Post Satyam Case: A Study of Impact on Role of Independent Directors

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Abstract:

Purpose – Independent directors are viewed as partners of management and as outside guardians whose job is to make sure that management stays focused on delivering shareholder value. They are the watchdogs, the one responsible for safeguarding the interest of minority shareholders. A serious question has been raised on the creditability of such ‘independent directors’ after Satyam scandal erupted and four independent directors of the company resigned. The study aims and analyzes the impact of Satyam scandal over the role of independent directors in corporate governance.

Design/methodology/approach – This research is a pure doctrinal research. It includes critical analysis of various reports like Kumar Mangalam Birla Committee’s Report on Corporate Governance, Blue Ribbon Report etc. The research also studies various judgments, articles and statutory provisions such as Clause 49 of Listing Agreement, regarding independent directors.

Findings – The research instruments such as reports and judgments are both authentic and reliable. The analyses reveals that through various enactments through various judicial decisions and reports there have been a positive impact on corporate governance vis-à-vis independent directors.

Research limitations/implications – This is a purely doctrinal research. It is limited to judgments passed by courts in India and enactments thereafter.
Practical implications – The result of this study will facilitate the corporate institutions and their stakeholders to understand the necessity of corporate governance. It will also help them to understand that how independent directors can be beneficial in providing corporate governance.

Originality/value – This study is probably is first to determine the impact of Satyam scandal over the role of independent directors in corporate governance. It offers a beneficial source to those corporate institutions, which are still lagging behind when it comes to corporate governance.

Keywords Corporate Governance, Independent Directors, Clause 49 of Listing Agreement, Satyam Scandal, Law and Ethics

Paper type Doctrinal Research Paper
CHAPTER-I

INTRODUCTION

On 7\textsuperscript{th} January 2009, just four months after receiving the ‘Golden Peacock Award’ for global excellence in corporate governance, a confessional letter from the founder and Chairman of the Indian’s fourth largest IT company, Mr B. Ramalinga Raju, came as a great shock to the Indian Corporate Industry, and it had never been the same thereafter. The historic confessional letter divulged an unprecedented multibillion dollar accounting scam. The admission of Rs 78 billion has caused the regulators and the investors everywhere to re-examine the corporate governance standards. The fact that company which was audited by one of the most prestigious audit firms and adopted most advanced accounting and transparent IFRS accounting system much ahead of time can penetrate such a colossal and a global fraud is clearly eye opening for corporate counsel worldwide. It was triggered with Satyam’s bid to acquire Matyas companies for US$ 1.6 billion.\textsuperscript{1} Though there are adequate checks and balances in the system to prevent fraud, it is the slack attitude of each institution responsible for upholding corporate governance that made such a fraud. One of such regulatory institution is of independent director. The role of independent directors now needs an urgent attention. It has been that there have been times when independent directors have disowned any responsibility, to others when they have face criminal charges for misdeeds done before they were even on board. Some are accused of excessive interference and infringing on executive responsibilities, while others are seen as mere yes-men of the promoters. A better understanding of independent directors is therefore essential.\textsuperscript{2} An event like this is a great learning experience, and there are many lessons that can be drawn from it and many have been drawn. Certainly, it calls for a close re-examination of the regulatory
framework. What can be done by way of mandatory requirements to prevent and deter such occurrences?\(^3\)

**NOTES**


3. Ibid
CHAPTER-II

DEFINITION OF INDEPENDENT DIRECTORS

In corporate governance literature, and in legislative and regulatory documentation around the world, several terms such as independent, unrelated, outside, disinterested, and non-executive directors, are somewhat interchangeably used to denote broadly independent directors. In fact, the connotations of these terms may vary. Academic attention has been devoted to discerning these precise meanings and the practical applications in which their specific attributes are relevant.\(^1\) An umbrella description, *non-management director*, has been suggested to cover all such directors on the basis that their common attribute in most jurisdictions requires them not to be part of the executive management of their companies.

‘Independence’ connotes largely economic and financial freedom from the company and its executive management, such that it can enable individuals to serve, without being inhibited by personal considerations of monetary losses, as a check on management in the interests of shareholders. Most definitions of independence incorporate conditions and circumstances that would enable the individual to do what appears to be just and right, without worrying about being in the good graces of executive management. While, as we shall see, this led governments, regulators and institutional investors to become more precise and explicit about the independence criteria, it has a natural corollary, and perhaps unwittingly, resulted in check-box ticking to demonstrate compliance without being internalized by organizations. Obviously, little else can be done in a rule-based framework but the courts could in their wisdom expand the scope of inquiry to ascertain more than just financial or economic impediments to independence of an individual.\(^2\)
In India, as of now, The Companies Act does not refer to independence anywhere in relations to directors. It only recognizes executive and non-executive directors. The Kumar Mangalam Birla Report and the listing agreements recognizes three distinct groups of directors, namely, executive, non-executive non-independent, and non-executive independent. The category of non-executive non-independent directors is presumably a recognition of ground realities that requires accommodation, in case of several family-run boards, besides the general objective of bringing a broader view to the company’s activities. The listing mandates however, draw a line when it comes to unbiased and objective decision-making. By insisting upon the proportion of independent directors on a board and also in constituting key committees of the board and their chairs.  

According to Naresh Chandra Committee, independent director was defined as follows:-

An independent director of a company is a non-executive director who:

1. Apart from receiving directors remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;

2. Is not related to promoters or management at the Board level, or one level below the Board (spouse and dependent, parents, children or siblings);

3. Has not been an executive of the company in the last three years;

4. Is not a partner or an executive of the statutory auditing firm, the internal audit firm that is associated with the company, and has not been a partner or an executive of any such
firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have material association with the entity;

5. Is not a significant supplier, vendor or customer of the company;

6. Is not a substantial shareholder of the company, i.e. owing two per cent or more of the block of voting shares;

7. Has not been a director, independent or otherwise, of the company for more than three terms of three years each (not exceeding nine years in any case);⁴

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2. Ibid.


4. The Institute of Company Secretaries in India (2007), Corporate Governance (Modules of Best Practices), 6th (Revised) Edn, New Delhi, Taxmann Publications (P.) Ltd, p.127-128
CHAPTER-III

ROLE OF INDEPENDENT DIRECTORS

A governance disaster of the Satyam kind was quite predictable given the lag in governance best practice in India. For example, clause 49 of the Listing agreement gives details of corporate governance issues to be followed by companies. But the reality is that the clause is adhered to more in theory the in practice, and nobody – least of all the capital market regulator – has done anything about this. Reporting on corporate governance by listed companies, which runs into innumerable pages in annual reports, is more often than not a meaningless ritual.

The Satyam board including its five independent directors, had approved the acquisition of Maytas Infra and Maytas Properties, owned by the Raju family. Without taking shareholders into confidence, the directors went along with the management’s decision. The fact that the company was spending money on a totally unrelated business at a time when its core business of SAP needed to be consolidated (after competitor HCL Technologies bought Axon which is strong in SAP) did not deter the board. This was curious, particularly which is keeping in mind the luminaries who sat on the board.

As it happens, Satyam is not alone in being partisan in its selection of independent directors. The fact that independent directors are quite often friends or associates of the management or controlling shareholders has become one of the major weaknesses of corporate governance in India. Former SEBI Chairman M Damodaran repeatedly drew attention to the fact that some directors became permanent entities on the board.

A round table discussion organized by Spencer Stuart, one of the world’s leading executive search consulting firms, showed that quite a few independent directors in Indian companies are
nominees of the chairman or the CEO and perform the role of ‘nodders’ – they nod in agreement at everything the chairman says. The vast majority, however, are people conditioned by culture i.e. of not expressing dissent very forcefully. A study by AT Kearney, AZB & Partners and Hunt revealed that 90 per cent of the companies they surveyed appointed independent directors using referrals from the CEO or chairman. Observers say the result is obvious: directors so appointed want to be viewed by the controlling shareholders as flexible and cooperative rather than rigorous or principled.

The only way to improve the situation is to have better evaluation process for the board members. The AT Kearney survey showed that the boards of Indian companies assessed themselves in 64 per cent of cases. In developed nations, however, over 70 per cent of companies had independent agencies evaluating their performances. Boardrooms in the US now use an improved process for selecting new board members that is normally led by the nominations committees. These sessions allow independent directors to discuss the effectiveness of the management, the quality of board and other issues or concerns. In spite of initial resistance, boards have found the practice so useful that many hold an executive session after every board meeting rather than the suggested once or twice a year.

In India the board reviews have faced similar resistance. The evaluation criteria include the independent directors’ ability to contribute to, and monitor, the company’s corporate governance practices, active participation in long-term strategic planning, and commitment to the fulfillment of a director’s obligations and fiduciary responsibilities. It is argued that the information available to independent directors is inherently limited and they can in no way prevent willful withholding of crucial information. But even if outside directors were unaware of the true state
of Satyam’s finances, some red flags should have been noticed. Though board members were not responsible for re-auditing financial statements, they had access to the auditors and the right and responsibility to question the audit. So, for example, on seeing an accumulated $1 billion on the books, the audit committee should have questioned the company’s plan for the cash, or how much it was earning on the money, which nobody bothered to do.¹

The Naresh Chandra Committee while expressing its view on the role of directors said, “at the core of corporate governance is the Board of Directors. Directors are fiduciaries of shareholders and not of the management. This does not imply that the Board must have an adversarial relationship with the management, but where the objectives of management differ from those of shareholders, the non-executive directors on the Board must be able to speak in the interest of the ultimate owners, and discharge their fiduciary oversight functions. This is why ‘independence’ has become such a critical issue in determining the composition of any Board. Clearly, a Board packed with executive directors, or friends of the promoter or of the CEO, can hardly be excepted to exercise independent oversight judgment.”²

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2. The Institute of Company Secretaries in India (2007), Corporate Governance (Modules of Best Practices), 6th (Revised) Edn, New Delhi, Taxmann Publications (P.) Ltd, p.127
CHAPTER-IV

CONCLUSION

Nomination committee can be advisably established comprising solely of independent directors or a majority of independent directors empowered to appoint the board and evaluate its performance. Although evaluation of performance is not yet mandatory under the extent of corporate governance regime yet it might yield a better result and in further coarse of time it should be made compulsory.

There should be a fixed tenure beyond which an independent director should not be associated with a company. An aggregate limit of nine years has been prescribed under clause 49 VII (ii) of the equity listing agreement, but such a requirement is not mandatory.

Regarding the remuneration of the independent directors the pecuniary payouts are usually incommensurate with the onerous role they perform. Adequate remuneration may ensure that the directors discharge their duty with care and diligence rather than just playing an ornamental role in the organization. Another step that might ensure a better working is that the independent directors should meet separately without any member in the management to discuss the affairs of the company. This would help them to make decisions on matters without being euphemistically ‘guided’ by the management.

*Limit on number of Directorships:* In case an individual is a managing or whole-time director in a listed company, the number of companies at which such an individual can serve as non-executive director, be restricted to 10, and the number of listed companies at which such an
individual can serve as a non-executive director, be restricted to 2. The maximum number of listed companies in which an individual can serve as a director is to be restricted to 7.

*Separation of roles of Chairman and CEO:* There should be a clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/CEO. The Roles of Chairman and CEO should be separated to promote balance of power. A “comply or explain” approach should be adopted.¹

**NOTES**

REFERENCES

Books:
3. The Institute of Company Secretaries in India (2007), Corporate Governance (Modules of Best Practices), 6th (Revised) Edn, New Delhi, Taxmann Publications (P.) Ltd.

Journals: