

A Study on Role of Independent Directors in Protecting the Rights of Minority Shareholders

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Abstract

The companies Act, 2013 mentions having minimum one -third of the total number of independent directors in the listed companies under section 149(4). The role of independent directors has been under scrutiny recently. It has been believed that the concept of Independent Directors has resulted in improved boardroom conditions. The step has brought effective measures in the matters relating to fraud and mismanagement. Independent directors are appointed for the company's welfare, and no shareholder holds a contribution towards appointing them. The Independent director doesn't possess a personal interest in the company and is assigned to present their neutral view of the company's interest matters. However, they can be dismissed through the voting rights of majority shareholders. Independent directors can also use their powers to save minority shareholders' rights by objecting to the wrong decisions. Their role has been crucial in Corporate Governance, which will be further discussed in this research paper.

Keywords: Independent directors, Corporate Governance, Fraud, Mismanagement

1. Introduction

The increasing number of minority shareholders raised the demand for Independent directors. The corporate governances have undergone many changes in the last couple of years, and Emerging of Independent director's lies one of them. After the Satyam scam was happening in 2009¹, many Independent directors had to resign from their post,

¹ Knowledge Wharton. *Scandal at Satyam: Truth, Lies and Corporate Governance – Knowledge Wharton*. 2021. Available at: <https://knowledge.wharton.upenn.edu/article/scandal-at-satyam-truth-lies-and-corporate-governance/> [Accessed 25 January 2021].

demonstrating powerless conditions. Promoters always dominated their position, and the Independent Directors need to fulfill minimum requirements stated in the definition of International Finance Corporation. The emergence of liberalization, globalization, and privatization has a significant role in the formation of Independent Directors. It is believed that the presence of independent directors had contributed to improvising the quality of corporate governance. The Independent directors need to provide a declaration in their first board meeting and every company's financial year. Independence directors are also not held accountable for matters pertaining outside their preview and knowledge.

Independent directors started taking an interest in reviewing the risk management and risk of fraud. For shareholders, wealth maximization is the crucial objective, and having similar independent directors in all these companies can result in fruitful. It also leads to better functioning of the companies without any conflicts.

SEBI mandates 10-15 percent of the composition on the board should consisting of Independent Directors. Such authority's steps were taken to bring objectivity, transparency, and accountability in corporate governance². These rules are taken to stop the scandals and scams like Satyam, who the top management itself was included in the fraud and malafide business practices. Such laws will bring greater oversight in companies Independent directors' functioning and restrict the founders thinking of indulging in such fraud practices.

2. Powers, Duties, and Powers of Independent Directors

Independent directors are chosen with the board's opinion. The person must possess the ability, integrity, and relevant experience, as mentioned in section 149(4) (a)³. He must not maintain the position of a promoter of holding or subsidiary company and must also not have any relatives holding such a relationship with the company. Schedule 4 mentions the functions needed for the Independent director to protect stakeholders' interests, including

²Sebi.gov.in. 2021. [online] Available at: <https://www.sebi.gov.in/sebi_data/attachdocs/1357290354602.pdf> [Accessed 25 January 2021].

³ mca.gov.in. 2021. [online] Available at: <<https://www.mca.gov.in/SearchableActs/Section149.htm>> [Accessed 25 January 2021].

minority holders⁴. Their role is to bring together their interest and harmonize the conflicts by analyzing the management's performance. Independent directors need to resolve the conflict between management and shareholders, and make themselves aware of its ongoing activities, including the external operating environment. The directors must not reveal confidential information relating to the company unless approved or permitted by the law board. Independent directors have the duty to take participate in all committees of the board or members actively. Their enthusiastic participation in this meeting will help them update their skills, knowledge, and familiarity with the company. They would be able to know more about their role functions, and responsibilities towards the company.

The Independent directors must hold a meeting with either Independent directors for analyzing the performance and exchanging valuable information about the company, including the objectives of the board meeting⁵. The meeting must be held once a year to evaluate the chairperson's performance and ensure the board of directors' smooth functioning.

The 2013 acts set a limitation on Independent directors' liability in the matters relating to omission or commission by a company that has taken place with his knowledge or through the boarding process. It must have taken place with his consent, where he has not acted with diligence. In such matters pertaining outside his knowledge, the Independent directors can't be held liable⁶.

2.1 New measures:

In 2019, the Indian Institute of Corporate Affairs had been directed by the ministry to maintain an e-database of all the desirable and qualified independent directors⁷. This has been made to ensure the standardization process of the independent directors of the

⁴ mca.gov.in. 2021. [online] Available at: <<https://www.mca.gov.in/SearchableActs/Schedule4.htm>> [Accessed 25 January 2021].

⁵ ebook.mca.gov.in. 2021. [online] Available at: <<https://www.mca.gov.in/SearchableActs/Schedule4.htm>> [Accessed 25 January 2021].

⁶ Lexology.com. 2021. *Independent Directors- Under The Companies Act, 2013* | Lexology. [online] Available at: <<https://www.lexology.com/library/detail.aspx?g=45f2cd2e-88a0-46bf-ba56-5b404c2e4681>> [Accessed 25 January 2021].

⁷ iica.nic.in. 2021: Welcome To IICA: [online] Available at: <https://iica.nic.in/cid_databank.aspx> [Accessed 25 January 2021].

companies. These guidelines have introduced an examination of the qualification of independent directors. In this exam, the candidate must secure a minimum score of 60% for the appointment for the post of independent director⁸. However, the merit of such reform is not tested yet and maybe resulted in unwarranted intervention reminiscent of license-quota raj prevalent pre-liberalization.

3. Protection by the Ministry

On 2nd March 2020, the ministry issued a circular clarifying that the civil and criminal cases shall not be initiated against independent directors unless enough evidence shall exist against them or, if initiated, must be reviewed thoroughly⁹.

The circular is an excellent initiative as it seeks to identify and ascertain the accountability of an officer who is in default or any other director taking specific responsibility in a company. It makes it necessary to clarify concerning the prosecution guidelines of independent directors. Primarily, it underlines the difference between a director and an independent director. Secondly, it focuses on the nature of default while ascertaining the responsibility. Thirdly, it shifts the burden of proof from the accused director to the investigation authorities. The guidelines also specify greater deliberation at the ministerial level before lodging prosecution against them.

For the same purpose, agencies should be sensitized about the role of independent directors who are at a disadvantage if a secret design is yet to come. Independent director does not have the benefit of privy to information which may be discovered too late. Such information might make a reasonable decision, which seems inappropriate. However, from such post facto data, the investigation authorities sometimes adopt a "guilty till proven innocent" attitude.

⁸ IndiaCorpLaw. 2021. *The Foibles of a Databank and Proficiency Test for Independent Directors - Indiacorplaw*. [online] Available at: <<https://indiacorplaw.in/2019/11/foibles-databank-proficiency-test-independent-directors.html>> [Accessed 25 January 2021].

⁹ KPMG. 2021. *MCA Provides Clarification On The Liability*. [online] Available at: <<https://home.kpmg/in/en/home/insights/2020/03/firstnotes-mca-circular-non-executive-independent-directors-section-149.html>> [Accessed 25 January 2021].

Although it is said that extraordinary powers come with great responsibility, therefore, this is a revised guideline of the post-corona situation of the market. All the independent directors will need to vitalize their role to safeguard their company from economic distress. Another additional duty of these guardians of the board is to check all the guidelines and policies to ensure the company's stakeholders. The main focus shall be upon providing credibility of the company that does not make them liable for the commission's Act that had occurred without the entity's knowledge.

3.1 The IFC Model

According to the definition of IFC, Independent directors must not be employed at the executive level of other companies if any family member had been engaged with the same in the span of the last five years. They must not possess any personal contracts or are involved with senior management for receiving the company's funding¹⁰. Independent directors also not be employed with present or former auditors.

3.2 Corporate governance & independent directors

Long back, Adam Smith in the 18th century, proposed about the invisible hand, which was meant to be self-interest. This particular thing is required to motivate the business, and it remains the concern in the changed scenario¹¹. Governance is all about taking the company in the right direction. It should be beyond the scope of the legislation. Such practices should not take place for the sake of sanction but also for achieving profitability. Independent directors can contribute to the board with their divergent views and lead the company towards the right interests.

3.3 The Satyam Saga

In January 2008, there was a shock in the Indian corporate sector when a confession made by then chairman of Satyam Computer, a public trading private company, confessed to

¹⁰Oecd.org. 2021. *Corporate Governance - OECD*. [online] Available at: <<https://www.oecd.org/corporate/>> [Accessed 25 January 2021].

¹¹ Encyclopedia Britannica. 2021. *Invisible Hand* | Economics. [online] Available at: <<https://www.britannica.com/topic/invisible-hand>> [Accessed 25 January 2021].

accounting fraud being held them¹². It was amongst the country's most reputed software company and were also listed in Bombay Stock Exchange, NSE, and New York stock exchange in the US. They eventually had to comply with clause 49 of the Oxley act within the prescribed guidelines. The whole scam was discovered among two phases: the promoter's involvement in related party transactions and the company's account's fudging. It all started when the company announced its bid of \$16 for two other companies, which was also promoted and controlled by the chairman of the Satyam Company's family¹³. Some of the independent directors also raised this concern.

But the board decided to continue with the proposal of acquisition. The same was notified to the stock exchange board for approval, which is a necessary step under listing guidelines. The bad reaction of the market forced Satyam to withdraw their proposal.

Later on, the chairman of the Satyam Company confessed to financial fraud and gave resignation from the company. He also disclosed that his last attempt to fill fictitious assets with real ones was to buy those companies. The Andhra police later arrested them, and the central government took over the company's control. They were charged with breach of trust, criminal conspiracy, and forgery under IPC¹⁴. This revealed the failure of present corporate governance, which relied on Independent directors for objectivity and improvement in the board's functioning. The Independent directors had no answers to the questions of management strategy. Their response was also late at the time of the company undergoing financial distress.

3.4 Post-Satyam reforms and responses

The CII in 2009 gave recommendations on improving the standards of corporate governance considering the Satyam scam. There were also recommendations provided by

¹² Business Line 2021. Finally, *The Truth About Satyam*. [online] @businessline. Available at: <<https://www.thehindubusinessline.com/opinion/columns/aarati-krishnan/finally-the-truth-about-satyam/article22985569.ece>> [Accessed 25 January 2021].

¹³ Firstpost. 2021. *Six Years Later: India Has More Checks And Balances But Can't Rule Out A Satyam-Like Scam* - Business News, Firstpost. [online] Available at: <<https://www.firstpost.com/business/six-years-later-india-has-more-checks-and-balances-but-cant-rule-out-a-satyam-like-scam-2191799.html>> [Accessed 25 January 2021].

¹⁴ The Hindu. 2021. *Telangana Police Arrest AP MLC In Cheating Case*. [online] Available at: <<https://www.thehindu.com/news/cities/Hyderabad/telangana-police-arrest-ap-mlc-in-cheating-case/article18732835.ece>> [Accessed 25 January 2021].

the Council of the Institute of Company Secretaries of India (ICSI), The National Association of Software and Services Companies (NASSCOM and India's Ministry of Corporate Affairs, and the guidelines were issued accordingly¹⁵. It was clear that even after the director's presence, such a unanimous decision was taken, and only the share market reacted strictly upon it. There was an announcement made by Independent directors taking resignation due to such activity, but it was too late by then.

Under the committee's recommendation has been examined to analyze the elements contained for independent directors. There are some points concerning independent directors.

1. Nomination Team: In all the reports that have been recommended by the board for selecting the independent directors through formation of a nomination committee comprised of a majority of independent directors with a chairman. The nomination committee also recommends an individual for the executive director's position.
2. Executive Meetings: in the CII report, it was recommended that the independent director must conduct executive meetings regularly, outside the management. The audit committee should also conduct sessions with other auditors.
3. Ease of mobilization to management and other resources: Some voluntary guidelines are issued by the ministry, suggesting independent directors' freedom to meet managerial works periodically. These guidelines recommend that the board provide independent directors to all the systems, procedures, and resources to inform all the company's details for effectively discharging their duties.
4. Honorarium: According to the committee's recommendation, all the independent directors must be paid adequate sitting fees. The fees shall be based on the company's net worth. According to the CII report, independent directors are permitted to stock options without exercising any options until completing the full year. However, there is a restriction over

¹⁵Icsi.edu. 2020. [online] Available at:
<https://www.icsi.edu/media/webmodules/GOVERNANCE_RISK_MANAGEMENT_COMPLIANCES_AND_ETHICS.pdf.

the issuance of stock options and profit compensation of independent directors from being compromised.

5. Act of Related Party Transactions: The CII committee recommended that the audit committee approve all the related party transactions to get backed in the ordinary business or transaction.
6. Shareholder Activism: The task force of the CII also appeals to the shareholder to be more active in the overall capacities.
7. Director Training: Both the ministry independently recommendation and ICSI reports suggested that the boards make a mandatory training program for all the newly introduced directors and ongoing programs for directors' development. The ICSI recommended that director training is specifically essential to make the directors technically competent to execute their duties in financial expertise. It is also suggested that the director shall be known about the audit's working committee.

4. Independent Directors and Minority Shareholders

Profit maximization has become the key objective of all the members of a corporate entity, in different parts of the world, the importance of independent directors in safeguarding minority shareholders' rights. There should be one-third of the independent director in a listing company and half of the independent director if the board has an executing chairman under Clause 49 of the Listing Agreement in India.

It is an excellent initiative to have an independent director who communicates the right and interests of the minority shareholders of the company. On the other hand, independent directors favor the company's management as of loyalty against the job. Perhaps, any shareholder voted against the majority shareholders' interest has the utmost risk of losing their job. In most cases, the directors' appointment is relatively neutral, which results in a lack of competency and knowledge in corporate affairs. They must work correctly for the company's smooth functioning without any major conflicts. Most of the competent directors stay loyal to the company.

An organization can't expect to improve overnight after having a disappointing performance by appointing more directors. Sometimes, independent directors do not have enough idea about the daily affairs of companies, because they are assigned on a term basis,

having no consistency in a particular company. One more advantage of the independent director is holding the director's position in many companies simultaneously, which affects their knowledge and efficiency towards a particular company. The financial condition of a company is directly proportional to the qualities of the independent directors. Under section 164 of the Companies Act, 2013, a person shall be an independent director for not more than 20 companies. Eligible and competent candidates are appointed by top companies and can easily manage their affairs. However, many other companies are stuck with incompetent directors, who are not so eligible to handle top-level management affairs. The involvement of Independent directors doesn't create any impact on the growth and development of the company. Although, a company can make independent directors of all other subsidiary companies for a fruitful outcome.

5. Protection of Rights of Minority Shareholders

In every democratic country, certain groups of people are affected by the majority's decision. It can only be balanced by raising the voice of the opposition party against the government. Similarly, it can be balanced with the independent director's voice for the minority shareholders' rights in corporate governance. However, it is not the sole purpose of the independent director. He is equally responsible for the company. The independent director should put the company's interest rather than the individual benefit of minority shareholders. However, the majority decision prevails, and the tribunal has the jurisdiction to control in some cases.

In exceptional cases, the tribunal can step in. These directors must work for the best of these shareholders. The director must have adequate responsibility for better performance and to be a vigilant watchdog. An independent director must maintain a balance of power higher and a lower level of management. The director should apply their abilities to attain justice for the shareholders. This principle has been universally accepted as the appropriate model of running a successful business. Another obligation of an independent director is accountability to public investors. However, there are lacunas behind the principle of independent directors while protecting the interest of the shareholders. Therefore, there is a need for reforms for the better functioning of this principle.

In the day-to-day business, tough choices ought to be taken relating to the company's internal management. The top-level management of the organization takes such decisions. During the decision-making process, there could be an instance where bulk shareholders' interest comes into conflict. However, if the decision is taken for the company's more considerable interest and carters to the part of the minority cluster, it will raise voice against such decisions. The protection of minority shareholders in a company is still constituted by issues facing matter under its Act.

The main focus should be to maintain a balance between effective management and minority shareholders' interest. However, it is right to expect that natural justice and fair play are considered on the choices for the stakeholders' benefit in the company's matters. Therefore it is necessary to safeguard the interest of those shareholders to be protected by independent directors.

Though the courts have dominated mostly for the majority rules taken by the company, these rules might not be applicable in the case of **Foss v. Harbottle**¹⁶, where the companies are competent to control social control sins. In this case, each of the stockholders could have sued to enforce duties owed to the company. Therefore, the stockholders had become a representative of the corporate interest.

6. Conclusion and Suggestions

The Companies act has mentioned the independent director in its everyday functioning by assigning the task and job profile to work more efficiently. It will not be an elaboration to state that the recent company laws have been much more progressive in handling and translating numerous post-Satyam committees' recommendations. The nature in which the current statute mandates companies to work explicitly considers that the independent director's stand has been progressed much more than merely solving the management-shareholders agency problem.

¹⁶ (1843) 67 ER 189