are being questioned, their appointment "seems" to be redundant, not because the position is flawed; but that there is a shortage of credible candidates.

There is a perception that independent directors should only serve as watchdogs or whistleblowers on the board in discussions about them nowadays. Regretfully, this viewpoint has resulted in Indian boards being uniform and largely centred around compliance. Rather, a multidisciplinary team that can analyse problems from multiple angles and add value to overall performance is required, as opposed to just looking at things from a compliance perspective.

Unfortunately, there is a general consensus that a company with well-known individuals on its board is naturally better run. The combination of this belief and the idea that there aren't many suitable applicants leads to a tendency to keep going back to the same people. However, higher standards of corporate governance are not always guaranteed by having well-known names on the board.

[10] Core, J.E., Holthausen, R.W. and Larcker, D.F. (1999) Corporate Governance, Chief Executive Officer Compensation, and Firm Performance. Journal of Financial Economics, 51, 371-406. https://doi.org/10.1016/S0304-405X(98)00058-0

The appointment of independent directors needs to be done with greater professionalism, objectivity, and transparency in order to meet these challenges. It is critical that businesses actively seek candidates for non-executive roles based on these criteria and match their strategic priorities with the required competencies in the boardroom. A business that plans to grow through acquisitions, for instance, ought to appoint a board member with experience in post-acquisition integration. Similar to this, a corporation growing internationally from its strong domestic base needs a board member with expertise in international business development.

The practise of including senior management executives from diverse and sizable groups—apart from CEOs, MDs, and promoters—in non-executive roles on the boards of other companies is a noteworthy but uncommon one in Indian companies. The main cause of this is that companies are reluctant to let their senior executives assume these kinds of responsibilities outside of their day jobs.

The idea of keeping an independent body in charge of an independent panel of directors has come up in recent discussions. It's unclear, though, if choosing an independent director from this kind of panel would actually improve governance. In the end, the CEO and the company will decide who should be an independent director in addition to the board's oversight. The CEO, the board, and the board itself must work together to determine the necessary skill set in order to guarantee the proper composition of the board.

THE NEED FOR AN EFFECTIVE ON BOARDING PROGRAMME:

Although it is true that companies have been sluggish to provide independent directors with thorough orientation and training, it is also true that independent directors have not given this aspect much thought. Given the current climate in which additional responsibilities are being assigned to independent directors, it is imperative that new members assimilate quickly into the core issues facing the company, particularly if they are not familiar with it.

Despite the fact that most businesses have a standard onboarding process that includes meetings with important individuals such as the CEO, CFO, Chief Internal Auditor, Legal Counsel, and the Board Chair, many believe that these processes fall short of giving independent directors a comprehensive understanding of the business, the industry, and its main challenges. It is crucial to inform independent directors about the company's financial reporting problems or recent successes, as well as the business model, industry, and competitive environment. Developing a director handbook that provides a thorough overview of the board's oversight procedures and the company's important operational, financial, and other risks is a recommended practise for onboarding.

Updates on business units are essential for assisting independent directors in understanding the unit's strategy, operational outcomes, and major financial and non-financial risks, according to research from KPMG's Audit Committee Institute. It may be necessary to ask Legal Counsel, Internal Auditor, or External Auditor to investigate these risks in more detail.

The company's and its industry's particular legal and regulatory compliance issues should be covered in the onboarding programme. If time allows, outside experts may be invited to address these issues with the audit committee and independent directors during formal meetings or special in-house training sessions. The effectiveness of an onboarding programme ultimately rests on how well it is tailored to each director based on their current level of experience and expectations for their role.

CONCLUSION:

According to research conducted by KPMG's Audit Committee Institute, it is critical to keep independent directors informed about updates from business units. Directors can better understand the unit's strategy, operational results, and major financial and non-financial risks with the aid of these updates. It could be wise to consult with a legal counsel, internal auditor, or external auditor to learn more about these risks. Particularly, the onboarding programme ought to cover legal and regulatory compliance matters that are pertinent to the business and its sector. If time allows, outside experts could be invited to address these matters in formal meetings or special in-house training sessions with the audit committee and independent directors. The ability of the onboarding programme to be tailored to each director individually, taking into consideration their expectations for their role and current experience level, is critical to its success.

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