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Notes and Comments

Articles

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Editorial Foreword

"Corporate Governance is essential to the survival of any institution and necessary for its long term sustainability while protecting the interests of its stakeholders. It is pertinent that in today's' challenging business environment, we enforce the practice of good corporate governance and adhere to the norms with diligence. Corporate governance is about your inner conscience that tells you the difference between what you have a right to do and what you have to do; it is about values. The students of today will become the future leaders and implementers of our legal system; I encourage them to show individual integrity and selflessness for nation building."

Mr. Deepak Parekh
Chairman,
Housing Development Finance Corporation (HDFC)

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Tax and Corporate Governance: Exploring the Connect

Tarun Jain[*]

'Tax Corporate Governance', is a new leaf of this ever expanding ebb of corporate governance. 'Tax Corporate Governance' relates to examination of inter-dependence of fiscal issues and policies with corporate governance practices. It encompasses not just the immediate choices relating to corporate decision-making such as location of plants in tax-efficient jurisdictions, etc., but also key issues relating to corporate structuring, tax-impact disclosures, income measurement, financial reporting, etc.

This paper aims to revisit the theoretical foundation of the relationship between Corporate Governance and Taxation while enumerating upon the instances of Tax and Corporate Governance interface. This note makes an attempt to identify such linkages and thus, serve as a background for the issue while noting the documented studies on this perspective. An attempt has been made to ascertain and enumerate the issues which require specific addressing from a corporate governance perspective on the issues arising out of fiscal policies and practices in India.

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Introduction

India's tryst with corporate governance is not new, yet not ideal. When in 1996, the Confederation of Indian Industry ('CII') undertook the first institutional initiative on corporate governance in India (leading to the 1998 report on 'Desired Corporate Governance: A Code'), the ideals of investor protection; increasing transparency in corporate management and decision-making; improving disclosure norms, etc. were in key focus. While substantial work has been done and various aspects of these areas highlighted, either in terms of the reports of the Committees constituted to this effect or through legal and regulatory initiatives, one cannot say with certainty even today of having attained a touchstone for measuring corporate performance. The deficiency, if any, does not owe to the lack of attempts on the part of the key subject but is solely on account of the qualitative nature of the concept. 'Corporate Governance' *per se* is an evolving concept which seeks to enthral within its ambit all desirable corporate managerial practices and putting in place in-built safeguards in corporate functioning and decision-making. 'Tax Corporate Governance', as a new leaf of this ever expanding ebb of corporate governance, finds focus in this note.

On a conceptual perspective, 'tax corporate governance' relates to examination of inter-dependence of fiscal issues and policies with corporate governance practices. It encompasses not just the immediate choices relating to corporate decision-making such as location of plants in tax-efficient jurisdictions, but also key issues relating to corporate structuring, tax-impact disclosures, income measurement, financial reporting, etc. Thus, its coverage extends from a micro level examination of corporate decisions relating to an amalgam of commodity taxes, transactional taxes, etc. to a macro level analysis of the impact of business taxes, fiscal policies and other related avenues for strategic decisions of the corporate enterprise. This note makes an attempt to identify such linkages and thus, serve as a background for the issue noting the documented studies on this perspective. An attempt has been made to ascertain and enumerate the issues which require specific addressing from a corporate governance perspective on the issues arising out of fiscal policies and practices in India.

Revisiting the Theoretical Foundation of the Relationship

The competing considerations and varied interest compelling the amalgam of perspectives vis-à-vis taxation and corporate governance can be enlisted as under:

A. Linkage Between Tax Policy and Corporate Governance

In their work titled, '*Taxation and Corporate Governance: An Economic Approach*', Desai and Dharmapala[1] pointed out that, "*when Adolf Berle and Gardiner Means launched the study of the agency problem - that managers appointed by shareholders may pursue their own interests - in the corporate setting, they were inspired by the role of taxes in diffusing ownership in the American economy*", *but "this link between corporate governance and taxation has been neglected in subsequent decades as the study of these two important features of an economy became segregated*". The authors also concluded that the linkage between "real effects of tax policies and the workings of corporate governance" has remained under-explored.

Thus, the study points out the need to undertake examination of the corporate decision-making process on the touchstone of tax considerations. In an economic analysis undertaken for selected Hong Kong companies, for instance, it has been concluded that corporate governance is interrelated with tax aggressiveness in as much as the "*number of shares held by directors, board independency, shareholders' power have significant relationship with effective tax rate (company tax aggressiveness)*"[2]. The necessity to analyze corporate decisions from a tax-perspective also arises "*as the company as such is not in the position to form a tax strategy, to file declarations or to transfer money to the tax authorities*". These decisions are taken by corporate managers but carry a significant impact upon the value and return of shareholders' investments, thus requiring one "*to look for a balanced view of the way tax obligations are allocated within the organizational and legal framework of the corporation*."[3]

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[1] Mihir A. Desai and Dhammika Dharmapala, *Tax and Corporate Governance: An Economic Approach*, 13-30 published in Wolfgang Schon (eds.), *Tax and Corporate Governance* (Springer, 2008)

[2] Yeung Chi Kwan Timothy, *Effects of Corporate Governance on Tax Aggressiveness*, available at http://libproject.hkbu.edu.hk/trsimage/hp/07014341.pdf (last visited on February 15, 2012)

[3] Wolfgang Schön, *Tax and Corporate Governance: A Legal Approach*, available at www.itdweb.org/documents/Schon.pdf (last visited on February 15, 2012)

B. Public Perception on Corporate Tax Positions

The importance of the issue is also buttressed from the fact that media coverage of tax disputes has the "*potential to influence public perception*"[4] which may be understood as "*a lack of sound governance by the board*"[5] and thus affecting the corporate image as well as the stocks' value in financial markets.[6]

C. Legislative Intrusion Through Tax Policies

The perspective of the linkage between tax and corporate governance, however, is not just confined from the corporation's perspective. There is a much larger dimension to the overall state-of-affairs in as much as even the legislative bodies have been found to be indulgent into framing of tax proposals and policies with a view to influence corporate behaviour.[7] Professor Steven A. Bank attributes to the United States Congress the recognition of the potential of corporate income tax "*to serve as a de facto system of federal corporate law*"[8]. There is a much greater dimension to these affairs in as much as tax and (national) governance are interlinked.[9]

D. Monitoring by Tax Authorities

There also exists a view that active monitoring by tax authorities protects the interests of outside investors by disciplining company insiders

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4 Miquel Timmers, *A Principle of Good Corporate Tax Governance*, (February, 2006), available at http://www.allbusiness.com/accounting/874677-1.html (last visited on February 15, 2012)

5 *Ibid.*

6 David F Williams, *Developing the Concept of Tax Governance*, KPMG's Tax Business School (February 2007) available at http://www.kpmg.co.uk/pubs/Tax%20Governance%20Feb%2007.pdf (last visited on February 15, 2012), which notes that, reputational impact is a significant issue in determining, in particular, a company's attitude to tax avoidance.

7 Nicola Sartori, *Corporate Governance Dynamics and Tax Compliance*, University of Michigan Law & Economics, SJD Working Paper No. 1361895 (2009) available at http://ssrn.com/abstract=1361895 (last visited on February 15, 2012)

8 Steven A. Bank, *Tax, Corporate Governance, and Norms*, available at http://ssrn.com/abstract=541244 (last visited on February 15, 2012), where the author has enumerated various instances towards this assertion

9 See OECD, *Governance, Taxation and Accountability: Issues and Practices* (2008) and OECD, *Citizen-State Relations: Improving Governance through Tax Reform* (2010)

against depriving them of their fair share of earnings[10]. The Seoul Declaration[11] in this context recognizes the need for "*encouraging top management and audit committees of large enterprises (e.g. CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies*." As a sequel, perhaps most tax-auditors have instituted corporate governance departments within their offices. The KPMG Tax Governance Institute, Deloitte's Centre for Corporate Governance are the extensions, just to name a few, towards this underlying idea of merging tax and corporate governance issues.

These diverse perspectives can be summarized as: "tax and corporate governance issues can intersect in several different contexts. One set of issues is how to ensure that tax does not encourage behaviour that is contrary to the interest of the company and/or of its shareholders. Another set of issues is how to ensure transparency and quality of management decisions in the tax area. In particular, it is important to ensure that the board, shareholders and other stakeholders are aware of the stakes that are involved in the management of taxes."[12]

Enumerating Instances of Tax and Corporate Governance Considerations Interplay

Given the complexity of the tax legislations developed, almost every corporate decision carries a tax impact. However, this does not imply elevating the entire tax paradigm as a corporate governance issue. For illustration, a tax shelter undertaken by a corporation that is wholly owned and managed by an individual has no corporate governance implications. Such a

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[10] Saidah Hamizah Ahmad, *An Evaluation Of Stakeholder Added Value In Today's Malaysian Corporate Governance Scene*, 6 International Review of Business Research Papers, No. 1, p. 404-431 (2010); Jeffrey Pittman, *The Corporate Governance role of Strict Tax Enforcement: Can a visit from the Tax Auditor save your company money?*, 26-29 CMA Management (December/January 2009); See also Desai, Dyck & Zingales, *Theft and Taxes*, 84 Journal of Financial Economics No. 3, p. 591-623 (2007) who demonstrate that increased tax enforcement reduces managerial rent extraction opportunities and increases shareholders' wealth.

[11] Organisation for Economic Development and Co-operation, *Third Meeting of the OECD Forum on Tax Administration, Seoul Declaration*, 14-15 September, 2006, available at http://www.oecd.org/dataoecd/38/29/37415572.pdf (last visited on February 15, 2012), Paragraph (ii)

[12] Jeffrey Owens, *Good Corporate Governance: The Tax Dimension*, OECD Centre for Tax Policy and Administration, available at http://www.itdweb.org/documents/Owens.pdf (last visited on February 15, 2012)

transaction merely diverts resources from the state to shareholders. For there to be a meaningful intersection of taxation and corporate governance, it must be the case that ownership and management are separated, and that the incomplete nature of contracting and monitoring creates the scope for managerial opportunism.[13] One therefore, needs to refine the span of coverage to exclude the routine transactions to those which require conscious decision-making at the higher levels of corporate hierarchy. In short, from a corporate governance perspective the focus can be confined to monitoring of 'aggressive tax strategies'[14]. Some of the areas which reduce the strategic tax outlook are enumerated in this part.

A. Certainty In Tax Assessments

An expert Group of the Organization for Economic Co-operation and Development ("OECD") points out that both tax administrations and large businesses want greater certainty. Tax administrations look for certainty around voluntary compliance with tax laws and large businesses having good governance arrangements in place. Large businesses look for certainty about which of their behaviours and transactions the tax administration is likely to see as risky, and how the administration is likely to respond to those risks.[15] There are no second thoughts over this proposition in the Indian context especially in the wake of recent controversies[16] over the huge tax liabilities sought to be enforced by tax administrations over corporate structures which in the recent past have been consistently held[17] to be tax efficient and thus, adding value to the shareholdings. Although, the recent decision of the

[13] *Supra* Note 1.

[14] Carlo Garbarino, *Aggressive Tax Strategies and Corporate Tax Governance: An Institutional Approach*, (2008) available at http://ssrn.com/abstract=1428772 (last visited on February 15, 2012) defines 'aggressive tax strategies as 'behaviour of tax managers who exploit the 'book-tax gap' to advance their own interests, creating a tension between managers and shareholders.

[15] Forum on Tax Administration (OECD's Committee on Fiscal Affairs), *General Administrative Principles: Corporate Governance and Tax Risk Management*, paragraph 30 (July, 2009)

[16] For illustration, the decisions of the Bombay High Court Court in *Vodafone International Holdings B.V. v. Union of India*, 2010 (112) BomLR 3792; *Aditya Birla Nuvo Ltd. v. Deputy Director of Income Tax* (Writ Petition No. 730 of 2009 decided on 14.07.2011), both dealing with India Mauritius Double Taxation Avoidance Agreements.

[17] Such as the categorical enunciation by the Supreme Court in the often-quoted case *Union of India v. Azadi Bachao Andolan*, (2003) 263 ITR 706 (SC) and of the Delhi High Court in *Shiva Kant Jha v. Union of India* [2009] 185 TAXMAN 424 (Delhi), both dealing with India Mauritius Double Taxation Avoidance Agreements itself.

Supreme Court in *Vodafone International Holdings*[18] has brought some respite to the corporations.

The need and manner for obtaining consistency in tax assessment is recognized and well documented. For illustration, international taxation rules generally provide[19] for ‘advance pricing arrangements’ as a means to ward-off transfer-pricing risks in tax-assessment of associated enterprises. The domestic law provisions of the different jurisdictions similarly also provide mechanisms for advance determination of corporate tax liability[20]. The Boards would do well to inculcate a culture of opting for advance determination of tax positions so as to avoid diminution of capital due to adverse tax positions.

B. Board’s Vision

It must be duly noted that, “*individual executives play a significant role in determining the level of tax avoidance that firms undertake incremental to characteristics of the firm*”[21]. Thus, an ideally governed corporation would be distinguished by the vision shared by the Board. It is easy and natural to follow industry trends but it is the vision, resulting into decision-making with a long term perspective, which lends credence and improve the goodwill of the firm. In the same place, where the corporations running on a small scale may consider opting for tax incentives in a mechanical manner; larger and publicly driven corporations are required to consider the impact of changing operating areas with a long-term perspective and anticipate that there are bound to be changes in tax regimes. The turtle-turn made by the successive Governments on area-based tax exemptions[22] and

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[18] *Vodafone International Holdings B.V. Union of India*, 2012 (1) SCALE 530

[19] See generally OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010.

[20] For illustration in India, the mechanism relating to binding ‘Advance Ruling’ given by a statutory authority under Chapter XIX-B of the Income Tax Act, 1961. See also Section 195 and 197 of the Act relating to advance determination before remittance of money outside India.

[21] Dyreng, Hanlon and Maydew, *The Effects of Executives on Corporate Tax Avoidance* (2009) available at http://ssrn.com/abstract=1158060 (last visited on February 15, 2012)

[22] The amendments in 2008 have restricted to specified percentage the complete exemption from Central Excise duty promised to industries set-up in backward areas *vide* Notification No. 56/2002-CE dated 14.11.2008 for Jammu & Kashmir, Notifications No.49/2003-CE and No.50/2003-CE, both dated 10.06.2003 for Himachal Pradesh and Uttaranchal, etc. which are under challenge before the Courts currently.

special economic zones[23], for illustration, only reflect that Boards need to plan the corporate functioning after consultation with a multifarious range of factors than just tax considerations.

C. Costs Of Planning Versus Sanctions

The managerial and external costs associated with tax-planning strategies are also a relevant factor required to be considered before taking decisions. Three competing factors need to be considered at this juncture. First, tax is a cost to business; second, pursuance of tax-planning strategies involve significant 'internal' and 'external costs'[24] for the business and; third, non-acceptance of tax claims by the governmental authorities recoil with significant costs and often accompanying penalties for the business. Even though tax consultants may promise significant tax advantages through drafting of extensive and complex agreements, the potential costs of tax-authorities revisiting these agreements are also to be considered before embarking on such exercise. In the midst of competing considerations, therefore, in most cases it would be expedient to bear tax as a cost to business rather than to involve significant expenditure on first planning and later defending the tax positions taken.

Apart from governance angle, one also has to take a practical perspective. As the shareholders are entitled to distributed profits only after providing for taxes, it is but natural that the Boards take decisions with the objective of achieving minimal tax rates. However, these decisions may appear counter-productive if aggressive tax strategies result in revisiting of tax liability along with ensuing penalties which tax authorities may pursue to impose.[25] Thus, it is even in shareholders' best interests for the Board to take tax-neutral stands.

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[23] The Income Tax Act, 1961 now levies the 'Minimum Alternate Tax' on the 'book profits' of SEZs after amendment by Finance Act, 2011. The provisions of the Draft Direct Taxes Code Bill, 2010, if enacted, would potentially wipe-out the tax exemptions extended under the Special Economic Zones Act, 2005.

[24] Where the "internal costs are mainly incurred as the time spent by managers and employees on structuring the tax-saving opportunities that could not be devoted to other activities, while the external costs are primarily the expenses paid to tax consultants as well as any other expenses necessary to set forth the tax planning strategy". *Supra* Note 14.

[25] See Carlos E. Jiménez-Angueira, *Tax Environment Changes, Corporate Governance, and Tax Aggressiveness*, (2007) available at http://www.uic.edu/cba/accounting/Documents/Jimenez-paper.pdf (last visited on February 15, 2012) who examines empirical data to conclude that "tax aggressiveness is more pervasive in firms with weak governance structures".

D. Avoiding Manipulative Accounting Practices for Obtaining Tax Advantages

Industry practices further suggest that the corporate decision-makers are often lured into adopting manipulative techniques in the accounting practices so as to project financial accounting benefits resulting into declaration of greater profits.[26] The comprehensive report of the *U.S. Joint Committee of Taxation on the affairs of Enron*[27] enumerates the multi-fold instances of the tax-motivated practices where, most of the transactions relied on differences between the tax treatment and financial accounting treatment of various items so that the tax benefits could be used to generate financial statement income[28] which led the Committee to "demonstrate the need for strong anti-avoidance rules to combat tax-motivated transactions that might satisfy the technical requirements of the tax statutes and administrative rules, but that serve little or no purpose other than to generate income tax or financial statements benefits"[29].

The OECD Guidelines for Multinational Enterprises also require the corporations to adopt management control systems that discourage bribery and corrupt practices, and adopt financial and tax accounting and auditing practices that prevent the establishment of 'off the books' or secret accounts or the creation of documents which do not properly and fairly record the transactions to which they relate.[30] Such scenarios may soon be dealt with in a statutory manner in India with the introduction of the 'Anti Avoidance Rules' in Indian Income tax laws[31] and power being vested to the tax officers to disregard transactions 'lacking commercial substance', thus, impliedly forcing corporations to take tax-neutral decisions which should ideally be taken as a matter of course by the corporations.

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[26] The case of Satyam Computer Services is an apt illustration to this effect in the Indian context.

[27] United States Joint Committee of Taxation, *Report of Investigation of Enron Corporation and related entities regarding Federal Tax and Compensation Issues, and Policy Recommendations*, Committee Prints, 108th Congress (February, 2003).

[28] *Id.* at p. 8

[29] *General Findings and Recommendations Relating to Business Tax Matters*, available at http://www.gpo.gov/congress/joint/jcs-3-03/vol1/025-026.pdf (last visited on February 15, 2012)

[30] OECD Guidelines for Multinational Enterprises (2008), Paragraph VI.5, available at http://www.oecd.org/dataoecd/56/36/1922428.pdf (last visited on February 15, 2012)

[31] See Section 123 of the draft Direct Taxes Code Bill, 2010, which is currently pending consideration of the Parliament.

Adding to Acknowledged Notions of Corporate Governance

Having examined the competing considerations and their cross-effects, the issue that arises is how to practically establish link that can be given a formalistic pattern such that, tax considerations are examined in an ideally governed corporate entity. As far as India is concerned, unfortunately this perspective has not been addressed and the governance paradigm has remained confined to mere book-keeping and disclosure of tax related financial data.[32] The currently-in-vogue Accounting Standard for reporting of tax positions seem unequipped to deal with reporting of governance related tax considerations.[33] However, the fault lies not in these standards for they are limited to accounting and reporting of transactions,[34] but with the governance codes which seek to address governance through the reporting of transactions[35] leaving the investors uninformed of the tax-strategies adopted by the Board and their potential ramifications. Thus, where the Boards adopt potentially contentious tax strategies and such positions are not informed to the investors, there lies an imminent risk to their investments in the wake of enforcement actions of tax authorities.[36]

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[32] For illustration, the '*National Voluntary Guidelines on Social, Environmental and Economical Responsibilities of Business*' (July 2011) prepared under the aegis of Ministry of Corporate Affairs confine the suggested framework for 'Business Responsibility Report' to presentation of Economic and Financial Data relating to taxes (page 36). Also see the '*Kumarmangalam Birla Committee on Corporate Governance*' (May 1999) which touches the chord minutely when it notes that the "treatment of deferred taxation and its appropriate disclosure" has "an important bearing on the true and fair view of the financial status of the company" (para 12.1) but does not go any further over reporting of other tax considerations.

[33] The Accounting Standard (AS) 22 on '*Accounting for Taxes on Income*' issued by the Institute of Chartered Accountants of India (ICAI) in 2001 confines the reporting requirements to observance of 'matching principle' (i.e. "taxes on income are accrued in the same period as the revenue and expenses to which they relate") and thus, concentrates merely on the timing of reporting for tax purposes. See also the yet to be enforced Indian Accounting Standard (Ind AS) 12 on '*Income Taxes*' issued by the Ministry of Corporate Affairs, Government of India which proposes similarly.

[34] ICAI, *Preface to the Statements of Accounting Standards* (2004), paragraph 3.3, available at http://220.227.161.86/237acc_bodies_preface_AS_revised04.pdf (last visited on February 15, 2012)

[35] See for illustration Securities and Exchange Board of India, *Report of the SEBI Committee on Corporate Governance* (Under Shri N. R Narayana Murthy), 2003, paragraph 1.3.2 and 1.3.3, available at http://www.sebi.gov.in/commreport/corpgov.pdf (last visited on February 15, 2012)

[36] Cristi A. Gleason & Lillian F. Mills, *Materiality and Contingent Tax Liability Reporting*, The Accounting Review Vol. 77(2), pp. 317-372 (April 2002)

A. Increased Reporting of Tax Considerations?

In this backdrop, it can be suggested that an idealistic system should require competing tax considerations to be placed on Board's agenda and mandatory reporting to stock exchanges, thus, placing the responsibility on the Board to assess the financial and reputation risks associated with any particular tax strategy. A well defined corporate tax policy and placing control systems at the appropriate levels is also advisable.[37] As a natural corollary, it is suggested that, good corporate governance would give the stakeholders a right to freely communicate their concerns both about illegal conduct (like tax evasion) or unethical actions (like tax avoidance), since such conduct would have a negative impact on the reputation of the firm as a whole and would increase the future risk of (tax) liabilities and (tax) penalties[38].

One must also add a caveat to increased disclosure requirements. However, "*if shareholders are to be effective monitors and controllers of firms' tax related decision*", financial reporting and tax regulatory bodies should consider requiring increased tax related disclosures by firms. However, shareholders face a dilemma if in demanding increased tax related disclosures, managers are discouraged from pursuing 'legitimate' tax planning activities.[39]

In a pragmatic scenario, a company that declines an aggressive tax avoidance scheme that is offered to it may thereby avoid damaging its reputation with those who disapprove of such schemes, but it is unlikely to enhance it – partly because the facts may not be widely known, and partly because that will be no more than is expected of it by that constituency.[40] Thus, even though decision on increased reporting of tax considerations is a vexed one, nonetheless must be addressed by each corporation on its own facts and circumstances.

B. Public Scrutiny of Corporate Tax Interactions?

There also exists a view that the income tax returns filed by the corporations should be publicly available for numerous considerations i.e.

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[37] Friese, Link & Mayer, *Taxation and Corporate Governance*, available at http://ssrn.com/abstract=877900 (last visited on February 15, 2012)

[38] *Supra* Note 7.

[39] Nor Shaipah Abdul Wahab and Kevin Holland, *Tax Planning, Corporate Governance and Equity Value*, available at http://eprints.soton.ac.uk/150017/1/Tax_Planning_Corporate_Governance_and_Equity_Value.pdf (last visited on February 15, 2012)

[40] *Supra* Note 6 at page 11.

making tax information public would help the lawmakers close loopholes that permitted tax avoidance, publicity will help keep tax administration honest by preventing officials from favouring high-income taxpayers. Publicity is necessary if the tax rules are to be seen as fair; and if wealthy taxpayers know that tax information is public, they will not engage in transactions that will reduce their tax liability.[41]

Not only this aspect goes beyond the acknowledged foundations of corporate governance, but such an approach may also be criticised on grounds of privacy-invasion and susceptibility to uninformed analysis. Presently, the law does not mandate such disclosure. Yet, this may well be an option worth-examining in the wake of increased reliance on tax considerations in corporate decision-making and a *suo motu* decision of the Board to report such an aspect either to the financial institutions or the general public at large that may well improve the image of the corporation.

Conclusion

The understanding of the interaction between tax and corporate governance can be concluded by contrasting the competing interests i.e. the governance norms requiring that the corporations should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations[42] whereas "*all obligations of directors and shareholders are in principle directed towards each other, not towards the tax authorities*"[43]. On a balance of competing considerations, instead of pre-empting to such effect, one might seek to rest the decision of incumbent tax disclosures on the Board by providing meaningful factors and touchstones to enable decision-making on such aspects.[44] The role and proactive approach of the Government can also improve the governance standards in a meaningful way.[45]

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[41] See generally Lenter, Shackelford & Slemrod, *Public disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives* (2003), available at http://www.brookings.edu/views/papers/ gale/20030425_lenter.pdf (last visited on February 15, 2012). Also see the decision of Central Information Commission (CIC) in *Rakesh Kumar Gupta* v. *PIO* (decision No. CIC/LS/A/2009/000647/SG/5887 dated 14.12.2009 in Appeal No. CIC/LS/A/2009/000647). The issue is currently pending consideration of Delhi High Court in W.P. (C) No. 206 of 2010.

[42] *Supra* Note 29.

[43] *Supra* Note 3 at page 4.

[44] See for example, David F Williams, *Supra* Note 6 who enlist six such factors as (1) Morality and business ethics; (2) Legality of actions; (3) Compliance with regulatory

While the issue of formal standards on corporate tax governance is yet to achieve international consensus, one cannot lose sight of the fact that tax considerations carry a significant bearing on the modern corporate decision-making systems. Nonetheless, a policy on regular reporting and examination at an appropriate level of corporate hierarchy is not only desirous but also necessary at pre-determined thresholds of revenue implications and objectively laid standards of tax aggressiveness. Disclosure of significant tax disputes to the stakeholders and an optimal engagement of the consultative processes available under the different tax laws would only do well to enhance the governance standards followed by the Board.

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demands; (4) Preserving the reputation of the company and the directors; (5) Commerciality; and (6) Corporate social responsibility.

[45] For illustration, the United Kingdom's Revenue Authority (HMRC) enlists on its website the ingredients of a clear tax policy for corporate tax governance – a tax policy which is policy aligned with business strategy and operations; supported by operating procedures that have been reviewed by the internal audit/business assurance department; includes an explicit statement that the company will openly share relevant and appropriate information with the tax authorities; and is regularly reviewed, available at http://www.hmrc.gov.uk/lbo/tax-in-the-boardroom.htm (last visited on February 15, 2012)

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Cairn Vedanta Deal- *Corporate Governance Put To Test*

Anindita Jaiswal[*]

Although corporate governance is not completely imbibed in the Indian context, healthy and virtuous corporate practices are slowly gaining momentum in Indian companies. The corporate governance accomplishments of India Inc. were tested in the Satyam episode of 2009, only to reveal an embarrassing and sympathetic picture globally. Two years later, India Inc. is confronted with a test in the context of majority rule vis-à-vis the minority rights and company interests in the much debated Cairn-Vedanta deal, which has once again accentuated India's vulnerability to corporate governance.

It is not that the majority-minority conflict has emerged for the first time in the Cairn-Vedanta deal; rather, this subject has been debated in different contexts, facts and circumstances in the past but no consensus was ever reached. This is mainly because of two reasons, those being (i) Indian companies and India's corporate laws work on the principle of majority rule, and (ii) the majority-minority conflicts are reckoned to be internal company affairs, thus, the courts of law prefer to refrain from intervening in such matters.

The solution to this recurring conflict lies in attaining the right balance between interventions by courts in company matters vis-à-vis protection of the shareholders' rights. What remains to be seen is whether the Cairn-Vedanta deal is able to strike this balance or succumbs to the majority pressure compromising on the company and minority shareholder interests.

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Introduction

The Cairn Vedanta deal has been assessed, deliberated and debated at length by industry players and academicians alike, and has also involved substantial brainstorming by the Indian regulators.

The Cairn Vedanta deal proposed in the year 2010 involved acquisition of Cairn Energy's 40% stake in Cairn India by the Vedanta Group. In view of Cairn India being a public listed company, one of the major concerns was in respect of India's takeover laws. Prior to the Securities and Exchange Board of India's (the "SEBI") recent announcement of increasing the minimum open offer threshold to 25%, any acquisition of 15% or more shares in an Indian listed company required the acquirer to mandatorily make an open offer to the other shareholders up to 20% at an offer price ascertained in accordance with the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the "Takeover Regulations"). Considering that Vedanta Group was seeking to acquire Cairn Energy's 40% stake, i.e., more than 15% shares of Cairn India, Vedanta Group initiated the open offer process and declared differential offer prices to the promoters and other shareholders of Cairn India. While the general shareholders were offered INR 355, the promoters were offered INR 405 including the excess INR 50 as non-compete fee. Notwithstanding that the Takeover Regulations then permitted payment of non-compete fee to promoters, the shareholders of Cairn India raised objections against such differential offer pricing. Consequently, while on one hand, the Vedanta Group was compelled to reduce the offer price to Cairn India's promoters to the extent of such non-compete, the SEBI on the other hand, succumbed to the minority shareholders' apprehensions to prohibit in its board meeting dated 28 July, 2011 payment of non-compete fee to promoters. The foregoing regulatory move triggered a fresh debate with views highlighting the potential pros and cons, more particularly where the promoters have some real quality contribution to the target's business.

Aside to the foregoing securities market concern, the Cairn-Vedanta deal has once again accentuated India's vulnerability to corporate governance aspects.

Cairn-Vedanta Deal Background

The much awaited clearance by the Cabinet Committee for Economic Affairs (the "CCEA") of the Cairn-Vedanta deal was obtained in July 2011. While the foregoing clearance settled several outstanding issues deterring this deal, the pre-conditions prescribed by the cabinet have raised an unprecedented corporate governance challenge. A brief background of the corporate governance tussle is explained below.

Oil and Natural Gas Corporation, a public sector undertaking ("ONGC") which is Cairn India's partner in all its oil exploration and energy producing assets, was required to grant its specific approval and waiver of its pre-emption rights as a prerequisite to Vendanta Group's acquisition of Cairn Energy's stake in Cairn India. ONGC, as a condition precedent to grant of its approval and waiver, required Cairn India to share the royalty payments in respect of the crude oil produced from Rajasthan oil fields and revise their agreement accordingly. As per the current agreement between Cairn India and the ONGC, the obligation to pay royalty is of ONGC owning 30% stake in the 6.5 billion barrel field, and Cairn India owning the remaining 70% stake is not responsible for any royalty payments.

Both, Cairn India and Vedanta Group objected to ONGC's royalty sharing proposition which was likely to reduce Cairn India's profitability by significant margins. Consequent to Cairn India's and Vedanta Group's refusal to accept ONGC's condition, ONGC withheld its approval and waiver and the CCEA too stalled the Cairn-Vedanta deal clearance, all of which were prerequisites to the deal closure. Subsequently, to get the deal into motion, Vedanta Group slashed the promoter non-compete fee and agreed upon uniform offer pricing to shareholders and promoters alike to ensure a green flag atleast from India's securities law angle. Aside to drawing accolades from the minority shareholders, this encouraging move once again gathered the interest of the CCEA. Eventually, pursuant to the ministers' meetings in May, 2011; the CCEA cleared the Cairn-Vedanta deal in July, 2011 retaining the preconditions but with certain modifications and dilutions while ONGC gave its approval only in September, 2011 and the Home Ministry did so in December, 2011. However, the approval of the CCEA had to be retaken in January, 2012 in light of certain conditions precedent that Vedanta was to fulfill. As regards the royalty sharing aspect, while the CCEA no longer requires Cairn India to make direct royalty payments, the CCEA has made such royalty payments cost recoverable, i.e., the royalty to be paid by ONGC will be added to the project cost which, in turn, will be deducted from oil revenues prior to distribution of profits between ONGC and Cairn India. It was a "*take or leave*" situation for Cairn India and Vedanta Group, i.e., they could either accept, *inter alia*, the foregoing precondition of royalty being cost recoverable or dispose the deal off the platter.

Corporate Governance Challenge

Cairn India and Vedanta Group reinforced their objections to the CCEA's precondition of having royalty as cost recoverable both, from a commercial and corporate governance standpoint. While accepting royalty as a cost recoverable means substantial hiving off Cairn India's profits commercially, the bigger issue is of corporate governance, i.e., whether a shareholder (Vedanta Group) of a public listed company (Cairn India) can for its own acquisition interests bind the company with contractual terms (royalty being cost recoverable vis-à-vis ONGC) that are adverse to the company (reduced profits). Vedanta Group argued that it cannot, in the capacity of a shareholder, agree to the suggested revisions in the ONGC-Cairn India contract which will necessarily result in Cairn India's profits and consequent loss to other shareholders of Cairn India. Likewise, Cairn India resisted the CCEA precondition stating that knowingly agreeing to adverse contractual terms for the benefit of a certain class of shareholders and to the detriment of the remaining shareholders, more particularly the minority shareholders, conflicts with corporate governance norms.

Assessing the foregoing in the context of law, it is imperative to note that India's company law mandates minimum 50% plus one share's ownership for an ordinary resolution and 75% share ownership for a special resolution. Thus, upon Vedanta Group's acquisition of Cairn India, the foregoing 50% plus one share ownership or 75% share ownership thresholds, as the case may be, can be met by Vedanta Group and Cairn Energy jointly, and thus, Vedanta Group's explanation that it cannot in the capacity of a shareholder revise the ONGC contract is untenable in law. Having said that, such revision of the contract for the benefit of a few shareholders, and which revisions are otherwise prejudicial to the company is challenged by corporate governance.

Corporate governance is all about the interplay of a company vis-à-vis external factors and *inter se* the company's management, its shareholders, auditors and other stakeholders. Thus, an important and inevitable component of corporate governance is the protection of minority shareholder rights from being oppressed by the majority. It is not that this aspect of corporate governance has emerged for the first time in the Cairn-Vedanta deal; rather, this subject has been debated in different context, facts and circumstances in the past but no consensus was ever reached. This conflict remains unresolved primarily due to two (2) reasons, those being (i) Indian companies and India's corporate laws work on the principle of majority rule, and (ii) the majority-minority conflicts are reckoned to be internal company affairs, thus, the courts of law refrain from intervening in such matters.

Needless to state, the solution lies in attaining the right balance between interventions by courts in company matters vis-à-vis protection of the shareholders' rights.

Minority Shareholders' Rights And Company Interests

The Cairn-Vedanta deal raises an instance of majority-minority conflict where the company's interests themselves are jeopardised, i.e., whether majority shareholders, acting individually or in consortium with other shareholders, can take actions which although beneficial to such shareholders' consortium is detrimental to the company and its minority shareholders. The irony is that nothing in law prohibits such actions if backed by appropriate shareholder resolutions, which then become legally valid, binding and enforceable. Having said that, where it can be proved that the company's affairs are being conducted in a manner prejudicial to the interests of the company or its shareholders, a possible remedy available to the minority shareholders is action of "oppression and mismanagement" under Sections 397 and 398 of India's Companies Act, 1956 (the "Companies Act").

"Oppression and mismanagement" are shareholder remedies by way of derivative action in situations where the company's interests and/or the minority shareholders' rights are prejudiced due to conduct of the majority or the company's management, but the company, despite having independent legal identity, is unable to sue the majority or its management. Such derivative actions premised on minority shareholders' rights and company's interests were first conceived in common law within the two paradigms of "rights" versus "interests".

The rights based rule was propounded in the case of *Foss* v. *Harbottle*[1]. This case involved legal proceedings by certain minority shareholders against directors of the company for misappropriation of company assets. The court dismissed the claim and established two rules, namely (i) the "*proper plaintiff*" rule which states the proper plaintiff in an action in respect of a wrong alleged to be done to a company is the company itself, and the minority shareholders do not have unlimited prerogative to exercise personal legal proceedings against the directors in this regard, and (ii) the "*majority right*"

[1] (1843) 67 ER 189

rule which barred minority shareholders' action if the alleged wrong could be ratified in law by the majority. Thus, this case restricted the scope of court intervention in company matters.

Gradually, it was realized that, notwithstanding a company having separate legal existence, it is practically impossible for a company, being an artificial legal person run by the majority, to bring legal actions against oppression or mismanagement by the ruling majority. Thus, the "proper plaintiff" rule was relaxed in the case of *Prudential Assurance Co Ltd* v. *Newman Industries*[2], where the Court of Appeal opined that a court can allow a derivative action by a shareholder if the shareholder can establish a prima facie case that the company is entitled to the remedy claimed and that it is an appropriate case for a person to litigate on behalf of the company. Further, the right based rule of *Foss* v. *Harbottle*[3] was later substituted with the more liberal "interest" based rule of *Ebrahimi* v. *Westbourne Galleries Limited*[4], which held that courts must have wide powers based on "just and equitable grounds" in instances of oppression of shareholders.

In parallel to the foregoing, the Cohen Committee recommendations brought statutory recognition for the first time to derivative actions founded on minority shareholders' rights and company's interests as an alternative remedy to winding up under Section 210 of England's Companies Act, 1948[5].

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[2] (No. 2) [1982] Ch 204
[3] *Ibid.*
[4] [1973] AC 360
[5] Original text of Section 210 of the English Companies Act, 1948: "Alternative remedy to winding up in cases of oppression:
(1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) or, in a case falling within subsection (3) of S.169 of this Act, the Board of Trade, may make an application to the court by petition for an order under this section.
(2) If on any such petition the court is of opinion-
(a) that the company's affairs are being conducted as aforesaid; and
(b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;
the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.
(3) Where an order under this section makes any alteration in or addition to any company's memorandum or articles, then, notwithstanding anything in any other provision of this Act but

In 1962, the Company Law Committee (the Jenkins Committee)[6] made recommendations to further improve Section 210, and which eventually evolved to the current Section 994 of the Companies Act, 2006[7] of England. The enactment of Section 210 of the Companies Act, 1948 of England paved the way for other commonwealth jurisdictions such as Australia, Canada,

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subject to the provisions of the order, the company concerned shall not have power without the leave of the court to make any further alteration in or addition to the memorandum or articles inconsistent with the provisions of the order; but, subject to the foregoing provisions of this subsection, the alterations or additions made by the order shall be of the same effect as if duly made by resolution of the company and the provisions of this Act shall apply to the memorandum or articles as so altered or added to accordingly.
(4) An office copy of any order under this section altering or adding to, or giving leave to alter or add to, a company's memorandum or articles shall, within fourteen days after the making thereof, be delivered by the company to the registrar of companies for registration; and if a company makes default in complying with this subsection, the company and every officer of the company who is in default shall be liable to a default fine.
(5) In relation to a petition under this section, S.365 of this Act shall apply as it applies in relation to a winding-up petition, and proceedings under this section shall, for the purposes of Part V of the Economy (Miscellaneous Provisions) Act, 1926, be deemed to be proceedings under this Act in relation to the winding up of companies."

[6] Board of Trade, *Report of the Company Law Committee (London)*, January 5, 1960, available at http://www.takeovers.gov.au/content/Resources/other_resources/ downloads/jenkins_committee.pdf (last visited on February 15, 2012)

[7] Section 994 of the Companies Act, 2006 of England: "Petition by company member:
(1) A member of a company may apply to the court by petition for an order under this Part on the ground—
(a) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or
(b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.
(1A) For the purposes of subsection (1)(a), a removal of the company's auditor from office-
(a) on grounds of divergence of opinions on accounting treatments or audit procedures, or
(b) on any other improper grounds,
shall be treated as being unfairly prejudicial to the interests of some part of the company's members.
(2) The provisions of this Part apply to a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law as they apply to a member of a company.
(3) In this section, and so far as applicable for the purposes of this section in the other provisions of this Part, "company" means—
(a) a company within the meaning of this Act, or
(b) a company that is not such a company but is a statutory water company within the meaning of the Statutory Water Companies Act 1991."

South Africa, New Zealand and India to legislate similar statutory provisions, and thus, Sections 397 and 398 were introduced in the Indian context.

Sections 397 and 398 of the Companies Act give a right to the members of a company eligible under Section 399 to apply to the court for relief in case of an alleged "oppression" and/or "mismanagement." Section 402 of the Companies Act lists out the likely reliefs that the court may grant if it concludes that:

(i) The company's affairs are being conducted in a manner prejudicial to public interest, or in a manner oppressive to any member or members;
(ii) The facts justify the passing of a winding up order; and
(iii) The winding up order would unfairly prejudice the applicants.

Or

(i) The company's affairs are being conducted in a manner prejudicial to public interest, or in a manner prejudicial to the company's interests; or
(ii) A material change not being a change brought about by, or in the interests of, any creditors including debenture-holders, or any class of shareholders, of the company has taken place in the management or control of the company whether by an alteration in its Board of Directors, or manager or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to public interest, or in a manner prejudicial to the company's interests.

It is imperative to note that neither the term "oppression" nor the term "mismanagement" is defined or explained in the Companies Act, and much depends on how the courts interpret them. Thus, most of oppression/mismanagement law is judge-made law based on the specific facts of each case and there is no standard formula prescribed to ascertain whether a case merits the relief under "oppression" and "mismanagement".

Considering that India traces the "oppression and mismanagement" remedy from English law, it is worthwhile to assess how certain English cases have interpreted these terms. For instance, in *Elder* v. *Elder & Watson Ltd.*[8], while interpreting Section 210 of the English Companies Act, 1948, analogous

[8] (1952) S.L.T. 112

to Section 397 of the Companies Act, the court has elaborately explained that, "*(1) The oppression of which a petitioner complains must relate to the manner in which the affairs of the company concerned are being conducted; and the conduct complained of must be such as to oppress a minority of the members. (2) It follows that the oppression complained of must be shown to be brought about by a majority of members exercising as shareholders a predominant voting power in the conduct of the company's affairs. (3) Although the facts relied on by the petitioner may appear to furnish grounds for the making of a winding up order under the 'just and equitable' rules, those facts must be relevant to disclose also that the making of a winding up order would unfairly prejudice the minority members. (4) Although the word 'oppressive' is not defined, it is possible, by way of illustration, to figure a situation in which majority shareholders, by an abuse of their predominant voting power, are' treating the company and its affairs as if they were their own property' to the prejudice of the minority share-holders…"*[9] Further, the term "oppression" has been explained as "… *conduct which at the lowest involves a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to the company is entitled to rely."*

Likewise, in *Re. Jermin Street Turkish Bath Ltd.*[10], it was held that, "*oppression occurs when shareholders having a dominant power in the company, either (1) exercise that power to procure that something is done or not done in the conduct of the company's affairs or, (2) procure by an express or implicit threat exercising of that power that something is not done in the conduct of the company affairs, and such acts are burdensome, harsh and wrongful and lacks the degree of probity which they are entitled to expect in the conduct of company's affairs."*

"Oppression" has also been coherently explained in the *Halsbury's Laws of England*[11] as, "…*'oppressive' means burdensome, harsh and wrongful. It does not include conduct, which is merely inefficient or careless. Nor does it include an isolated incident: there must be a continuing course of oppressive conduct, which must be continuing at the date of the hearing of the petition. Further, the conduct must be such as to be oppressive to the petitioner in his capacity as a member: whatever remedies he may have in respect of exclusion*

[9] Followed in *Shanti Prasad Jain* v. *Kalinga Tubes Ltd*, AIR 1965 SC 1535
[10] [1970] 1 WLR 1194
[11] James Bowman and Lord Hailsham (eds.), *Halsbury's Laws of England – Volume 7*, (4th Edn., Butterworths Law, 2005) para 1011 cited from *Kamal Kumar Dutta* v. *Ruby General Hospital Ltd.*, 2006 (7) SCC 613

from the company's business by being dismissed as an employee or a director, he will have none under the provisions relating to oppression. On the other hand, these provisions are not confined merely to conduct designed to secure pecuniary advantage to the oppressors; they cover the case of wrongful usurpation of authority, even though the affairs of the company prosper in consequence."

In the Indian context, the Supreme Court of India in the case of *Needle Industries (India) Ltd.* v. *Needle Industries Newey (India) Holdings Ltd.*[12] has held that the person complaining of oppression under Section 397 must show that he has been constrained to submit to a conduct which lacks in probity, conduct which is unfair to him and which causes prejudice to him in the exercise of his legal and proprietary rights as shareholder. Further, the alleged oppression should be a continuous act, and not a single incident or an instance of the past.

On similar lines, the case of *Chatterjee Petrochem (Mauritius) Company* v. *Haldia Petrochemicals Ltd.*[13] stated that, "*provisions of Section 397 seeking relief against oppression can be invoked only when a shareholder feels aggrieved or oppressed that his rights as shareholder are being affected. A shareholder has certain rights conferred by the Companies Act which are statutory rights. Sometimes, certain rights are conferred by the Articles also like preemption rights in case of transfer of shares, non rotational directorship, etc. In both these cases, if the shareholders rights are affected, they can allege oppression. Sometimes, certain rights accrue to a shareholder on the basis of agreements to which the company is a party and there are cases wherein, even though the company is not a party, it has acted upon the said agreement or has derived benefits out of the private agreements. There could be instances, wherein without any written documents, certain rights might have been enjoyed for a long time and when the same is subsequently denied, the affected shareholders may allege oppression. In the last three cases, whether the breach of the terms of the agreements or understandings could be considered to be an act of oppression will depend on the facts of each case."*

In *Sangramsinh P. Gaekwad* v. *Shantadevi P. Gaekwad*[14], the Apex Court held that the advantage accruing to the majority through the alleged

[12] [1981] 3 SCR 698
[13] (2008) 143 Comp Cas 726 (CLB) - para 65
[14] AIR 2005 SC 809

oppressive acts need not necessarily be pecuniary in nature. Instead, if the alleged oppressive acts secure advantage for the majority to the detriment of the minority or cause wrongful usurpation of authority, such conduct can form "oppression."

Further, the case of *Binani Metals Ltd. and Triton Trading Co. Pvt. Ltd.* v. *Gallant Holdings Ltd.*[15] prescribed the following fivefold test to ascertain whether such case merits relief under "oppression":

(a) What is the alleged act of oppression;
(b) Who committed the act of oppression;
(c) How it is oppressive;
(d) Whether it is in the affairs of the company; and
(e) Whether the company is a party to the commission of the act of oppression.

As regards meaning of the term "mismanagement", English law reads both, "mismanagement" and "oppression" together within the *unfair prejudice conduct* test. However, Indian law differentiates between the two concepts by a fine line of distinction, i.e., prejudice to the interests of the company. Aside to prejudice to public interest, while "oppression" (Section 397) deals with conduct of company affairs in a manner oppressive to any member(s), "mismanagement" (Section 398) includes conduct of company affairs in a manner prejudicial to the interests of the company.

Therefore, if the affairs of a company are being run by the board of directors in a manner which is prejudicial to the interest of the company or to the public it is said to be mismanaged. In *Re, Albert David*[16], it was held that a company being run by the board in their own interest overriding the wishes and interest of the company or the shareholders will be reckoned as mismanagement. Courts have also ruled that erosion of a company's substratum, abuse of fiduciary duties, and misuse of company's funds are all instances of mismanagement that come within the ambit of Section 398.[17] In view of the above, whether the foregoing distinction is justified, whether interests of company does not necessarily involve interests of the members, whether the scope of Sections 397 and 398 are overlapping, and questions alike run endlessly and can potentially form a full- fledged research subject.

[15] MANU/CL/0085/2006
[16] (1964) CWN 163, 172
[17] *Narain Das (K.) Bristol Grill (P.) Ltd.*, (1997) 90 CC 79

Additionally, India's company law prescribes different standards of proof for cases falling under "oppression" vis-à-vis cases falling under "mismanagement", i.e., the requirement of facts justifying the making of a winding up order, and which winding up order, if made, would unfairly prejudice the applicants, which is pertinent to "oppression" cases under Section 397, does not apply to "mismanagement" under Section 398. Having said that, due to the overlap of the foregoing provisions, most cases are initiated reading both, Sections 397 and 398 jointly, and thus, the standards of proof and tests applied by courts in "oppression" and "mismanagement" cases are similar from a practical standpoint.

To sum up, it is clear that to avail the remedy of oppression and/or mismanagement, the alleged wrong must be burdensome, harsh and wrongful[18] prejudicial to public interest, members and/or the company itself. To prove oppression and mismanagement, mere lack of confidence in the majority or the management is not adequate, rather lack of fair dealing and probity has to be clearly established. Further, such conduct must cause prejudice to the members in the exercise of their legal and proprietary rights as shareholders, or to the interests of the company, or to public interest in general. The burden to prove oppression or mismanagement is upon the petitioner, who has to approach the court with clean hands. The Court, however, will have to consider the entire materials on record and may not insist upon the petitioner to prove each act of oppression if otherwise oppressive conduct is established up to reasonable extent.

While it is acknowledged that Sections 397 and 398 grant statutory recognition to minority rights, more particularly when the majority acts against the interests of the company, these remedies are seldom endorsed due to heavy costs involved, which small stakeholders find difficult to afford. Moreover, Indian retail shareholders are not so well informed of their rights or of the company affairs to make judgments of the right or wrong done. In terms of the Cairn-Vedanta deal, Cairn Energy's acceptance of the government conditions to accomplish the sale of its stake to Vedanta Group despite such conditions increasing Cairn India's costs and reducing Cairn India's profitability has not been well received by Cairn India's minority shareholders. However, it is yet to be seen whether the minority shareholders take recourse to Sections 397 and 398 of the Companies Act in protest for Cairn India's interests and their rights.

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[18] *Scottish Cooperative Wholesale Society Pvt. Ltd.* v. *Mayor,* (1958) 3 All ER 66 (HL)

Independent directors

Aside to Sections 397 and 398, another instrument for protection of company interests and to prevent abuse by majority is the nomination of *independent directors* on the board of a company. The purpose of having independent directors is to have the corporate decisions scanned through unbiased and impartial eyes before being implemented so that not only the promoters but all investors and the company, as a whole, prosper. An independent director has the responsibility to improve corporate credibility, governance standards and risk management. Accordingly, a majority decision prejudicial to the company or to the minority which lacks probity and fair dealing should ideally be blocked by independent directors.

The concept of "independent directors" was first discussed in India by the 1999 Kumar Mangalam Birla Committee on corporate governance, which was followed by the Naresh Chandra Committee, and finally streamlined by the Narayanmurthy Committee in 2004. Appointment of independent directors was made mandatory for Indian public listed companies through the progressive Clause 49 in the Listing Agreement introduced by SEBI, which requires at least 50% of the board of directors to consist of independent directors in case of companies with an executive chairman, and at least one-third of the board of directors to consist of independent directors in case of companies with a non-executive chairman. While experts opine that Clause 49, as currently worded, covers within its ambit adequate safeguards from corporate governance standpoint, substantial doubts are raised on how efficient this "independent directors" mechanism has been in practice, more so after the Satyam debacle of 2009.

The two basic qualifications with which an independent director must be equipped with are (i) in depth knowledge of the company's business and affairs, and (ii) independence from being directly or indirectly controlled by the promoters or majority. As regards (i) above, independent directors are swamped with directorship of multiple companies not being cognizant of such companies' operations and affairs, and have played a placid role to make way for the promoters' wants and wishes. This is further compounded with high remuneration being paid by promoters to such independent directors. In respect of (ii), it appears that "independent directors" in Indian companies merely conform to the statutory definition of "independence" in words, and not in spirit. In most cases, "independent directors" are promoter nominated directors in disguise, and thus, no more than a myth or an eyewash. All in all, "independent directors" has been a utopian concept for India, not evidenced in practice.

Having said the foregoing, the role of independent directors has been under the regulatory scanner pursuant to the wake-up call in the Satyam debacle, and may once again have been put to test in the Cairn-Vedanta deal. It is to be seen how and on what grounds the independent directors of Cairn India approve and justify the acceptance of the government conditions which clearly conflict with the company and the minority interests only to accomplish certain majority shareholders' objectives.

Conclusion

Although corporate governance has always been a challenge in the Indian context, companies are now striving hard to augment their corporate credibility by adhering to healthy corporate practices. In this regard, while on one hand, companies are actively formulating policies and enforcement mechanisms to attain corruption free corporate culture, on the other hand, companies are also working towards a harmonized corporate environment, where each component, including the majority and minority shareholders, complements, and not conflicts, with the others. Although investor awareness is still at a nascent stage in India, the majority is now cognizant that minority interests can no longer be disregarded or overlooked, and majority rule is slowly giving way to accommodate the minority voices. Having said that, this progression is slow and India still needs a lot of motivation to work out practicable solutions within the contours of law and corporate governance for challenges such as Cairn-Vedanta. While the Cairn-Vedanta deal may have got the nod from the CCEA finally[19], additional hurdles in the form of other issues of corporate governance such as the recent allegations of serious human rights violations, default of payment, and environmental damage in its mining and metal projects in India had to be faced.[20]

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[19] The Times of India, *Cairn-Vedanta Deal gets CCEA Nod*, January 25, 2012

[20] Sujay Mehdudia, *Cairn-Vedanta Deal Comes Under a Cloud*, The Hindu, January 18, 2012 (Print Edition)

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Forewarned is Fore armed: Human Rights Violations by Corporations in India

Harshit Anand[*] and Surya Prakash[**]

Corporate activity in India in its struggle for control over land, water and mineral resources has raised serious concerns relating to Human Rights violations. The crucial elements for protection of Human Rights, access to justice and effective legal remedies are denied by a system which is plagued by inadequate laws, endemic judicial delays and widespread corruption.

Enactment of laws of responsibility and forms of liability in emerging areas is a herculean task, pitched against a strong corporate lobby that guides national politics.

This comment analyses the existing legal framework and aims to address limitations in guaranteeing redress to victims of corporate human rights abuses in India and thereby argues for a mandatory Corporate Social Responsibility and Liability of the sternest proportions for human rights violations.

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Introduction

The conventional legal framework for protection of human rights is state-centric; it obligates primarily states to promote human rights and act against violations.[1] The international community is realizing that in order to achieve fuller and wider realisation of human rights, the umbrella of human rights obligations and their enforcement should cover Multinational Corporations ("MNCs").[2] The basic fallacy in the system today is that it was never designed in a way which would cover MNCs in a comprehensive manner.

World over there are numerous instances of companies, from Indian to foreign companies and their subsidiaries, joint venture enterprises, etc. violating human rights and causing irreversible damage.[3] Early instances of corporate human rights abuses can be traced to illegal business activities such as the slave trade or opium trafficking by the British East Indian Company[4] and more recent examples include the gas leakage at Union Carbide's Chemical plant at Bhopal,[5] Enron's Dabhol power project in Maharashtra,[6] Tata's proposed car plant in Singur, West Bengal;[7] and Vedanta's mining operations in tribal areas of Orissa.[8]

It is in this light that the authors have analysed the Indian legal system, discussed the position of Law in the United States of America and finally concluded by suggesting suitable amendments to the Indian legal framework.

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[1] Surya Deva, *Human Rights Violations by Multinational Corporations and International Law: Where from Here*, 19 Conn. J. Int'l L. 1 (2003-2004)

[2] Steven R. Ratner, *Corporations and Human Rights: A Theory of Legal Responsibility*, 111 Yale L.J. 443, 461 (2001)

[3] International Commission of Jurists, *Access to Justice: Human Rights Abuses Involving Corporations - India*, available at www.indianet.nl/pdf/AccessToJustice.pdf (last visited on February 15, 2012)

[4] Donald C Dowling, *The Multinational's Manifesto on Sweatshops, Trade/Labour Linkage, and Codes of Conduct*, 8 Tulsa Journal of Comparative and International Law, p. 528

[5] Amnesty International, *Clouds of Injustice: Bhopal Disaster 20 Years On, Amnesty International, London* (2004)

[6] Human Rights Watch, *The Enron Corporation: Corporate Complicity in Human Rights Violation*, January 23, 2002, available at http://www.hrw.org/reports/1999/enron/ (last visited on February 15, 2012)

[7] Gargi Gupta, *Singur farmers: Why they oppose Tata plant*, 9 December, 2006 available at http://www.rediff.com/money/2006/dec/09tata.htm (last visited on February 15, 2012)

[8] The Economic Times, *Environment Ministry stalls Vedanta's Niyamgiri project in Orissa*, August 24, 2010 (Print Edition)

Liability of Corporations under Indian Law

A. International Legal Instruments

India has acceded or ratified a number of international human rights instruments that have direct or indirect relevance to the human rights responsibilities of companies such as the International Covenant on Civil and Political Rights, the Abolition of Forced Labour Conventions, etc.[9] but the Indian government has entered substantive reservations to many of these instruments,[10] thus, diluting the effect of its treaty obligations.

Also, India is yet to ratify several important international instruments such as the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, the Rome Statute of the International Criminal Court. More importantly, it is pertinent to note here that, apart from ratification of international instruments and subsequent enactment of municipal laws in India, a much greater emphasis should be on enforcement and the laws must be moulded accordingly.

B. The Companies Act, 1956

The Indian Companies Act of 1956 contains several provisions that contemplate the criminal liability of companies and/or its relevant officers in various situations. Section 168 makes a company and its officers criminally liable if an annual general meeting is not held in accordance with Section 166. Criminal sanctions (in terms of fine) against companies and their officers are provided for not filing annual returns with the Registrar,[11] for a breach of provisions related to auditing;[12] criminal penalty is also stipulated for an improper issue, circulation or publication of balance-sheet or profit and loss account.[13] Furthermore, other provisions of the Companies Act contemplate criminal sanctions only against corporate officers. Section 63 provides that if a prospectus includes any untrue statement, 'every person who authorised the issue of the prospectus shall be punishable with imprisonment for a term

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[9] University of Minnesota Human Rights Library, *Ratification of International Human Rights Treaties – India*, available at http://www1.umn.edu/humanrts/research/ratification-india.html (last visited on February 15, 2012)

[10] Rule of Law in Armed Conflict Project, *India: International Treaties Adherence*, available at http://www.adh-geneva.ch/RULAC/international_treaties.php?id_state=107 (last visited on February 15, 2012)

[11] Section 162

[12] Section 232

[13] Section 218

which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both'. Similarly, any person who fraudulently induces another person to invest in shares/debentures is punishable under Section 68. Also, if a dividend declared by a company is not paid to the shareholders within thirty days of such declaration, every director shall be criminally liable if she was knowingly a party to the default.

This appraisal of the provisions of the Companies Act signifies that, although corporations and/or their officers could be held criminally liable, the same arises for breach of restricted corporate governance issues. It is thus, inconceivable to invoke these provisions in cases where the allegation is that a given company harmed the interests of stakeholders beyond shareholders, investors or managers by, for example, violating human/labour rights or polluting the environment.

Although the current companies law framework does not offer much hope for victims of human rights abuses, three developments seem to indicate a change in this regard. First, the Companies Bill, 2011 *vide* Clause 178(5) states that the "Board of Directors of a company having a combined membership of the shareholders, debenture holders and other security holders of more than one thousand at any time during a financial year shall constitute a Stakeholders Relationship Committee consisting of a chairman who shall be a non-executive director and such other members of the Board as may be decided by the Board." It further provides that this Committee "shall consider and resolve the grievances of stakeholders."

Further, Clause 135 of the Companies Bill, 2011, includes Corporate Social Responsibility by making,

"Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director."

Finally, the 2009 Corporate Social Responsibility (CSR) Voluntary Guidelines issued by the Ministry of Corporate Affairs[14] lay down the following as a fundamental principle:

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[14] Ministry of Corporate Affairs, Government of India, *Corporate Social Responsibility Voluntary Guidelines 2009*, December 2009, available at http://www.mca.gov.in/Ministry/latestnews/CSR_Voluntary_Guidelines_24 dec2009.pdf, (last visited on February 15, 2012)

"Each business entity should formulate a CSR policy to guide its strategic planning and provide a roadmap for its CSR initiatives, which should be an integral part of overall business policy and aligned with its business goals. The policy should be framed with the participation of various level executives and should be approved by the Board."

An objective analysis tells us that the above mentioned 'paper laws' have failed to meet the end for which they were brought. It is pertinent to note that the following suggestions need to be incorporated in the Companies Bill to make the framework effective:

1. Specific offences such as mis-representation and fraud should be made directly cognizable.
2. Fines and penalties under the Companies Act should be revised periodically so as to retain their deterrent value.
3. The Annual Report of a company must make a disclosure in this regard that the Company has not indulged in any such violative practices.
4. The National Company Law Tribunal once enacted and presently the High Court should be empowered by a specific provision to order winding up of a corporation in cases of human rights violations, thereby ensuring adequate compensation.

C. Criminal Law

Section 2 read with Section 11 of the Indian Penal Code (the "IPC") are sufficient to book corporations for crimes under the code. In *Standard Chartered Bank* v. *Directorate of Enforcement*,[15] the Supreme Court has held that a company cannot avoid criminal liability merely on the ground that the mandatory punishment provided for a given offence is both "imprisonment and fine" and a company cannot be imprisoned. Hence, the company must be compelled to pay substantial fines and damages.[16]

This purposive interpretation opens the possibility of companies being prosecuted for a larger number of criminal offences than that would otherwise be possible.[17] Also, Section 3 and 4 give extra-territorial applicability to the IPC thus; MNCs can be prosecuted in Indian Courts. Finally, the Indian

[15] AIR 2005 SC 2622
[16] *Iridium India Telecom Ltd.* v. *Motorola Incorporated*, (2011) 1 SCC 74
[17] M Vidhan, *Company's Liability where Imprisonment is Mandatory Part of Sentence*, (2007) PL June 6

position as to the liability of the persons controlling corporations is very clear that liability of officers and directors may be separately established[18] and they may be prosecuted upon establishment of a reasonable nexus of the offence with their official capacity.[19]

Therefore, there are specific limitations for establishing criminal liability i.e.:

1. Weak law-enforcement agencies are ill-equipped to act against large and powerful MNCs.
2. The Courts are reluctant in lifting the Corporate Veil and legal precedents in this regard are unclear while fixing liability of executives and board members.

D. Environmental Laws

Currently, India has complex web of environmental laws,[20] and their efficacy and implementation remain matters of serious concern. The difficulties experienced by victims in securing some form of immediate compensation following an industrial disaster such as Bhopal led to the enactment of the Public Liability Insurance Act (the "PLIA") in 1991.[21] The PLIA aims to provide "immediate relief" to "persons affected by accident[s] occurring while handling any hazardous substance and for matters connected therewith or incidental thereto." Accordingly, it introduces a provision for no-fault compensation to victims of not all industrial accidents but only those involving hazardous substances. In this regard, the establishment of the National Green Tribunals is a welcome step, however, the Tribunals have not been provided sufficient means to prosecute and penalize corporations.

E. Other Areas

Other areas which need to be synchronized to fix corporate liability for human rights abuses are:

1. Worker welfare laws must spell out specific duties for MNCs to be carried out in consonance with international standards.
2. Land Acquisition Laws in India have been the major bone of contention, a few examples being the TATA project in Singur, POSCO project in Orissa etc.

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[18] *UP Pollution Control Board* v. *Modi Distillery*, (1987) 3 SCR 798

[19] *Anil Hada* v. *Indian Acrylic Ltd.*, (2000) 1 SCC 1

[20] C M Abraham & Armin Rosencrantz, *An Evaluation of Pollution Control Legislation in India*, 11 Columbia Journal of Environmental Law, p. 101 (1986)

[21] *Supra* Note 3

3. Information laws i.e. primarily RTI must be extended to activities of Corporations which affect public and social life at large.
4. The upcoming SEZs are exempted from the applicability of certain crucial laws which may see that MNCs exercise undue influence in securing their interests.
5. The state-business nexus must be checked and public opinions must be seen as the directing force. A crucial suggestion being made here is that a plebiscite from the local population before setting up big industrial plants should be taken up as an essential custom.

Forum Non Conveniens

Forum non conveniens "is a common law doctrine which permits courts to dismiss cases on the basis that the balance of relevant interests weighs in favour of trial in a foreign forum." The test that courts apply to dismiss a case on the ground of forum non conveniens varies between countries.[22] In the Bhopal case, Judge Keenan for the US District Court on 12 May, 1986 dismissed the suit on the ground of forum non conveniens. As all private and public interest factors favoured the dismissal of the suit, Keenan was "firmly convinced that the Indian legal system is in a far better position than the American courts to determine the cause of the tragic event and thereby fix liability." The judge was also of the view that this will afford the Indian judiciary an "opportunity to stand tall before the world" and dispel any signs of judicial imperialism.[23] But Judge Keenan required Union Carbide Corporation ("UCC") to agree in advance to submit to the jurisdiction of the courts of India. The US Court of Appeals affirmed the order of dismissal on the ground of forum non conveniens. The dismissal of the suit from the US courts was seen as a victory for UCC, which did prefer to litigate, if at all, in India. From the victims' perspective, on the other hand, it was a major blow to their hopes of securing adequate compensation. Other victims of corporate human rights abuses have similarly experienced the obstacle of forum non conveniens.[24]

[22] Peter Prince, *Bhopal, Bougainville and Ok Tedi: Why Australian Forum non Conveniens Approach is Better*, 47 International & Comparatively Law Quarterly, p. 573 (1998)
[23] *Supra* Note 3.
[24] Upendra Baxi, *Inconvenient Forum and Convenient Catastrophe: The Bhopal Case*, (N M Tripathi Pvt. Ltd., Bombay, India, 1986), pp. 2-30.

A. Locating stakeholders' interests in Company Law

Traditionally, Indian companies (at least prominent ones) practiced social philanthropy.[25] But such corporate philanthropy is neither widely practiced nor adequate to promote a general corporate culture to respect human rights and embrace sustainable business policies. In recent years, it is increasingly felt that company law has an important role to play in developing a corporate culture in which business decisions are informed by a concern for human rights.

B. Liability of Corporations under American Law

In United States (the "US") federal court suits against corporations are filed under the Alien Tort Statute ("ATS").[26] Although, most ATS cases concern violations committed abroad, some have related to corporate abuses committed in the US. The question of the proper scope of liability of corporations and their executives for aiding and abetting human rights violations remains unclear after the US has witnessed a number of high profile matters:

1. Caterpillar, for selling bulldozers to the Israeli military, which used them to demolish Palestinian homes.[27]
2. Yahoo, for providing the Chinese government with internet records leading to the identification and alleged torture of a human rights activist.[28]
3. Wal-Mart, for failing to stop suppliers from committing labor abuses.[29]
4. Nestle, for buying cocoa and providing services to cocoa farmers employing child labor.[30]
5. Unocal, for participating in a Burmese gas pipeline construction project, whose contracted security forces allegedly engaged in forced labor, forced displacement, murder and rape.[31]

Though in the US, the laws of prosecution are clear and firm but liability is seldom fixed thus, defeating the very purpose of enactment of the statute. Also, enforceability and preventing coercion of affected parties remain largely neglected.

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[25] A C Fernando, *Business Ethics: An Indian Perspective* (Pearson Education, New Delhi, 2009) p. 236-37
[26] Alien Tort Claims Act, 28 U.S.C. § 1350 (2007)
[27] *Corrie* v. *Caterpillar Inc.*, 403 F. Supp. 2d 1019 (W.D. Wash. 2005)
[28] *Xiaoning* v. *Yahoo! Inc.*, No. 07-CV-2151 (N.D. Cal. July 30, 2007)
[29] *Doe* v. *Wal-Mart Stores Inc.*, No. 05-CV-7307 (C.D. Cal. Dec. 28, 2005)
[30] *Doe* v. *Nestle S.A.*, No. 05-CV-5133 (C.D.Cal. July 14, 2005)
[31] *Doe I* v. *Unocal Corp.*, 395 F.3d 932 (9th Cir. 2002)

India must also undertake enactment of such a suitable legislation wherein at least roadblocks for prosecution of MNCs may be cleared.

C. OECD

In 1976, the OECD adopted a Declaration on International Investment and Multinational Enterprises designed to protect the rights of investors. As part of this 1976 package, it produced the Guidelines for Multinational Enterprises. Critics say these “OECD Guidelines” were a concession to criticism about the power of multinationals over governments and talk in the UN at the time of a New International Economic Order. Ministers from OECD states adopted revised OECD Guidelines in June 2000. They set out standards of practice for multinationals covering disclosure of information, workers’ rights and industrial relations, environmental protection, bribery, consumer interests, science and technology, ensuring competition and payment of taxation.[32]

The most significant change introduced in the 2000 revision was a tentative general statement that said that multinationals should respect human rights.[33] This entirely new paragraph II.2, states that:
“[Enterprises should] respect the human rights of those affected by their activities consistent with the host government’s international obligations and commitments.”

India is a member of the OECD but the country’s corporate governance framework has not incorporated any provision in this regard. The Guidelines are, rather curiously, accompanied by a detailed implementation procedure that is binding on OECD member states, though not on multinational enterprises.[34] The OECD guidelines have off late acquired substantial importance in the international arena and these guidelines must be deliberated upon further to widen their scope and presence.

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[32] International Council on Human Rights Policy, *Beyond Voluntarism: Human Rights and the Developing International Legal Obligations of Companies*, February 2002 available at http://www.ichrp.org/files/reports/7/ 107_report_en.pdf (last visited on February 15, 2012)
[33] OECD, *Guidelines for Multinational Enterprises: Review 2000*, June 27, 2000, C (2000) 96/REV.1., para.3
[34] Decision of the Council on the OECD Guidelines for Multinational Enterprises, adopted by the Council at its 982nd session, 26-27 June, 2000

D. UN Sub-Commission Draft Fundamental Human Rights Principles for Business Enterprises

The United Nations has also attempted to develop a comprehensive declaration setting out the responsibilities of companies in relation to human rights. The Draft Fundamental Human Rights Principles for Business Enterprises have been prepared under the authority of the UN Sub-Commission on Promotion and Protection of Human Rights. The Sub-Commission, a subsidiary body of the Commission on Human Rights, is composed of 26 independent experts and in its long history has developed and proposed numerous human rights standards, a number of which have been endorsed by the Commission and the UN General Assembly.[35]

The Draft is wide-ranging, dealing with general obligations to respect human rights; specific duties in areas such as workers' rights, the right to health, food and other economic, social and cultural rights; civil and political rights such as freedom of expression; as well as the application of human rights standards to newer issues such as corruption, consumer protection and environmental protection.[36] Once officially endorsed by the sub-commission the draft is most likely to be taken up by the commission on Human Rights. The Preamble to the current draft states that although,
"... governments have the primary responsibility to promote and protect human rights, transnational corporations and other business enterprises, as organs of society, are also responsible for promoting and securing ... human rights" [and]

"transnational corporations and other business enterprises, their officers, and their workers are further obligated directly or indirectly to respect international human rights and other international legal standards"

In its first article, the Draft states:
"... transnational corporations and other business enterprises also have the obligation to respect, ensure respect for, prevent abuses of, and promote international human rights within their respective spheres of activity and influence."

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[35] *Supra* Note 32.
[36] Draft Universal Human Rights Guidelines for Companies, May 21, 2001, with Addendum 1 that contains the previous draft. UN Doc: E/CN.4/Sub.2/2001/WG.2/WP.1 (Introduction), and UN Doc: E/CN.4/Sub.2/2001/WG.2/WP.1/Add.1 (Addendum 1).

The Draft Principles aim both to supplement existing international law, and help to clarify the scope of legal obligations on companies. The drafting process has included consultation with NGOs, trade union organisations, employer federations, some governments and companies and intergovernmental organisations such as the ILO.[37] The above steps seem to be very positive but the time period taken and the nature of the resolution being overtly general require a lot of effort to be made effective and efficient. It may be seen that the General Assembly and the WTO may now take responsibility to take this initiative to the desired result.

Conclusion

Looking ahead a policy of greater liberalisation and more emphasis towards increasing private sector participation in crucial industries such as power, infrastructure etc. is visible. It is imperative that the grey areas discussed in this paper must be addressed and preferably a special statute be enacted to safeguard public interest.

It is highly inexplicable as to why no such specific jurisprudence wherein corporations are regulated in an efficient manner has developed in India even though there is no dearth of examples of gross human rights violations across the country. India is now a major market for an ever increasing number of global corporations and it is inconceivable that we should regulate them with half a century old laws.

Finally, the approach to regulate corporations should be in a manner wherein they are required to file compliance reports with the government. The strategy should be one of prevention rather than cure. In the long run, it is bound to be in the country's favour if we develop a strong, sound and efficient legal framework with a higher credibility than before where in transparent processes of stakeholder participation in sensitive matters are developed.

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[37] Report of the Seminar to Discuss UN Human Rights Guidelines for Companies, Geneva 29-31 March
2001, Addendum 3 UN Doc: E/CN.4/Sub.2/2001/WG.2/WP.1/Add.3 (Addendum to UN Doc: E/CN.4/Sub.2/2001/WG.2/WP.1).

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PotemkinVillage of Independent Directors

Neeti Shikha[*]

Over the past decade, despite the adoption of the Cadbury Committee Recommendations, the success in area of corporate governance remains elusive. As the economic power of the Board has been increasing, many structural changes have been suggested in mechanism of corporate governance in order to bridle the increasing power of the Board. Of the broad spectrum of structural changes under contention, few come with such broad support as the notion of the "independent" or "outside" directors on the Board.

Though the success of combined code itself has been questioned, its recommendation of having an independent director remains to hold the highlight even today. Many argue that addition of independent directors to corporate boards would not only make the Board more independent by avoiding the conflict of interest, it will also solve the problem of corporate social responsibility without incurring the costs of external regulation. Hence, in tune with the practices in the West, India has also adopted a similar approach and has made the role of independent directors in corporate governance almost inevitable. The New Companies Bill suggests that one-third of the Board to be comprised of independent directors.

This paper will critically analyse the likelihood of their success in this new role. It will throw light on the obstacles independent directors will encounter in policing managerial conflicts of interest and in monitoring the maximization of shareholder wealth, especially in Indian scenario where most of the corporations are family owned. It may be improper to infer that independent directors can perform the still more difficult task of nurturing social responsibility to a significant extent as to justify eliminating or diluting regulatory controls on corporate behaviour. In the end, the paper will forward a few suggestions that will help in achieving the objective of independence.

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CONTENTS

I. Introduction

Over the past decade, since the adoption of the Cadbury Committee Recommendations, the success in the area of corporate governance remains elusive. As the economic power of the Board has been increasing, many structural changes have been suggested in the mechanism of corporate governance in order to bridle the increasing power of the Board. Of the broad spectrum of structural changes under contention, few come with such broad support as the notion of "independent" or "outside" directors on the Board. The proposition that directors should "act independent of management, through a thoughtful and diligent decision-making process" has been a major preoccupation of corporate governance scholars for several decades. Indeed, the need for active, independent boards has become conventional wisdom.[1] Professor Victor Brudney noted that the concept of independence "does not carry a clear meaning for many of its proponents or the same meaning for all its proponents".[2]

Though the success of combined code itself has been questioned, its recommendation of having an independent director holds significance even today. Many argue that addition of independent directors to corporate boards would not only make the Board more independent by avoiding the conflict of interest, it will also solve the problem of corporate social responsibility without incurring the costs of external regulation. Hence, in tune with the practices in the West, India has also adopted a similar approach and has made the role of independent directors in corporate governance almost inevitable. The New Companies Bill suggests that one-third of the Board is to be

[1] *Beyond "Independent" Directors: A Functional Approach to Board Independence*, H.L.R, Vol. 119, No. 5, p. 1553-1575 (March, 2006)
[2] Victor Brudney, *The Independent Director: Heavenly City or Potemkin Village?*, H.L.R, Vol. 95, No. 3, p. 597-659 (January, 1982)

comprised of independent directors.[3] Whether introduction of independent directors in such a number alone can solve the problem of ill governance is yet another debate. The purpose of this article is to suggest measures that go beyond independent directors. The author strongly believes that the current position of independent directors in India may prove to be a whammy. This is so because, on one side, the number and power of such directors is escalating and on the other side, duties and liabilities set out for them are not properly defined. In fact, there are some suggestions that, those independent directors should be protected from incurring liabilities. As such, there is a fear for corruption of economic power, there is equal concern about the commitment of independent directors whose interest is not inclined with the company performance and also bear no liability for their action.

The nexus of contract theory implicitly concedes that directors' control of shirking (or agency problems) would be suboptimal if decision agents, *i.e. decision management* and *decision control,* are not properly separated.[4] According to this theory, Board of directors have two fold roles, as an agent of the company and a monitor for the implementation of managerial policies and performances.[5] Effective discharge of these functions would imply that management does not influence directors' judgement or decisions on the hiring and firing of managers, while the contractualists seem to recognise the problems that may result from lack of separation in decision processes; they, however, assume that the board members (insiders and outsiders), particularly the outside members, have incentives to develop reputations as experts in decision control.[6] However, this view is not supported by any empirical

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[3] Clause 132 (3) Companies Bill, 2011

[4] Ronald H. Coase, *The Nature of the Firm*, 4 Economica, New Series 16, 386-405 (1937) Reprinted in Oliver, E. Williamson & Sidney (eds.), *The Nature of the Firm: Origins, Evolution and Development* (Oxford University Press, New York, 1993). See Daniel J. H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees - Revisited*, 69 S. Cal. L. Rev. 1021 (1996); Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989).

[5] Harold Demsetz, *The Theory of the Firm Revisited*, Oliver, E. Williamson & Sidney (eds.), *The Nature of the Firm: Origins, Evolution and Development* (Oxford University Press, New York, 1993), p.159 at 162. Note that in law, a board of directors is the agent of the corporation rather than that of the shareholders. However, it is sometimes loosely said that directors are the agent of the shareholders.

[6] *Supra* Note 5. (The early development of transaction cost paradigm deals with the question of the existence of firms. Why do firms emerge as viable institutions when the perfect decentralization model amply demonstrates the allocative proficiency of the prices that emerge from impersonal markets? The question was asked and answered by Coase). Most outside directors of open corporations are either managers of other corporations or important decision agents in other complex organizations. They use their directorships to signal to

evidence. Studies reveal that Board performance is conditional upon many factors; one of which is effective monitoring and the presence of outside directors on the board of firms experiencing gross failure of strategy and performance.[7] Even in this situation, effective monitoring by the board has, sometimes, been linked with the shares that directors (or management generally) have in a firm, rather than just being outsiders or independent of management.[8] Interestingly, other studies demonstrate that most cases of boards' activism, particularly those involving top executive turnover, are engendered by pressure from institutional shareholders rather than purely from boards' initiatives.[9] Recently, Klein's study of the link between board composition and firm performance dissects the issue further by showing that a board's effectiveness in monitoring management depends not only on the ratio

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internal and external markets for decision agents that (1) they are decision experts, (2) they understand the importance of diffuse and separate decision control, and (3) they can work with such decision control systems." See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Margaret M. Blair, *A Contractarian Defense of Corporate Philanthropy*, 28 Stetson L. Rev. 26 (1998); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective*, 84 Cornell L. Rev. 1266 (1999); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. Law & Econ. 327 (1983) [hereinafter called "*Agency Problems and Residual Claims*"]. It is not possible to exhaust all the arguments in this article.

[7] James A. Beckley, Jeffrey L. Coles, et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. Fin. Econ. 371 (1994); John W. Bird & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. Fin. Econ. 195 (1992); Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. Fin. Econ. 175 (1990); Michael Weisbach, *Outside Directors and CEO Turnover*, 20 J. Fin. Econ. 421 (1988)

[8] *Supra* Note 4; See Michael Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990). Hyeon Cho, *Ownership Structure, Investment and the Corporate Value: An Empirical Analysis*, 47 J. Fin. Econ. 103 (1998); J. McConnell & H. Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. Fin. Econ. 597 (1990) (These two studies confirm, however, that inside ownership produces optimal alignment of managerial interests with the shareholders only if it is at low levels. At high levels, managerial ownership makes management more entrenched, less insensitive to shareholders interests and less subject to market discipline).

[9] See Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757 (1989); David J. Denis & Jan M. Serano, *Active Investors and Management Turnover Following Unsuccessful Control Contests*, 40 J. Fin. Econ. 239 (1996); David J. Denis & Diane K. Denis, *Performance Changes Following top Management Dismissal*, 50 J. Fin. 1029 (1995) at 1055. See also D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lesson from K-Mart*, 74 N. C. L. Rev. 1034 (1997).

of inside to outside directors, but on the committees on which inside directors serve.[10]

Cadbury report and other major reports on corporate governance confirm the many problems that afflict board operations, which are overlooked in the "nexus of contracts" theory.[11] Victor Brudney observes that, "if they are inside directors, their conflicts of interest make impossible a market in which stockholders can fairly be said to function, let alone function optimally, in the selection process;[12] if they are outside directors, their conflicts of interests are less acute; but their social and economic relationship with managers, their personal economic incentives and time constraints, and velvet sanction for managerial non-performance infect all efforts to identify them exclusively with stockholders' interests in selecting, retaining, or monitoring management. Indeed, they are likely to identify more closely with management than with stockholders, particularly in terminating management."

As the economic power of the Board has been increasing, many structural changes have been suggested in mechanism of corporate governance in order to bridle the increasing power of the Board. Though the success of combined code itself has been questioned, its recommendation of having an independent director remains to hold the highlight even today. Many argue that addition of independent directors to corporate boards would not only make the Board more independent by avoiding the conflict of interest, it will also solve the problem of corporate social responsibility without incurring the costs of external regulation.

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[10] Positive linkages are found between the percentages of inside directors on finance and investment board committees and accounting and stock market performance measures - Sanjai Bhagat & Bernard Black, *The Uncertain Relationship between Board Composition and Firm Performance*, 54 Bus. Law. 921 (1999)

[11] Alchian & Demsetz define team production as *a production in which (1) several types of resources are used and (2) the product is not a sum of separable outputs of each cooperating resource. An additional factor creates a team organisation problem and; (3) not all resources used in team production belong to one person*. See *Ibid.* at 779. The theory, as earlier noted, assumes that the board would perform efficiently in monitoring managerial activities. In any event, the market would serve as a discipline for an under-performing board. This approach overlooks the likely possibility of a board's dependency on management and the impact of this on the shareholders' interests. Also see Ige Omotayo Bolodeoku, *Economic Theories Of The Corporation and Corporate Governance: A Critique*, Journal of Business Law 411 (2002).

[12] Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 Geo. Wash. L. Rev. 325 (1987)

This article will critically analyse the likelihood of their success in this new role. It will throw light on the obstacles independent directors will encounter in policing managerial conflicts of interest and in monitoring the maximization of shareholder wealth, especially in Indian scenario where most of the corporations are family owned. It is not contended that introduction of independent directors on the Board will not strengthen the corporate governance regime. Rather, the aim of the article is to suggest that there is a need to think beyond independent directors and strengthen the other tenets of corporate governance for evolving the best practice.

II. Independent Director - Theoretical Justification

This section will reflect upon the theoretical justification of independent directors and critically analyse whether such justification has practical significance.

The notion is largely prevalent that independent directors add objectivity to the Board. The emphasis on the value of independence in both academic and practitioner work reflects the notion that independent directors are better at monitoring the management because they are not, or are less, subject to the classic agency problem.[13] Fama and Jensen note that the majority of independent directors are managers or decision makers who care about their reputation.[14]

There has been conflicting evidence, however, on whether the supposedly effective monitoring by independent directors materializes. Observations from noted scholars show that the contribution of independent directors to firm performance is insignificant while some scholars have attempted to show that stock price reacts positively to the nomination of independent directors to the board.

The notion that independence of directors is essential and advantageous is undisputed, but what constitutes director independence and how it effectuates the aims of corporate governance reforms is often put to dispute. A quarter of a century ago, Professor Victor Brudney noted that the concept of independence "does not carry a clear meaning for many of its

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[13] B.D. Nguyen and KM Neilsen, *The Value of Independent Directors: Evidence from Sudden Deaths*, available at http://www.efa2009.org/papers/SSRN-id1342354.pdf (last visited on February 15, 2012)

[14] Fama, Eugene F. and Michael C. Jensen, *Separation Of Ownership And Control*, Journal of Law and Economics 26, 301-325 (1983)

proponents or the same meaning for all its proponents."[15] The intervening years, which have witnessed a raft of empirical studies searching for links between director independence and board effectiveness,[16] have only deepened the ambiguity that pervades the independence literature.[17] Such ambiguity has long afflicted legislative, regulatory, and judicial definitions of independence as well.[18] And once these definitions become legal mandates, the definitional ambiguity rapidly entrenches itself in corporate charters, rendering attempts to develop independence based reforms more complex.

Clause 49 of the Listing Agreement in India provides that two-thirds of the audit committee shall have independent directors, with a minimum of three members, and the Chairman of the audit committee shall be an independent director. The clause specifically provides that the Chairman of the Audit committee shall be present at the Annual General Meeting to answer shareholder queries. The new Companies Bill in India has taken the task to define who is an independent director.[19]

A key role of an independent director is bringing in special expertise that provides guidance to the company in its strategic policies while evaluating decisions of the management of the company. Transparency in companies is the most important issue being faced today. Mandates can ensure good standards in a limited way when markets are driven by greed. Only investors can, and should punish those at the helm of companies that get caught. In fact, the investors may even condone corporations that admit to having made genuine mistakes and undertake to learn, and incarcerate those who use corporate governance merely as a cover up for their "business as usual" approach. Thus, it is important to provide clarity to their role, responsibilities and legal liabilities by creating self evaluation procedures. Boards must set their goals as well and evaluate their performance. This should be beyond assumption of risks and taking huge rewards for this. Corporate Social Responsibility should play a more important role. It is

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[15] *Supra* Note 2.

[16] See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. Rev. 898, 921-39 (1996) (collecting studies)

[17] As Professor Donald Langevoort puts it, "Independence is a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals." Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797, 798 (2000)

[18] See *Supra* note 2 (Summarizing various definitions of "independence").

[19] Clause 132 of the new Companies Bill defines who is an 'Independent Director'.

necessary for the directors to have appropriate information to understand and monitor the risks that their company faces. For this, learning-avenues to update their skills should be introduced. Finally, directors whether independent, executive or non-executive must seek to balance their roles as strategic advisors and setting good governance practices.

The Satyam fraud has raised questions about the integrity of Boards and it seems that despite the company complying with the mandate of clause 49, the conduct of the directors went unnoticed. The waves of concern were felt not only in India but also elsewhere. In India, the parliament seems to have addressed this by defining directors' duties in the proposed Company Bill, 2011[20]. The Bill defines the duties of directors and norms for composition of boards. It also seeks to provide that every company shall have at least one director who would be ordinarily resident in India.[21] The clause further provides the conditions for appointment of independent director. The clause also seeks to define the terms "independent director" and "nominee director" and seeks to provide that an Independent Director shall not be entitled to any remuneration, other than sitting fee, reimbursement of expenses for participation in Board meeting and profit related commission and stock options as approved by the members.[22] Interventionist policy of India with regards to company laws has been a separate debate and many question the success of foreign investment in India if such policy continues. One may ask why should government be concerned and make such laws to ensure corporate governance when role of directors and shareholders are primarily based on the terms they have contracted on with the company? A substantial amount of literature has focused on the relationship between governance and performance.

Millstein and Mac Avoy[23] find that good governance at board level has a non-trivial impact on share prices. In a survey of the literature, Patterson[24] finds little qualitative evidence to either prove or disprove such a practice. There are however important policy angles. From an economic policy perspective, rising institutional and transaction costs in the realm of corporate decision-making and finance impacts the competitiveness of economies, the

[20] Section 147 The Companies Bill, 2011
[21] Clause 134 The Companies Bill, 2011
[22] *Ibid.*
[23] Millstein, Ira and P. MacAvoy, *The Active Board Of Directors And Performance Of The Publicly Traded Corporation*, 98 Columbia Law Review 1283(1998)
[24] Patterson, Jeanne, *The Link Between Corporate Governance And Performance*, The Conference Board Report, No. 1215-98-RR (1998)

corporate investment levels and the allocative efficiency of capital markets. From an institutional perspective, corporate governance is of direct relevance to policy makers because laws, institutions and regulations are one of its most important sources (and of its costs). Professor Hart observes that the *"governance structures can be seen as a mechanism for making decisions that have not been specified by contract*"[25]. Further, there is also a concern about the cost involved in regulating such behaviour. The performance of the enterprises might be significantly influenced by their size and the identity of their bearer.[26] For instance, if most of the cost is borne by shareholders, the cost of equity financing will rise and the structure of the capital market will be seriously tilted towards debt financing and/or direct or indirect state subsidies. Labour and employment relations might also be influenced by governance structures, where the former has an important role in defining company strategy. There might be losses in the efficient redeployment of resources. On the contrary, where employees are kept completely isolated from the information flow and decision making process within the firm, there may be a lower commitment to the firm's development and more social costs may arise down the line. Majority would agree that corporate governance regimes are (and should remain) the product of private, market-based practices.[27] However, there are various policy angles that concern the government.

Company law, securities regulations, prudential regulation of banks, pension funds and insurance companies, accounting and bankruptcy laws impact on the way corporations make their decisions and behave in the market -- and towards their different constituents. To come back to Hart's aphorism, the legal and institutional framework shapes most of the relationships that are outside the contractual realm. Policy makers are responsible for striking the best balance between mandatory law and contract in each jurisdiction thus providing the optimum mix between flexibility and predictability.[28] Considering the reality where most firms have multiple small block holders

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[25] Organisation for Economic Co-operation and Development, *Corporate Governance in Asia - A Comparative Perspective*, p. 19, available at http://www.oecd.org/dataoecd/7/10/1931460.pdf (last visited on February 15, 2012)

[26] A substantial amount of literature has focused on the relationship between governance and performance. Findings are often contradictory, which may be largely due to insufficient data. Millstein and Mac Avoy (1997) find that good governance at board level has a non-trivial impact on share prices. In a survey of the literature, Patterson (1998) finds little qualitative evidence to either prove or disprove such a link.

[27] *Ibid.*

[28] Black, Bernard and Reinier Kraakman, *A Self-Enforcing Model Of Corporate Law*, 109 H.L.R, 1911-1986 (1996).

who either do not have sufficient stake to directly intervene in the governance or for whom such intervention comes with great price.

Hence, it seems a settled position that corporate governance needs a discipline in form of regulation, especially in Indian context where the minority shareholders need special protection of law. At this point, it is submitted that independent directors brought on the board will aid protection of minority shareholders. Further, for an effective role they must be present in majority so that objectivity is at no time sacrificed. In tune with this spirit, it has been proposed under the New Companies Bill that number of such independent directors in a listed company should not be less than one third of the total number of directors. However, as it has been discussed above, there are some concerns regarding allowing independent directors in such a number where they can also block decision making and affect smooth running of a company through their over cautious approach. Moreover, to discipline such directors who bear no accountability to shareholders directly is yet another concern.

In well-managed companies, the notion of independent directors is equated as partners of management and outside guardians whose role is to ensure that management remains focused on delivering shareholder value; while other companies may consider them to be a burden that has to be borne mainly to satisfy regulatory rules for compliance. Need for presence of Independent directors may vary based on the size and type of company. According to the Irani Committee, there is no universally applicable principle to suit all companies and hence, the number of Independent directors may be prescribed through rules for different categories of companies. However, the Report observes that in general one-third directors on the Board should be independent directors.[29] Further, the Standing Committee on Finance examining the Companies Bill, 2009, had proposed legislative protection for such directors and observes that the Independent directors on company Boards should be able to function without any fear.[30] A natural question arises, "who will monitor the independent directors? Is it desirable to introduce independent directors in larger number on the board without making them liable for their action?"

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[29] Ministry of Company Affairs, *J.J Irani Committee Report on Company Law*, (Para 8.1), available at http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf (last visited on February 15, 2012)

[30] Hindu Business Line, *Independent Directors to Shoulder Less Liability*, September 2, 2010, available at http://www.thehindubusinessline.com/todays-paper/tp-corporate/article 1003047.ece (last visited on February 15, 2012)

III. Assessing Role of Independent directors

This part of the article will assess the role of independent directors in India. It will highlight the significant difference in the ownership structure that exists in U.K. and the U.S. and will argue that supplanting the same to Indian corporate system may not serve its objective.

Dahya and McConnell in their study found that during the 1990s and beyond, "at least 26 countries have witnessed publication of guidelines that stipulate minimum levels for the representation of outside directors on boards of publicly traded companies."[31] However they argue that though post 1990s and beyond, countries around the world have witnessed calls and/or mandates for more outside directors on publicly-traded companies' boards even though extant studies find no significant correlation between outside directors and corporate performance.[32]

It seems that most of the countries adopted the Cadbury Committee recommendation of introducing independent directors on the Board without assessing its relevance and success in their corporate regime. It is not contended that the independent directors do not add objectivity to the Board. However, such a step may not always be successful especially in India, as it has been in the West. We need to understand that there are significant differences in the corporate ownership structures and legal systems between the countries of origin of independent directors on the one hand and India on the other.

The U.S. and the U.K. display dispersed share ownership with large institutional shareholdings.[33] This essentially follows pattern of the Berle and Means Corporation[34] which is represented by dispersion of ownership.[35] As a result of dispersed shareholding, shareholders lack incentive as well as control over the management. They typically have no interest in managing the

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[31] Jay Dahya & John J. McConnell, *Board Composition, Corporate Performance, and the Cadbury Committee Recommendation*, (October 2005). Available at http://ssrn.com/abstract=687429 (last visited on February 15, 2012)

[32] *Ibid.*

[33] *Ibid*.

[34] The theory propounded by Berle and Means and its implications on 'Modern Corporate Governance' and board independence.

[35] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, (Transaction Publishers, 1991) p. 47

company and retain no relationship with the company except for their financial investments-the separation of ownership and control is at its best.[36] Due to the existence of diffused shareholding and the separation of ownership and control, the primary effort of corporate law in these jurisdictions is to curb the "agency costs arising from self-serving managerial conduct"[37], by acting as a check on the activities of managers and by enhancing their accountability towards shareholders.

Most of the shareholding in the U.S.A and U.K. are diffused and there exists an excruciating problem of agency. The managers enjoy immense economic power and key management decisions vesting with them, without shareholders having right to question. There is a need to check on the power and to ensure that they act in the best interest of shareholders. An additional problem is the diffused shareholding where, each person's shareholding is so small that it is too costly for such shareholder to monitor the company's activities closely.

Contrastingly, India follows the insider model of corporate governance, which is characterized by cohesive groups of 'insiders' who have a closer and more long-term relationship with the company.[38] The form of corporate governance in India is much closer to the East Asian 'insider' model where the promoters dominate governance in every possible way.[39] Indian corporates which reflect the pure 'outsider' model with widely dispersed shareholdings and professional management control are relatively small in number. A distinguishing feature of the Indian Diaspora is the implicit acceptance that corporate entities belong to the 'founding families' though they are not necessarily considered to be their private properties.[40] The insiders (who are essentially the controlling shareholders) are the single

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[36] Brian R. Cheffins, *Putting Britain On The Road Map: The Emergence Of The Berle-Means Corporation In The United Kingdom*, in Joseph A. McCahery, Piet Moerland, et. al (eds.), *Corporate Governance Regimes: Convergence And Diversity*, (Oxford University Press, U.S.A, 2002) p. 151

[37] Tong Lu, *Development of System of Independent Directors and the Chinese Experience*, available at http://www.cipe.org/regional/asia/china/development.htm (last visited on February 15, 2012)

[38] For further discussion see Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance,* 6 Hastings Business Law Journal, No. 2, p. 281 (2010)

[39] Reserve Bank of India, *Report of the Advisory Group on Corporate Governance (Executive Summary)*, available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/20022.pdf (last visited on February 15, 2012)

[40] *Ibid.*

largest group of shareholders, with the rest of the shareholding being diffused and held by institutions or individuals constituting the 'public'[41].

The insiders typically have a controlling interest in the company and thereby possess the ability to exercise dominant control over the company's affairs. In this regime, the minority shareholders do not have much of a say as they do not hold sufficient number of shares in the company so as to be in a position to outvote or even veto the decisions spearheaded by the controlling shareholders percent of the shares. Likewise, in the United States, large shareholdings and especially majority ownership, are uncommon.

As to the identity of the controlling shareholders, they tend to be mostly business family groups or the state. This tends to be particularly true of Asian countries, which are "marked with concentrated stock ownership and a preponderance of family-controlled businesses while state-controlled businesses form an important segment of the corporate sector in many of these countries."[42] The family owned business in India is similar to *Keiretsus* in Japan and *Chaebols* in Korea. Thus, inter-locking and "pyramiding" of corporate control within these groups make it difficult for outsiders to track the business realities of individual companies in these behemoths. Also, since managerial control of these businesses is often very concentrated within a family, who either own the majority stake, or maintain control indirectly for instance through financial institutions, the interests of majority shareholders may not coincide with those of the other minority shareholders. It is likely that in such family owned business, the controlling shareholders occupy senior managerial post and nominate senior members of management. Where companies are controlled by the state, board and senior managerial positions are occupied by bureaucrats. What such system lacks is a robust and a sophisticated capital market. This often leads to expropriation of minority shareholder value through actions like "tunnelling" of corporate gains or funds to other corporate entities within the group.[43]

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[41] Berglöf, Erik and Von Thadden, Ernst-Ludwig, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries*, Conference Paper, Annual World Bank Conference on Development Economics, Washington D.C (1999) available at SSRN: http://ssrn.com/abstract=183708 (last visited on February 15, 2012)

[42] Rajesh Chakrabarti, *Corporate Governance in India – Evolution and Challenges*, United Nations Public Administration Network, available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN 023826.pdf (last visited on February 15, 2012)

[43] *Ibid.*

Further, the regulatory framework in India is arguably not altogether favourable to corporate activity and investor protection, although noteworthy improvements have been effected post liberalisation, it is unduly multifarious and still contains vestiges of strong government control of companies. It thus, becomes important to find a sufficient number of independent directors and rating agencies who can potentially act as gatekeepers of corporate governance.

There is a strikingly paradoxical aspect to this increase in regulation. The increase in state regulatory power has been accompanied by the increasing privatization of regulation. Increased competition among European securities exchanges brought about by EU integration and globalization has prompted more stringent exchange self-regulation, accounting, and disclosure standards.[44] This trend is most advanced in Britain where 'codes of best practice', drafted by the privately convened and constituted Cadbury, Hampel, and Greenbury commissions, were incorporated in substantial part into the listing rules of the London Stock Exchange - thereby rendering them mandatory and quasi-legal in character. Though not as advanced as in the British case, similar trends in increased stringency of self-regulation by stock exchanges can be discerned in Frankfurt and Paris. This comparison of corporate governance regimes under the pressures of globalization reveals a pattern of institutional development that supports some preliminary and conjectural conclusions about the relationship between national political economies and globalization.[45] First, significant financial market reforms and increasing securities market regulation have driven the development of more transparent and liquidity and investment flows and ownership structures both domestically and internationally.

Thus, it may be inferred that, due to the diffused shareholding structures, the independent directors were ushered into corporate governance norms in U.K. and U.S.A. to represent the interest of shareholders and monitor the over ambitious decisions of managers. It is equally important to note that these countries follow an outsider model of corporate governance which is premised on primacy of shareholder interests in the company law and

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[44] John W. Cioffi, *Governing Globalization? The State, Law, and Structural Change in Corporate Governance*, 27 Journal of Law and Society, No. 4, p. 572-600 at 598 (2000)
[45] *Ibid.*

enlightened shareholder value, well defined statutory minority protection and stringent disclosure norms"[46]

Each stage in the evolution of board independence bears testimony to this fact. However, as Prof. Verottil argues, transplantation of the concept to a country such as India without placing emphasis on local corporate structures and associated factors is likely to produce unintended results and outcomes that are less than desirable.[47]

IV. Assessing the Duties and Liability of the Independent Directors

Role of independent director has been greatly debated. Many argue that the cost of objectivity achieved through them is very high and some time futile. To an even greater extent than was the case in the United Kingdom before the Companies Act 2006, directors' duties in India have historically been a matter for the common law rather than statute, the 1956 Act being silent in this regard. Very strikingly, however, the case law in this regard has been described as "sparse".[48] In discussing this issue, the Irani Committee refers specifically to the United Kingdom as an example of the wide range of duties that may be set out in law. It asks, however, "whether all such duties … can be recognized in law".[49] Given the centrality of this issue to company law and the extent to which it may be seen to have been one of the principal concerns of the Company Law Review in the United Kingdom, the speed with which it is dealt with in the Irani Report and the vagueness of the language is remarkable. Thus, the Committee calls for further debate but suggests that the law "may" include certain duties of directors. In this regard, it wants an "inclusive" but "not exhaustive" list to be set out in the Act[50] and suggests as examples a duty of care and diligence, the exercise of powers in good faith and the "duty to have regard to the interests of the employees, etc.".[51] Nothing further is offered.

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[46] Stilpon Nestor and John K. Thompson, *Corporate Governance Patterns in the OECD Economies: Is Convergence Under Way?*, available at http://www.oecd.org/dataoecd/7/10/1931460.pdf (last visited on February 15, 2012)
[47] *Supra* Note 38.
[48] World Bank, *Report on the Observance of Standards and Codes: Corporate Governance Country Assessment –India*, (Document of the World Bank 35084, April 2004), p.11.
[49] *Supra* Note 29, Ch.IV, para.18.1
[50] *Ibid*, Ch.IV, para.18.2
[51] *Ibid*, Ch.IV, para.18.3

Given this vagueness, it is perhaps not surprising that cl.166 of the 2009 Bill stays on familiar territory and offers no innovations of the sort seen in s.172 of the UK Companies Act 2006.[52] Thus, statutory expressions of the duty to act in good faith in the best interests of the company, the duty of skill and care, the duty to avoid conflicts of interest and undue personal gain find place but no attempt to give expression to the Committee's vague desire "to have regard to the interests of employees, etc". The Bill's drafters may have been influenced by the Irani Committee's evident doubts in the U.K's more extensive list, though commentators seem clear that it simply provides clarity to the law rather than modify it and that its primary effect will be in reminding directors of the obligation to take account of others to the extent that this is in the interests of the company. It could, therefore, be suggested that a similar approach would be a useful addition to Indian company law given that self-serving decisions may be more of an issue in the context of closely held companies and statutory clarity as to the duties of a director would simplify matters.

An effective Board of Directors is the most vital attribute of all successful Companies. In this regard, independent directors play a crucial role in implementing the principles of effective corporate governance. The business activities of the corporations are crossing the national boundaries and involve shareholders and investors from all around the globe thereby requiring independent directors at the top level to keep up with the dynamic mindset. A common trait of such Companies is that they have systems in place, which allow sufficient freedom to the boards and management to take decisions towards the progress of their Companies and innovation, while remaining within a framework of effective accountability. In other words, they have a system of good corporate governance.[53] It is important that insiders do not take undue advantage of their position. In order to prevent such a situation, the need for independent directors has risen in India. Independent directors can counterbalance managerial infirmities in the company while ensuring legal and ethical behavior of the company on one hand and being the source of well conceived long term decisions for the company on the other. They are believed to provide the necessary personal and technical expertise in order to abate fraud, misappropriation by the company or its members.

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[52] For a discussion, see Andrew Keay, *Section 172(1) Of The Companies Act 2006: An Interpretation And Assessment*, 28 Company Lawyer 106 (2007)

[53] Securities and Exchange Board of India, *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, available at http://web.sebi.gov.in/commreport/corpgov.html (last visited on February 15, 2012)

V. Looking beyond Independent Directors

This part of the article will discuss various mechanisms that will lead to sound corporate governance.

A. Including Other Stakeholders in Corporate Governance

Corporate Governance involves the issue of appropriate management and control structures of a company and the conventions relating to the power relations between owners, board of directors, management, auditors and its stakeholders such as employees, suppliers, customers as well as the public at large. The aim of "Good Corporate Governance" is to enhance the long-term value of the company for its shareholders and all other partners. The true significance of Corporate Governance is evident in this definition, which encompasses all stakeholders. Corporate Governance assimilates all the participants involved in a process, which is economic, and therefore at the same time social. This definition is intentionally deliberately wider than the general notion that Corporate Governance postulates are aimed at shareholder interests. The broader interpretation is imperative in terms of the long-term success of a company.

A precondition for the inclusion of other stakeholders is a balance between economic and social objectives and an alignment of the interests of the individual, the company and society. Many instances have reflected the negative impact of inadequate Corporate Governance not only for shareholders and bondholders, but also for employees, suppliers and customers, as well as for society at large. Without the inclusion of other stakeholders, the ability of Corporate Governance to promote fruitful economic development will only have a piecemeal effect.[54]

B. Minority Protection

Minority protection in India under Companies Act, 1956 has been primarily been provided under action for oppression and mismanagement. The law has not defined what is 'oppression' for purposes of section 397 and it is left to Courts to decide on the facts of each case whether there is such

[54] Kasper Muller, *Corporate Governance and Globalisation: The Role and Responsibilities of Investors*, available at http://www.ellipson.com/files/debate/debate_summer_02e.pdf (last visited on February 15, 2012)

oppression as calls for action under this.[55] Further, the conduct of the majority shareholders should not only be oppressive to the minority but must also be burdensome, harsh and wrongful and continuing up to the date of petition. The lack of confidence between the majority and minority shareholders should also spring from oppression of minority in the management of the company's affairs.[56]

It has been observed that the problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders.[57] Shareholder activism is practically inexistent in India.[58]

Significant in this regard, and perhaps influenced by developments in the United Kingdom and the United States, is the suggestion that while the existence of derivative and class actions have been recognised by the courts in India, these should be placed on a statutory footing.[59] The new (Indian) Companies Bill, 2009 takes an analogous view over investors however, while it refers to a class action,[60] it does not include a statutory derivative action.[61] This seems to be a loss of chance to enhance the protection of minority shareholders and encourage higher standards of governance. The approach of the Irani Committee might also be read as an indication of the success of earlier efforts aimed at minority protection, such as the possibility for companies of a certain size to have a director elected by small shareholders on the board.[62] Irani Committee observed that the minority interests have to be given a voice to make their opinions known at the decision making levels and there is a need of substantive to provide for such a mechanism.[63] The specific minority appointed director/independent director could also play an important role in investor protection. Further, the Report noted the need of allowing

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[55] *Shanti Prasad Jain* v. *Kalinga Tubes Ltd.*, 1965 (1) Com LJ 193: AIR 1965 SC 1535
[56] *Id.*
[57] Jayant Rama Varma, *Corporate Governance in India: Disciplining the Dominant Shareholder,* 9 IIMB Management Review, No. 4, p. 5-18, available at http://www.iimahd.ernet.in/~jrvarma/papers/iimbr9-4.pdf (last visited on February 15, 2012)
[58] Institute of International Finance Advisory Group, *Corporate Governance in India: An Investor Perspective (Task Force Report, February, 2006),* available at www.iif.com/download.php?id=MCi8tGJ+W/U (last visited on February 15, 2012)
[59] *Supra* Note 29, Ch.VI, para.10.2.
[60] Companies Bill, 2009 cl. 245
[61] For further discussion, please see the statutory derivative action now provided in the UK Companies Act, 2006 under Ss.263 and 268
[62] See Companies Act, 1956 s. 252, inserted by the Companies (Amendment) Act, 2000.
[63] *Supra* Note 29.

derivative suit in case of fraud on the minority by wrongdoers, who are in control and prevent the company itself bringing an action in its own name, derivative actions in respect of such wrong non-ratifiable decisions, have been allowed by courts. Though these principles have been upheld by courts on many occasions, the Irani Committee felt that the need of the hour is to reflect these principles in law.[64]

Hence, it is submitted that what is needed is strong legal framework which gives adequate protection to minority shareholder so that they do not have to depend on independent directors as a life guard but have right to bring an action for unfair prejudice, director's negligence and wrongful action. Such minorities can keep a check on the directors and their actions. Proper protection of minority through substantive legislation can help in upholding the spirit of corporate governance.

C. Investor Education and Protection and Developing a Stewardship Code

India has been witnessing a surge in foreign institutional investment ("FII") activity since the opening of its capital markets. Owing to its high growth potential, India has become a favourite destination for FII activity. FIIs, convinced of India's economic progress and strong corporate earnings, are continuously investing in the country. In 2010 itself, India attracted nearly US$ 30 billion of net foreign inflows, which was just under 50 per cent of all inflows into emerging Asian markets, excluding China.[65] Foreign investors have invested Rs 6,460 crore (US$1.45 billion) in Indian stock markets in just five trading sessions of July 2011 and the trend is expected to continue, according to analysts. In the first six months of 2011, overseas investors infused around Rs 17,000 crore (US$3.82 billion) into the Indian market, including stocks and bonds. In the same period, FIIs made investments of Rs 9,948 crore (US$2.23 billion) in the debt market, with investments in stocks being Rs 2,670 crore (US$ 599.79 million) FIIs bought equities and debt securities worth Rs 26,004 crore (US$ 5.84 billion) till July 10, 2011, according to the data available with market regulator Securities and Exchange Board of India ("SEBI").[66] The number of FIIs registered with SEBI increased from 1,718 as of December 31, 2010, to 1,730 as of July, 2011.[67]

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[64] *Id.*
[65] The Economic Times, *FIIs invested over Rs 6,460 cr. in Indian stock markets in July*, July 10, 2011, available at http://articles.economictimes.indiatimes.com/2011-07-10/news/29758177_1_fiis-indian-stock-markets-market-regulator (last visited on February 15, 2012)
[66] *Id.*
[67] *Supra* Note 2

The trend shows that India seems to have become an attractive destination for foreign investment. The protection of investors has to move beyond regulatory norms and participation of investors in corporate governance seems to have become a mandate.

It is submitted that in tune with U.K., the corporate governance in India needs to envisage the Stewardship Code. Some may argue that involving investors in corporate governance makes less sense as their primary interest lies in redeeming back the investment returns which can be well protected through contractual agreements.

Shleifer and Vishny[68] observe that institutional investors by virtue of their large stockholdings would have greater incentives to monitor corporate performance since they have greater benefits of monitoring. Most of the reports on corporate governance have emphasized the role that the institutional investors have to play in the entire system. The Cadbury committee[69] for example, states that "because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code" (para 6.16).[70] The working group on corporate governance of Harvard Business Review has, similarly, concluded "the institutional investors of public companies should see themselves as owners and not as investors."[71] In India, the CII report on corporate governance has also brought out the importance of the role that the institutional investors can play in the corporate governance of a company. The Kumar Mangalam Birla committee on corporate governance similarly emphasizes and they thus, have a special responsibility given the weightage of their votes and have a bigger role to play in corporate governance as retail investors look upon them for positive use of their voting rights. The role that the institutional shareholders can play in the corporate governance system of a

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[68] Shleifer, A. and R Vishny, 1986, *Large Shareholders and Corporate Control*, 94 Journal of Political Economy, 461 – 488

[69] Cadbury, A., *Report of the Committee on the Financial Aspects of Corporate Governance,* (1992)

[70] Pitabas Mohanty, *Institutional Investors and Corporate Governance in India*, National Stock Exchange of India, available at http://www.nseindia.com/content/research/Paper42.pdf (last visited on February 15, 2012)

[71] Robert C. Pozen, *Instituional Ivestors: The Reluctant Activists*, Harvard Business Review (January, 1994) available at http://hbr.org/1994/01/institutional-investors-the-reluctant-activists/ar/1 (last visited on February 15, 2012)

company "… in view of the Committee is that, the institutional shareholders put to good use their voting power…[72]

The Irani Committee takes seriously the idea that markets operate properly on the basis of appropriate information, while recognising that matters are different for different types of investors.[73] The Committee recalls that the development of the Indian capital market is a relatively recent phenomenon with its roots in the liberalisation of the early 1990s. It commends SEBI for its work so far, but suggests that there is nevertheless "a need for the framework to develop further in a balanced manner keeping in view the Indian context while enabling best international practices".[74] Interestingly, a fund for investor education and protection (the Investor Education and Protection Fund) was established under s.205C of the 1956 Act and the committee considered how that fund could be used more effectively.[75] Clause 125 of the 2011 Bill mirrors s.205C. Note, however, that the SEBI has more recently been active in this regard.[76]

What is needed is a strong stewardship code, similar to U.K. where by it seeks to create greater transparency around the way investors oversee the companies they own by encouraging better dialogue between shareholders and company boards.[77] The Stewardship Code in the U.K. aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The U.K. Corporate Governance Code which traditionally emphasised the value of a constructive dialogue between institutional shareholders and companies based on a 'mutual understanding of objectives', now in the Stewardship Code, the Financial Reporting Council sets out the good practice on engagement with investee companies which it believes institutional shareholders should aspire to.[78] India too needs a similar provision where by investors are educated, informed and participate in governing the company by ensuring that the directors do not become over

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[72] *Supra* Note 53.
[73] *Supra* Note 29, Ch.VII, para.1
[74] *Ibid* at paragraph 5
[75] *Ibid* at paragraph 12
[76] See Securities and Exchange Board of India (Investor Protection and Education Fund) Regulations, 2009 - Regulation 3(2) states that "the Fund shall be deemed to have been established on the 23rd day of July 2007".
[77] Arad Reisberg, *The Notion of Stewardship from a Company Law Perspective: Re-Defined and Re-Assessed in Light of the Recent Financial Crisis?*, 18 Journal of Financial Crime, p. 126-147 (2011)
[78] *Ibid.*

ambitious and lose the touch of reality, that may open the doors for insolvency.

D. Sound Accounting and Auditing Practice and Internal control

Series of corporate collapses led to the formation of Cadbury Committee which for the first time reflected the need of separate auditing committee constituted primarily by outside directors. The aim of the audit committee was to add to the quality and integrity of the management's financial reporting.

The Irani Committee notes, as did the earlier Birla Committee, that work is under way on the part of the ICAI to bring Indian accounting standards into line with international standards and that progress is expected shortly. However, in contrast to the earlier Chandra Committee report, there is no call for mandatory rotation of auditors.[79] This has been left to the decision of shareholders. The Companies Bill, 2011 remains silent on this issue.

Again reflecting the recognition of the significance of internal control in other jurisdictions,[80] the Irani Committee "feels that the internal controls in any organization constitute the pillar on which the entire edifice of Audit stands".[81] Accordingly, these controls "should be certified by the CEO and CFO of the Company and in the Directors' report through a separate statement on the assessment".[82] This recommendation is found in the 2011 Bill in cl.134(5) which states that the Directors' Responsibility Statement shall state inter alia that "the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls have been complied with". This is supported by cl. 143(3)(i), which requires that the auditor's report shall state "in the case of listed companies, whether the company has complied with the internal financial controls and directions issued by the Board".

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[79] *Supra* Note 29, Ch.IX, para.25.

[80] See Sarbanes-Oxley Act, 2002 Ss.302 and 404. See also Turnbull Report (UK): *Internal Control: Guidance for Directors on the Combined Code* (London: Institute of Chartered Accountants in England and Wales, 1999)

[81] *Supra* Note 29, Ch.IX, para.31

[82] *Ibid.*

E. Codification of Directors Duties and Imposing new duties

The need for and role of such directors has been a feature of the debate on corporate governance in a number of jurisdictions and has most recently resurfaced in the United Kingdom in the context of the Walker Report on corporate governance in banks and other financial institutions.[83] A number of issues that have caused concern in India have also been contentious in the United Kingdom, for example the question of whether there are enough suitably qualified and motivated people to fulfil all the positions opened up by the requirements of the Combined Code.[84] One issue, however, that seems to have caused particular concern in India is the fact that independent directors are subject to the same duties as executive directors. Recall, for example, that the Chandra Committee called for there to be exemptions for independent directors from a wide range of civil and criminal liabilities.[85] Furthermore, there is evidence that the Satyam scandal has raised fears in the minds of many independent directors, sparking something of a mass exodus from Indian boardrooms.[86]

It is worth taking a moment here to consider the arguments for and against such an approach. From the point of view of independent directors, it is certainly the case that the liabilities that may be incurred as a result of taking on such a position are potentially very serious indeed. Those who favour a reduced exposure to those liabilities for independent directors as compared to executive directors do so, on the basis that a non-executive does not occupy a position with the company that implies full-time, ongoing, day-to-day engagement with its business, but rather performs a more intermittent role characterised by a concern with strategy and oversight. Accordingly, they are concerned that a independent directors may find him- or herself exposed to liabilities that arise from failures or problems among managerial staff. This concern has a superficial appeal until one considers the situation from the perspective of the shareholders. Their expectation is that the non-executives will perform an important role in protecting their investment and ensuring that the board and indeed the company as a whole is properly run and focused on

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[83] David Walker, *Walker Review of Corporate Governance of UK Banking Industry*, 2009, Ch.3

[84] *Ibid*. As regards India, see, The Economic Times, *India Inc needs 18,000 qualified Independent Directors*, January 18, 2009 (Print Edition)

[85] Paterson, *Corporate Governance in India in the Context of the Companies Bill 2009 (Part 1: Evolution)* [2010] I.C.C.L R. 46 [section 2(c)]

[86] Abha Bakaya, *Independent Directors On Quitting Spree*, The Economic Times, April 20, 2009 (Print Edition)

its key objectives. And, of course, this is very much the understanding of the role of the independent directors that the Combined Code has taken up and developed. There are accordingly very serious risks associated with any attempt to water down the liabilities to which a non-executive might be exposed. In the ultimate, these would include the creation of a situation where independent directors were no more than window-dressing, employed with the pious hope that they might keep the company on the right track but with no particular incentive to do so and certainly no particular sanction in the event of failure. This is particularly an issue where there is evidence that the role of independent directors has traditionally been understood as a sinecure and where there has been little interest in performing the monitoring role envisaged or in asking tough questions of management.[87] In short, the seriousness of a jurisdiction's commitment to corporate governance would profoundly be called into question should it seek to insulate independent directors from the consequences of poor performance. It was, therefore, reassuring that the Irani Committee rejected this idea and recommended that the issue be dealt with on the basis of a knowledge test.[88]

Additionally, while the Companies Bill reflects the Irani Committee's recommendation that directors' duties should be statutorily endowed rather than relying on their traditional common law expression, it does not directly address the issue of knowledge test. The closest it comes is in the statutory expression of a duty of skill and care, but even here there is a question as to just how sophisticated this test is and what impact it might have, if any, on the differential treatment of executive and non-executive directors. Clause 147(3) states that "A director shall exercise his duties with due and reasonable care, skill and diligence". In the absence of anything further, it would appear that the existing Indian common law reasonableness test remains[89]. By contrast, in the United Kingdom, the Companies Act, 2006 took the opportunity to set out in detail a two-part test inspired by s.214 of the Insolvency Act, 1986 that was first enunciated as an expression of the common law by Hoffmann J. in 1991[90]

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[87] Nandini Rajagopalan and Yan Zhang, *Corporate Governance Reforms in China and India: Challenges and Opportunities*, 51 Business Horizons 55, 62 (2008). See also World Bank, *Report on the Observance of Standards and Codes, Corporate Governance Country Assessment: India*, April 2004, s.III.3; John Peterson, *Corporate governance in India in the context of the Companies Bill, 2009: Part 3: Proposals*, I.C.C.L.R, 21(4), 131-143 (2010)

[88] Recall that the jurisprudence has been described as "sparse". World Bank, *Report on the Observance of Standards and Codes: Corporate Governance Country Assessment--India, April 2004)*, p.11

[89] *Norman* v. *Theodore Goddard*, [1992] B.C.L.C. 1028 Ch D

[90] *Id.*

and subsequently supported by the Law Commissions.[91] Thus, s.174 of the 2006 Act reads as follows:

"(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with-

(a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) The general knowledge, skill and experience that the director has."

In other words, the test has both an objective and a subjective element. A closer look at this test might, however, only serve to increase the concerns of those who fear that independent directors are excessively exposed given their position on the board coupled with only intermittent involvement with the company: whereas the subjective test by itself at one time would have served precisely to protect disengaged independent directors from onerous liabilities,[92] coupled with the objective test it can only serve to heighten and never reduce the standard to which a director will be held.

It would accordingly appear that while the United Kingdom's recent Companies Act might provide a clearer and more satisfactory test of skill and care than that appearing in the (Indian) Companies Bill from the perspective of shareholders, it is still insufficient to reassure independent directors about the risks that they may be running by accepting such positions on the boards of Indian companies. In this regard, it is perhaps most constructive to look at the recent Australian case law where there has been more deliberation of the specific question of the standard to which independent directors are to be held. Thus, there has been acknowledgment that although both executive and non-executive directors are subject to the same standard, nevertheless what will be required of them in specific circumstances will depend upon what role and function each has been entrusted with in a given company. In *AWA Ltd Daniels*, for example, Rogers C.J. observed that, "in contrast to the managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of

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[91] Law Commissions, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, Law Commission No.261 and Scottish Law Commission No.173, Cm.4436 (1999)

[92] The classic statement of the original subjective test is by Romer J. in *City Equitable Fire Insurance Co, Re* [1925] Ch. 407 CA

the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow of a uniform standard".[93]

On the other hand, this should not be read as meaning that independent directors can essentially abdicate responsibility either to other directors or to management or expert advisers where what is at issue are matters that they "knew or should have known about", as the Supreme Court of New South Wales has recently held in the case of *ASIC MacDonald.*[94]

It is thus, submitted that independent directors under such an approach would not be held to an overly high standard but that they would be expected to fulfil the roles they are employed by the shareholders to do. The Companies Bill could usefully be more closely modelled on the UK Companies Act in order to offer more guidance to the courts (and specifically to the future National Company Law Tribunal (NCLT), which would then be in a position to develop the jurisprudence on this point). Beyond that, it is also noteworthy that the courts in the United Kingdom, Australia and India now have a good deal of material to look at in reaching conclusions about what should reasonably be expected from independent directors in the shape respectively of the Combined Code, the Corporate Governance Principles and Recommendations and the CII Code in the same way that directors are expected to look to these documents for guidance or instruction on how they are to exercise their functions, it is no more than reasonable that the courts should look to these too in any case where there is a question as to what a director ought to have known or done.

VI. Conclusion

The current position of independent directors in India may prove to be a whammy. This is so because on one side, the number and power of such directors are on increase and at the other side, duties and liabilities set out for them are not properly defined. Exclusion of liability towards the company and shareholders and giving immunity may give absolute unfettered power to such directors which may, in long run prove to be perilous. Hence, it is submitted

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[93] *AWA Ltd* v. *Daniels*, (1992) 7 A.C.S.R. 759 at 867

[94] *Australian Securities and Investments Commission* v. *Macdonald*, (No.11) [2009] NSWSC 287 at 259-261

that for sound corporate governance, we need to look beyond independent directors and focus and improve the roles of other stakeholders. Emphasis has to be given to education of investors, minority protection and codification of duties of directors. Further, since the role and power of independent directors are increasing on the Board, their duties and liabilities towards the company and the shareholders cannot be ignored. The New Companies Bill seems to be a step forward but in the world of governance, it seems a very small step, unlikely to make any giant leap.

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Effective Independence of 'Independent Directors': A Critique

Lakshmi Neelakantan[*] *and Rishabh Bansal*[**]

This paper seeks to critically examine, under the broad umbrella of corporate governance, the meaning of independent directors in the wake of several proposed policy reforms in the area. Despite the amendment to Clause 49 of the Listing Agreement, corporate mismanagement shows no signs of being curbed. This is partly due to the definition of the term 'independent director' which does not reflect the characteristics of true independence. The definition present in Cl. 49 only addresses the superficial meaning of independence.

Part I of the paper scrutinizes the meaning of the term 'independent directors' with an added emphasis on what constitutes effective independence. It examines the loopholes in the current definition and proposes to explain how the definition is not pragmatic. Part II of the paper inspects two other systems of corporate system – the German system and the Delaware system – and recommends as to the importation of certain features from the aforementioned. Part III imparts the suggestions of the authors with respect to developing an effective code of independence and accountability so as to foster the growth of good governance.

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CONTENTS

I. Effective Independence of 'Independent Directors'- An Introduction

The concept of an independent board that duly discharges its functions has undergone many changes. In the wake of Satyam, Enron and other corporate scandals, the purported magic solution to the ills of corporate governance was the presence of independent directors.[1] The wave of regulatory reforms began with the perception that the presence of individuals with no financial ties with members of the Board would, in itself, lead to good governance. Stringent regulations were further imposed to crystallize this perception.[2] But there was no noticeable decrease in the number of cases of corporate mismanagement[3], thus, leading to a gradual reexamination of the idea. Questions regarding the nature of independence, the characteristics of true independence and governance continued to crop up with persistent regularity.

The law would have been accepted without question had there been an effective shift in the performance of companies after compliance with such a rule. This has not been the case. The list of companies that had scrupulously

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[1]Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=595138 (last visited on February 15, 2012)

[2] Clause 49 was amended vide SEBI/CFD/DIL/2004/12/10 dated October 29, 2004. The amended clause provided for the definition of independent directors, among other measures of corporate governance, and came into effect on 1st January 2006. These were subjected to various amendments thereafter. *See* Securities and Exchange Board of India, SEBI/CFD/DIL/CG/1/2008/08/04 (Apr. 8, 2008); Securities and Exchange Board of India, SEBI/CFD/DIL/CG/2/2008/23/10 (Oct. 23, 2008); Securities and Exchange Board of India, SEBI/CFD/DIL/LA/2009/3/2 (Feb. 3, 2009).

[3] Donald C. Clarke, *Setting The Record Straight: Three Concepts Of The Independent Director*, (The George Washington University Law School Public Law and Legal Theory) Working Paper No. 199 (2006), available at http://ssrn.com/abstract=892037 (last visited on February 15, 2012)

filled their boards with independent directors and subsequently been grossly mismanaged is seemingly endless.[4]

The article proceeds as follows. First, it examines the definition and scope of the term 'independent directors' as per Clause 49 of the Listing Agreement. The paper then proceeds to examine the shortcomings of such a definition and the difficulties it poses for the implementation of the law. The paper then progresses into systems of corporate governance that have an effective model of independence and which could further improve upon and supplement the Indian system of corporate governance. Finally, the paper concludes with the recommendations of the authors and the proposed changes to the law pertaining to independent directors.

II. The Definition Clause: Abstract v. Real Independence

As per Clause 49 of the Listing Agreement[5] which defines the term 'independent director', a non-executive director who:

a) Does not have any material pecuniary relationships with the company, its promoters, its directors, its senior management
b) Is not related to promoters or persons occupying management positions at the board
c) Has not been an executive of the company in the immediately preceding three financial years
d) Is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following :
i) The statutory audit firm or the internal audit firm that is associated with the company, and
ii) The legal firm(s) and consulting firm(s) that have a material association with the company
e) Is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director
f) Is not a substantial shareholder of the company *i.e.* owning two percent or more of the block of voting shares

Is defined as an independent director

The most striking feature of the definition seems to be an undue emphasis on eliminating who *might* possess ties to the company and arriving at a category of the persons who do not fall into the categories enumerated

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[4] *Supra* Note 1.
[5] *Supra* Note 2.

above. The primary problem seems to lie with a lack of a positive definition of an 'independent director'.[6] Hence, the resulting conflict is something like this, since the definition is comprehensive in its fleshing out of who *will not be* independent, it assumes that the remaining individuals will most definitely be independent. This defeats a basic premise of reason; the negation of certain stereotypical features of a non-independent director does not automatically generate a definition of an independent director.

The problems likely to stem from such a negative definition are a few.[7] First, the definition, while seemingly comprehensive, might have inadvertently missed out on a possible feature of dependence. This problem is not insurmountable. It is always possible that judicial interpretation will adopt a purposive reading and read into the intention of the statute, thus, avoiding the pitfalls of such exclusion. However, at that point, the losses caused by an incompetent board may well be considerable.

The second problem lies in the "time frame" that the definition adopts, in a manner of speaking. On a closer scrutiny of the definition, it is observed that, all of the criteria laid down adopt a concept of independence that only exists till the moment the director becomes a member of the board. The "time frame" thus, does not provide for a situation where the independence of a director may be diluted after the joining of the company. The fact that an independent director is expected to exercise discretion and caution during the process of overseeing the acts of the company is thus, not within the scope of the definition.

This ramification is potentially the more sobering of the two. If the definition only takes into consideration who *might not* be dependent, and further restricts the scope of this faulty definition to a restricted time frame, the pitfalls are numerous. Clause 49, thus, does not address a plausible concern of ensuring continued independence.

Further, while examining the standards laid down in the definition, there is a barrage of requirements that postulate the complete lack of ties with an organization. Thus, an independent director is one who must not have exhibited financial ties with the company in question, significant or otherwise, and further not have been present in any activities that the company had undertaken. What we have here is thus, a situation where an outsider, by

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[6] Umakanth Varottil, *Evolution And Effectiveness Of Independent Directors In Indian Corporate Governance*, 6 Hastings Bus. L.J. 281 (2010)

[7] *Ibid.*

virtue of a complete lack of association with the company in question, is deemed to be 'independent'. The question that arises, thus, is whether complete unfamiliarity guarantees skepticism and thorough scrutiny, which an independent director is expected to possess. The problem seems to lie with the act of equating outsider status with independence. What does true independence entail?

Evidently, lack of financial ties does not, in itself, guarantee independence.[8] This is due to a multitude of reasons. The first lies in the sequence of events; it is one thing to conclude independence from a lack of ties with the company but it is quite another to assume continued independence of the individual for the remainder of his presence. Dependant ties may be developed in a variety of ways after the appointment of the director.[9] Such dependence could be a reluctance to disobey authority. The Milgram experiment[10] has sufficiently established an individual's disinclination to rebel against authority. Adding financial dependence to this mix results in an even weightier concoction. A feeling of 'beholdenness'[11] when taken into consideration leads to a positively alarming scenario wherein the independent director, hired for rational and independent thought, is reduced to just another individual dependent on the company for his salary. This is an important consideration, with regard to the high percentage of cases wherein the appointment of independent directors who are likely to monitor the activities of the company aggressively decreases with an increase in the involvement of the CEO.[12]

Further, in an effort to give independent directors the incentive to undertake such a task, they have been provided with the option of serving on 10 committees as a member or 5 as a chairman.[13] This translates into two things: a certainty of conflict of interest and further, the growth, or lack

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[8]April Klein found a positive correlation between firm performance and the presence of insiders on board finance and investment committees. *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275(1998)

[9] Usha Rodrigues, *The Fetishization of Independence*, available at http://ssrn.com/abstract= 968513 (last visited on February 15, 2012)

[10] Randall Morck, *Behavioral Finance in Corporate Governance- Independent Directors and Non-Executive Chairs,* available at http://ssrn.com/abstract=527723 (last visited on February 15, 2012)

[11] *Supra* Note 9.

[12] Anil Shivdasni & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis* available at http://papers.ssrn.com/paper.taf?abstract_id=169528 (last visited on February 15, 2012)

[13] *Supra* Note 6.

thereof, or real loyalty. The eventuality of conflict of interest is certain, considering the range of activities that a corporation enters into these days. The interest may not be purely financial, as is outlined in the definition but may acquire various forms. In such a situation, it is difficult to determine who the director is beholden to and predictability of independence, which the statute is expected to provide, is conspicuously absent.

Secondly, the idea of an individual who is expected to be alert and attentive to potential misgivings is primarily based on interest. Hence, sufficient interest in the wellbeing and performance of a company is the mantle upon which true independence can rest.[14] This implies that being allowed to serve on multiple committees means that the chances of growth of true loyalty are scarce. If independent directors are allowed to serve on multiple boards with sufficient remuneration and no particular incentive, the growth of independence is likely to be scarce. True independence is not a likely consequence of indifference.

Another problem which seems to defeat the entire exercise is that the presence of independent directors does not seem to improve board performance. This is reflected not only in isolated examples but in studies that almost universally attest to this.[15] Board independence alone does not guarantee effective and honest management.[16] There are certain studies that have proved the existence of a negative relationship between board performance and board independence.[17] So, the inference seems to be that at best, there is a dearth of evidence affirming the value addition of independent directors; at worst, a visible slide into inefficiency.[18]

Considering the above factors, one can conclude that the definition which exists in the Listing Agreement does not seem to fulfill the goal of good governance. While the presence of independent directors is admirable, it does not seem to particularly reduce the chances of mismanagement.

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[14] *Supra* Note 9.
[15] Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 27 (2002)
[16] *Supra* Note 2.
[17] Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders*, 31 J. *Fin. & Quantitative Analysis* 377 (1996)
[18] Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002)

III. Evaluating Other Systems of Corporate Governance

At this point, it has been sufficiently established that the definition does not take into account sufficient modalities of independence. The Higgs Report[19] does not have concrete suggestions for the improvement of the same. A consistently present problem seems to be an inherent lack of separation of the concepts of ‘outsider’ and ‘independent director’.

The German corporate system, in that regard, has garnered some attention for its system of governance.[20] The essence of such a system is a dual-board management system, a management board (Vorstand) which is appointed by a higher supervisory board (Aufsichtsrat). The system works in such a way that the managing board is restricted to running the company, i.e. taking managerial decisions. The supervisory board, on the other hand, is to oversee the management of the board and ensure legal and fair dealings. A review of the performance of independent directors would thus, be restricted to the supervisory board.

This system eliminates some of the problems that could arise due to an insufficiently clear definition. For one, the system exhibits a clear understanding of the meaning of the term ‘independence’. It suggests that an outsider status does not guarantee independence; any more than an insider status implies misfeasance. The key factor is, in fact, that being closely involved in the company and making decisions in consonance with the outside world can translate into good governance. It is the recommendation of the

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[19] The Higgs Report, as per Code Provision A.3.4, defines independence as not comprising of the following factors:

i. Is a former employee of the company or group until five years after employment (or any other material connection) has ended; has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
ii. Has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme;
iii. Has close family ties with any of the company’s advisers, directors or senior employees;
iv. Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
v. Represents a significant shareholder; or
vi. Has served on the board for more than ten years.

These requirements reflect the standards present in Clause 49 and do not include measures to ensure continued independence.

[20] *Supra* Note 1.

authors that this feature of independence and the conflict between an outsider and an independent director be sufficiently incorporated into the rule.

Examining another system of governance- Delaware law, and particularly its approach to the appointment and the working of independent directors could be helpful in this case. Section 144 of the Delaware General Corporation Law[21] prescribes that a potential 'conflict of interest' transaction shall not be voidable in the presence of the following conditions:

(1) The relevant facts are known to the board and a majority of disinterested directors approve;

(2) The relevant facts are known to the shareholders, and the shareholders approve;

Or

(3) The terms of the transaction are, as of the time it is authorized by the directors or the shareholders, fair to the corporation.

Let us examine the first condition. The first condition in the process of determination renders a 'conflict of interest' transaction valid if the relevant facts are known to the Board and a majority of disinterested directors approve. By incorporation of this provision, the statute in essence provides for two things: first, that the details of the transaction that may be in the 'grey area' are revealed to the board so as to create an information pool and second, the majority of directors who are disinterested have the opportunity to examine such a transaction and form an opinion as to the veracity of the circumstances. In such a case, an important implication is the creation of an effective disclosure system that allows the independent directors to carry out a sufficient examination of the transaction.

This can be understood in the larger light of consequences. The aim of appointing independent directors is that transactions of a suspicious nature are identified and checked. The Delaware law thus, proceeds to this stage directly without going into the abstractions of independence. This gives fruition to the important aim of ensuring continued independence; a case-by-case transaction achieves the elusive goal of directors being in a position to make an independent assessment in a *specific* situation.

On analysing the second requirement, we see that the onus now shifts to the shareholders. This provision cleverly provides for the situation where the vote of independent directors alone may not be sufficient to clearly

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[21] *Supra* Note 8.

determine the nature of a transaction. Sufficient weightage, in the absence of a clear cut scrutiny by the independent directors, must necessarily be given to the shareholders, who are after all the section of population most likely to be hit by mismanagement. However, this provision also has a drawback of acting as a fillip to the clout of institutional shareholders. Excessive importance being granted to the interests of the shareholders might not necessarily further the implementation of the democratic goals it seeks to achieve. Institutions which possess a substantial amount of shareholding could well misuse such a provision for the fulfillment of their own goals.

The final prong provides for the blend of the two. By granting both the shareholders and the directors the power to approve or disapprove, it accomplishes a *double scrutiny* of the transaction. If the directors as well as the shareholders reach an agreement, it could also be the operation of the principle of checks and balances in action.

Throughout it all, the statute, by providing for a case-by-case transaction envisions a scenario wherein only the most egregious-seeming transactions becomes litigious; thus, avoiding unnecessary litigation. It thus, provides for the amicable resolution of merely suspicious transactions that may not have actual wrongdoing as well as not ignoring situations wherein illegal activity is likely to be camouflaged.

IV. Conclusion

The authors would thus, like to summarize the lacunae and the suggestions for improving the effectiveness of the functions of the independent director.

Firstly, there must be a clear demarcation of the 'outsider' from the 'independent director'. By separating the two, one can develop a code for practical independence. Abstract independence does not quite explain the various scenarios in which dependence could be created or ensure a system that will constantly foster independence. Independence as a stop-gap measure only carries the torch of good governance so far; creating a sustainable system of independence would do better in the long run.

Secondly, the concept of dependence as only comprising of financial dependence must be eliminated to make way for a comprehensive system of dependence. To further this end, a definition which provides for the inclusion of any scenario that might result in a 'conflict of interest' transaction must be in place. It is unwise to assume that the law makers can provide for every situation where the ingenuities of human nature can be defeated. It would be far more prudent to have a definition that is equipped to deal with all forms of wrong doing, no matter what form it might take.

Third, it is important to adopt the principle behind the Delaware Corporation Law. It is important to have a law that understands what the consequences of an illegal act and enacts a law dealing with such a situation, no matter the scale and the magnitude. Thus, the scope of independent directors that we possess today must first be enlarged to incorporate the suggestions made above and further, must include a mechanism of the exercise of the normative functions of an independent director.

Finally, in order to foster loyalty among the independent directors which will act as an impetus to the performance of their duties, they must be restricted from sitting on 10 boards at once.[22] The remuneration as well as the liability must be decreased and increased, respectively. It may be argued that this measure might, in fact, act as a deterrent to individuals wanting to take up positions of directorships but it must be emphasized that a rational middle ground must be struck in this respect. Considering the inefficiency of the system that we possess today, it is but logical to scale back the perks given to the independent directors and create a system where the directors will be closely involved in the working of the company and will receive appropriate remuneration and will further, develop a code of loyalty and accountability.

[22] *Supra* Note 6.

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Ensuring Independence of Independent Directors through Transparent Appointment

Pallavi Sridhar[*] and Rukmani Seth[**]

Dr Madhav Mehra, President of the World Council for Corporate Governance, has pointed out that the purpose of appointing non-executive directors is to make them a watchdog for shareholders. Executive directors are concerned with the actual management of the company and are normally appointed on a full-time basis. The possible misuse or abuse of the centralized powers concentrated in the hands of a few on the board is always a risk for capital providers in any corporate democracy. In this regard, the appointment of non-executive directors has become pivotal in the modern corporate sector as, although there is no statutory definition of the distinction between executives and non-executive directors currently, they are assumed to play a key role on the monitoring front. When the appointment of directors itself lies in the hands of executive directors, it shouldn't be a surprise to the law makers and enforcers to find transparency missing, for when the foundation is weak, the structure is bound to collapse. The main essence of independent directorship is that there has to be minimal possible nexus between the executive and independent directors and thus, the presence of a clear class distinction and a functional separation.

Through this paper, the authors will attempt to bring to light existing and possible procedures and requirements in various jurisdictions regarding the appointment of Independent directors which will ensure independence in their functioning from the very inception of the office. Independence of these directors when understood in its truest sense will alone lead to appointment of capable directors who will ensure transparency in the working of the business favourable to the aspirations of the investors.

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I. Introduction

While comparing a corporate democracy with that of a national democracy, analogies can be drawn to say that the role of the institution of independent directors ("IDs") in the board of a company is like that of Opposition in the Parliament. The challenges involved in both democracies are similar as to the scale of their operations and the task of making institution of IDs functional, effective and efficient in India is as tedious as making the Opposition work. It is true that expecting shareholders from the public who lack the technical and business sense, to actually participate in the business is not very practicable. Thus, the Indian legal process needs to have a practical formula to infuse a professional attitude into the shareholders, even if it be done vicariously through the concept of independent directors.

ID as a concept is extremely novel. But, the State needs to go beyond and seek proper enforcement of the concept so that actual benefits can be reaped. IDs if institutionalized properly could actually instill the pillars of corporate governance i.e. transparency and disclosure. The key question thus, hinges on "Who audits the audit?" An ID's skill, independence and integrity are basic components in the corporate investment scenario, considering the fact that the public will make investment decisions based upon financial statements and disclosures of a company ratified by him. Hence, regulating IDs is necessary to ensure that they fulfill their fiduciary duty towards the shareholders of the company.

II. Critical Analysis of the Concept of Independent directors

Corporate governance draws a clear line between ownership and the management involved in company affairs by dividing and categorizing powers between shareholders and the board.[1] The Higgs Report[2], issued in 2003 in the United Kingdom plays an instrumental role in describing the function of IDs in a company, in which certain key elements are identified i.e. constructive contribution to development of strategy, scrutinizing the performance of the management to ensure alignment with agreed goals, ensuring risk management systems to be robust and defensible and playing a role in appointing executive directors, senior management and determining their remuneration.

Dr Madhav Mehra, President of the World Council for Corporate Governance, points out that the purpose of appointing IDs is to make them a watchdog for shareholders. Executive directors are concerned with the actual management of the company and are normally appointed on a full-time basis. The possible misuse or abuse of the centralized powers concentrated in the hands of a few on the board is always a risk for capital providers in any corporate democracy. In this regard, the appointment of IDs has become pivotal in the modern corporate sector as, although there is no statutory definition of the distinction between executives and non-executive directors, they are assumed to play a key role on the monitoring front.

Some of the major collapses in American and British companies such as Enron, World.Com, Waste Management, were due to accounting irregularities. In order to avoid losses being experienced by shareholders, actual losses were shown as profits endangering the value of shares in the market. An urgent need exists for the appointment of a non-executive component in such companies to ensure that "accounting engineering" does not take place.[3] Furthermore, the shareholders of a public company barely have corporate and commercial knowledge. Their role is that of a fund provider, nevertheless they have strategic interest in the company and would thus, expect the law to guarantee adequate protection through good corporate governance so that opportunist executives and managers do not take undue advantages by misappropriating economic benefits normally due to the shareholders.

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[1] J. Farrar, B. Hannigan, *Farrar's Company Law*, (Butterworths, London, 1998), p.332

[2] D. Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (2003), available at http://www.ecgi.org/codes/documents/higgs.pdf (last visited on February 15, 2012)

[3] M. Hemraj, *Good Corporate Governance: The Recipe for Corporate Survival*, 26 Company Lawyer 122 (2005)

III. Impediments inherent in the Concept of IDs[4]

IDs receive only that information that the executive management wants to pass on and it is based on this information that their ability to scrutinize the company's status and affairs is predicated. This is because the executive directors fear that any kind of immunity that they possess will be removed in case they divulge all information. In this light, it could be desirable for non-executive directors to maintain their own staff to report authentic and up-to-date information to them.

Shareholders with large stakes might support the unethical behavioural standards of the management which might render the very existence of independent directors futile. They merely ratify the appointment of IDs who are actually nominated by the Executive Directors. Thus, independence of this directorial position is lost. As per Clause 49 of the listing agreement, 50 per cent of the directors on boards of listed firms should be IDs. The inclusion of the relatives, friends and neighbours, who may qualify as IDs, ultimately imply failure to function independently due to their close connections with the board.[5]

Once appointed, the Companies Act, 1956 doesn't envisage any difference between an ID and an Executive Director. Thus, the liabilities that are independent by virtue of the same may be very harsh. This is the reason why after the Satyam Scandal, India Inc. saw as many as 340 independent directors resigning from their positions in the year, fearing that their reputation might be at stake if the company fails to live up to investors' expectations.[6] The IDs do not perceive any incentive attached to the position in terms of remuneration as well as authority.

The answer to the question whether the institution of IDs would work to the benefit of a company lies in the professional attitude that the executive directors take. Thus, while some may view them as guardians, others however, might consider them to be a burden that has to be borne mainly to satisfy regulatory rules for compliance.

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[4] Sharmila Mahamuni , *The Potential Role Of Non-Executive Directors In Indian Companies*, 18 ICCLR No. 6, 207-215 (2007)

[5] Silicon India, *75% of Independent Directors are relatives of promoters*, available at http://www.siliconindia.com/shownews/75_percent_of_independent_directors_are_relatives_of_promoters-nid5696 1.html (last visited on February 15, 2012)

[6] Agencies, *340 Independent Directors Quit In 2009*', Express India, available at http://www.expressindia.com/story.php?storyId=459282 (last visited on February 15, 2012)

IV. Ensuring Transparency through Appointment

Transparency is what the law is profusely trying to seek. There have been many propositions on the concept of IDs which have been automatically translated into law and procedure without checking for practicability. The law on IDs seems to stumble on the first step of implementation. When the appointment of directors itself lies in the hands of executive directors, it shouldn't be a surprise to the law makers and enforcers to find transparency missing, for when the foundation is weak, the structure is bound to collapse. The main essence of IDs is that there has to be minimal possible nexus between the executive and IDs and thus, the presence of a clear class distinction and a functional separation seems to be missing in the present framework.

"Independent directors are the cornerstone of good corporate governance," says Dr Mehra.[7] The key difference between a non-executive & non-executive independent director is that the latter is forbidden to have any pecuniary relationship with the company apart from receiving a sitting fee. But, the Companies Bill seeks to appoint even those persons as independent directors who transact with the company for less than 10% of its turnover. IDs are raking 8-12 lacs a year per company in commission alone, excluding the sitting fee. At present, one can be a director on the board of 15 listed companies that means, almost 2 crores a year. This fogs the distinction between an ID and executive director. However, the independence should not be compromised by expectation of excessive rewards. It is obvious that when a director has developed a stake in a company to the tune of 10-15 lacs a year, he would not be able to risk it all by going against the current.

V. Appointment Procedures under other Jurisdictions

IDs are expected to act as a counterweight to executive directors to uphold the basic pillars of corporate governance. Thus, their mode of appointment has a significant bearing as they can make qualitative contributions only when their selection is made by an apposite constituency.[8]

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[7] Dr. Madhav Mehra, *Are We Making A Mockery Of Independent Directors?* Available at http://www.wcfcg.net/ht130304.htm (last visited on February 15, 2012)

[8] Harjeet S. Bhabra, *Independent Directors and Corporate Performance: Evidence from Listed Firms in China*, available at http://southwesternfinance.org/conf-2010/B1-2.pdf (last visited on February 15, 2012)

The following section deals with their appointment criteria in select jurisdictions.

A. Mechanism in United States of America

With the rapid growth of the economy due to primarily, the growth of corporations, the need was felt to elevate the status of the board of directors of corporations from merely a rubber stamp controlled by the management. The appointment and role of IDs has been recognized in the Sarbanes-Oxley Act, 2002. The *'outsider model'* of corporate governance has been adopted in the U.S. wherein, the management has not much to do with the appointment of IDs. This system has certain characteristics namely[9], dispersed equity ownership with large institutional holdings; recognized primacy of shareholder interests in the company law, strong emphasis on the protection of minority investors in securities law and regulation and relatively strong requirements for disclosure.

B. Mechanism in United Kingdom

The appointment of IDs is carried out through the nomination committee that is expected to follow an objective criterion while evaluating the balance of skills, experience, independence and knowledge on the board. Both executive and IDs are appointed in a like manner.[10] It was for the first time in 2006 that, duties of directors including IDs were enshrined in the legislative framework in the U.K. Companies Act, 2006[11] which provides for minimum standards in the form of duties of the director such as, to adhere to the Articles of the company[12]; mandate to act in ways he considers in good faith would most likely promote the success of the company for the benefits of the members as a whole[13]; duty to exercise independent judgment[14], reasonable care, skill and diligence[15], avoid conflicts of interest[16] and not to

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[9] Stilpon Nestor & John K. Thompson, *Corporate Governance Patterns in the OECD Economies: Is Convergence Under Way?*, available at http://www.oecd.org/dataoecd/7/10/1931460.pdf (last visited on February 15, 2012)

[10] Provision B.2.1. of the UK Corporate Governance Code, 2010 (June, 2010, Financial Reporting Council)

[11] S.172-177 of the Companies Act, 2006 of United Kingdom

[12] S. 171 of the Companies Act, 2006

[13] S. 172 of the Companies Act, 2006

[14] S. 173 of the Companies Act, 2006

[15] S. 174 of the Companies Act, 2006; See *City Equitable Fire Insurance Co Ltd, Re,* [1925] Ch. 407-based on *Overend & Gurney Co v Gibb*, (1871-72) L.R. 5 H.L. 480 at 486-487

[16] S. 175 of the Companies Act, 2006

accept benefits from third parties[17] as well as disclosures regarding arm's length transactions[18]. These provisions purport to capture the spirit of corporate governance the ultimate objective of which is shareholder considerations while balancing other factors such as protection of environment.[19]

C. Mechanism in China

As a new global economic powerhouse, China introduced the idea of IDs into its regime in 1997 and formally injected it into the legal system in 2005.[20] A new system of appointment of IDs was adopted in 2001 for listed firms[21] in the form of "Guidelines for Establishing Independent Directors System in Listed Firms"[22] issued by the China Securities Regulatory Commission (CSRC) which provide for the appointment mechanism to be followed for IDs. What amounts to 'independent' has been defined through certain negative qualifications namely, neither the individual nor his relatives work for that listed company or its subsidiaries; the individual does not own directly or indirectly more than 1% of the stock of that listed company; neither the individual nor his relatives are one of the largest ten shareholders of that listed company nor do they work for a company that owns more than 5% stock of that listed company and lastly, neither the individual nor his relatives work for the largest five shareholder companies. There is a positive qualification also although that needs to be met by at least one of the independent directors on the board where one-third are to be IDs i.e. he should be an accounting professional.

These IDs are nominated by either board of directors or a supervisory board or by shareholders who independently or jointly hold more than 1% of the shares issues and outstanding.[23] The role of IDs has also been taken care of in these guidelines namely, playing an active role in significant committees such as nomination, auditing and remuneration; approving major related party transactions before the board sanctions them; and take charge in the sense of

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[17] S. 176 of the Companies Act, 2006

[18] S. 177 of the Companies Act, 2006

[19] Anu Arora, *Corporate Governance Failings in Financial Institutions and Directors' Legal Liability*, Comp. Law. 2011, 32(1), 3-18

[20] Company Act 2005, S.123: "A listed company shall have independent directors"

[21] As has been highlighted in Cadbury Report (U.K), Bosch Report (Australia), Cardon Report (Belgium), Dey Report (Canada), Vienot Principles I and II (France) and Peters Code (Netherlands) among others.

[22] Regulation No. 102 (2001) of the CSRC

[23] *Supra* Note 8.

calling interim shareholders as well as board meetings and appointment or removal of the accounting firm. Their tenure is the same as other directors although consecutive terms of the IDs can't exceed six years. Grounds for removal have also been provided for in the guidelines. An insider model of corporate governance is followed in the appointment of the IDs.

Thus, like China, India also follows the insider model of corporate governance, which is characterized by cohesive groups of "insiders" who have a closer and more long-term relationship with the company.[24] While the U.S. and the U.K. largely adopt a market-based approach towards corporate law and governance, both China and India continue to depend largely on state involvement through rule-based regulatory regimes that govern corporate activity[25].

VI. Recommendations

1. *Structural Organization of IDs:* In India, the ICAI, the Companies Act (1956), and SEBI Act, 1992, are the primary regulators of the accounting profession. Organizations that have subsidiary powers over the accounting and auditing profession include the ICSI, and Institute of Cost and Works Accountants of India [ICWAI], which regulates cost accountants. These organizations are statutory bodies - not mere self-regulating organizations. Similarly, it is not difficult to envisage the same for the concept of IDs. *Management is a thriving field of education and it needs to be formally recognized as a profession. Affiliation to SEBI is another important requirement.*
2. *Organization to train and issue eligibility certificates:* Management can be regulated as a profession thus, requiring training for applicants as well as a certificate of completion on fulfillment of eligibility criteria. IDs will be required to go through a special training system under the new Companies Bill, as part of the government's drive to clean up on corporate accountability and turn over control of business to shareholders.[26]
3. *Organization to be a database of IDs:* At present, PRIME Database, is an independent primary market-monitoring firm, which has set up a list of professionals eligible to be IDs on the board of listed companies. This

[24] Rafael La Porta, et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998)
[25] Umakanth Varottil, *Independent Directors and their Constraints in China and India*, 2 Jindal Global L. Rev. 127 (March, 2011)
[26] Salman Khurshid ,*Companies Bill To Require New Training For Independent Directors*, The Hindu, available at http://www.thehindu.com/business/article102099.ece (last visited on February 15, 2012)

Website has been in response to the grievance of the corporate sector of its inability to find suitable professionals as IDs under Clause 49. All listed companies are required to comply with the listing agreement which mandates that IDs should constitute a minimum percentage of their boards.[27]

4. *The applicants to various listed companies could be checked for independence before appointment:* If the organization to be statutorily setup has appropriate mechanism, it could check for independence of applicants through a Board or Commission so that no form of material relationship subsists between the applicant and the company. This will also remove the doubts of honest appointment as usually the management themselves nominate IDs and have to check for independence. There ought to be a demarcation in substantive terms as regards the position of directors and IDs so that the professionals applying in would be clear as to their rights and liabilities and at the same time would know there powers and functions.
5. *Remuneration to IDs can be routed through the Organization:* This can be furthered by appropriate accounts which would be held by the companies and IDs with the organization so that no perverse commercial transaction can transpire between the parties.
6. *Establishing a mechanism for correcting professional misconduct:* When the Statute clearly defines the role and functions of an ID, any act against the spirit of such mentioned function or acts of professional negligence can be subjected to disciplinary action. *Fixing differential liability for IDs will enable them to function as an effective oversight body, thereby reducing accidents*[28]

VII. Conclusion

The turn of the century witnessed a proliferation of independent director requirements beyond the borders of the corporate bigwigs of U.S. and U.K. This is due to the profound impact that reforms have had on corporate governance norm-making around the world, particularly in relation to the appointment of independent directors as an essential matter of good governance.[29].

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[27] Bureau, *Hunt For Independent Directors: Prime Database Lists 8,500 Professionals*, The Hindu Business Line, available at http://www.thehindubusinessline.com/2005/11/22/stories/2005112202191500.htm (last visited on February 15, 2012)

[28] S Mahalingam , *Are Independent Directors Liable?*, Business Standard, The Business Standard, available at http://www.business-standard.com/india/news/are-independent-directors-liable/399821/ (last visited on February 15, 2012)

[29] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 Hastings Bus. L.J. 281 (2010)

The 2007-09 global financial crisis is just one of the many instances where corporate governance failures have been pointed out as one of the key factors leading to institutional failures[30], yet, supervisors and boards of companies have not been able to take steps that match the magnitude of the collapses. It is in light of the above that the role of independent directors assumes much importance. They have become a symbolic icon of modern corporate governance.[31] While regulatory frameworks provide for appointment of IDs, what is lacking is a mechanism to ensure their independence. This can be ensured by, to begin with, an appointment criterion that diminishes the possibility of these directors failing in the fulfillment of their roles as well as ensuring that their position isn't just a nominal one.

Dr. Mehra suggests that, a solution to eliminate, the cozy relationship between IDs and their companies can be found by creating an independent body under SEBI. It is this organization which will be charged with the role of screening[32] and recruiting them and placing them with listed companies. All fees and allowances to the IDs are paid by the independent organization under SEBI. The organization should be funded through a special levy charged by SEBI from each listed company based on the turnover of the company. IDs are our only hope to instill some discipline in the murky world of corporate finance. It needs to be ensured that greed plays no part in their appointment. As lucrative as this suggestion seems, it is also equally practicable. Unconsciously, Indian Corporate Governance is moving towards institutionalizing independent directorship. However, it would suit public purpose if it were to be made legal and were to be regulated.

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30 HM Treasury, *A Review of corporate governance in UK banks and other financial industry entities: Final Recommendations*, available at http://www.hm-treasury.gov.uk/walker_review_information.htm (last visited on February 15, 2012)

31 Yuan Zhao, *Nomination and Election of Independent Directors: From Anglo-Saxon Style to Chinese Practice*, Comp. Law. 2011, 32(3), 89-96

32 The Hindu, *Independent Directors Need A Watchdog*, Business, Jan 27, 2009 (Print Edition)

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Independent Directors: Will Of the Company or Not?

G. Sneha Sindhu[*] and Saumya Kumar[**]

As per the definition of independent director in the code of Corporate Governance, an independent director should not have any pecuniary relations or transactions with the company or its promoters; his decisions should be independent of those who have controlling stake in a company and be in the overall interest of the company and its stakeholders. The Companies Act of India does not have a definition of 'independent directors' though the definition of independent director as given in the recently amended clause 49 of listing agreement is an inclusive definition, which says who could be independent directors.

The concept of "independent directors" is new to India and was first brought to India by the 1999 Kumar Mangalam Birla committee on corporate governance. Three years later the Naresh Chandra committee gave governance more thought; and subsequently in 2004 the Narayan murthy committee affected changes to clause 49 of the listing agreement. The very purpose behind appointing independent directors is to put checks and balances on each and every activity of the company and bring independence, impartiality and wide experience.

After Satyam *scandal the issue of independent directors is back in focus. It is not only in Satyam that independent directors showed lack of commitment; earlier in the case of Enron, WorldCom and other companies in which corporate governance as well as independent directors failed to perform effectively.*

The article deals with the fundamental question of whether the independent non executive directors can become the directing mind and the will of the company. The paper will look at the duties and responsibilities of these directors and examine this pertinent question in detail.

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CONTENTS

I. Introduction

Independent Directors, as suggested by the name requires that the individual must function in an independent capacity in the interest of the company. Though the Kumar Manglam Birla Report envisaged a regulatory role of such directors, but the same has heralded an expansive forum of debate regarding the appointment and the liabilities of independent directors. Amidst this debate, the essence of the appointment regarding the skill and the contribution made by the non-executive director has lost its ground. A director's independence is an essential element of an enhanced corporate governance framework. In the course of the paper, the aim is to identify the variety of provisions provided in relation to non-executive directors in United Kingdom and India indicating the duties and the obligations applicable on them. In relation to the same, the intention is to identify whether the arena of powers granted to them empowers them to direct the course of the company as per their direction to identify them as the will of the company. In the course of the paper, analyzing the present applicable scenario in relation to non-executive director, certain criteria which must be considered while formulating the structure of the legislation related to non-executive directors shall be proposed.

II. A Brief Study of the Cadbury Report

The Cadbury Report, titled *Financial Aspects of Corporate Governance*, is a report of a committee chaired by Adrian Cadbury that sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures[1]. The report was published in 1992. The report's recommendations have been adopted in varying degree by the European Union, the United States, the World Bank, and others. The Report and Code of Best Practice published by this committee have ever since been known as the Cadbury Report and the Cadbury Code[2].

The main objectives of this Committee were[3]:

'To consider the following issues in relation to the financial reporting and accountability and to make recommendations on good practice:
a) the responsibilities of executive and non-executive directors for the reviewing and reporting on performance to shareholders and other financially interested parties; and the frequency, clarity and form in which information should be provided;
b) The case for audit committees of the board, including their composition and role;
c) The principal responsibilities of auditors and the extent and value of audit;
d) The links between shareholders, boards, and auditors;
e) Any other relevant matters'

The Report talks about the various aspects of Corporate Governance, and this paper would examine the provisions relating to Independent Directors. The Cadbury Report studied the role of non-executive independent directors and the independence which such individuals were required to bring with them. The section titled "Board Effectiveness" has recommendations dealing with Independent Directors in Boards of companies[4]. It states that each company must have a Board of Directors which can lead the company effectively, and it goes on to say that this means that there must be a combination of executive directors and non-executive directors. The rationale behind this setting is that the executive directors have an 'intimate knowledge' of the business and the independent directors or the non- executive directors bring fresh knowledge and perspective from outside, and can at times become the devil's advocate also.

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[1] Cadbury Committee Report (1992), available at http://www.jbs.cam.ac.uk/cadbury/report/index.html (last visited on February 15, 2012)
[2] *Ibid.*
[3] Prithivi Haldea, *The naked truth about Independent Directors*, available at http://www.directorsdatabase.com/IDs_Myth_PH.pdf (last visited on February 15, 2012)
[4] DK Prahalada Rao, *Role of Independent Directors under lens*, available at http://www.business-standard.com/india/news/roleindependent-directors-under-lens/347721/ (last visited on February 15, 2012)

It was intended that non-executive directors be appointed to the board of directors so as to bring an independent judgment to bear on issues of strategy, performance and resources, including key appointments and standard of conduct.

The Board's effectiveness can be gauged by the way the Directors gel with each other and handle pressure, and how democratically they act when taking decisions. The Board must work under the Chairman whose role in Corporate Governance is fundamental.

Every Director on the Board has equal responsibility in the eyes of law for the actions and decisions of the Board. The Board has the overall responsibility to ensure that the Directors (even with different individual duties) are meeting its overall objectives[5].

The report clearly lays down that Independent Directors have a twofold purpose in the Board that is:

1. Reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views. If the chairman is also the chief executive, board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the effectiveness of the board. A number of companies have recognised that role and some have done so formally in their Articles[6].

2. Taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession, or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations[7].

Besides ensuring the well-being of the corporation, independent directors are also expected to champion the interests of shareholders,

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[5] Tarjanarai, *Independent Directors and their Independence in Corporate Governance Practice*, available at http://jurisonline.in/2010/01/independent-directors-and-their-independence-in-corporate-governance-practice/ (last visited on February 15, 2012)

[6] *Supra* Note 1 at p. 20

[7] *Ibid.*

stakeholders and the society at large. The approach taken by the UK Cadbury Report, which is mirrored in Singapore and Malaysian Codes also, was substantially similar where it refers to independent directors as needing to be only independent of management and free from any business or other relationship which could affect their independent judgment. The views expressed in the Cadbury Report were generally unmodified by the Hampel Report, prepared by the Committee on Corporate Governance chaired by Sir Ronald Hampel in June, 1998.

III. A Brief Analysis of the Higgs Report

In April 2002, Derek Higgs was appointed by the Secretary of State for Trade and Industry to head the said review. His report, 'Review of the Role and Effectiveness of Non-Executive Directors', was published in January, 2003.[8] Though, the same has been subjected to further scrutiny by the Financial Reporting Council, yet the Higgs Report technically provides the fundamental version of the duties and liabilities of non-executive directors in United Kingdom.

The Board's recommendation was based on the principal that the Board of a Company is responsible for the success graph of the Company where each and every minute decision of the Board directly affects the contours of the Company's profitability. Owing to this importance of the Board of a Company the Committee, proposes the appointment of non-executive directors with appropriate methods outlined to ensure that they aided in carrying out their tasks as a non-executive director effectively. The Committee proposes the innovative idea of introducing potential non-executive directors to the functioning of the company to familiarize them with the arena in which the company moves.[9]

Besides in accordance with acting as a watch-dog of the company, the non-executive directors are required to conduct regular meetings which must be notified in the annual general report to provide an overview to the members of the company in relation to the functions undertaken by the non-executive directors. The Committee in its recommendation pointed out that the same

8 The Higgs Report on Non-Executive Directors (2003), available at http://www.fide.org.my/publications/reports/ 0007_rep_20081211.pdf (last visited on February 15, 2012)

9 The Report of the EU High Level Group of Company Law Experts, available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf (last visited on February 15, 2012)

meeting must be undertaken in the absence of the chairman or the executive directors.[10] Such a mode of meeting ensures that all the non-executive directors enjoy the freedom of expressing their area of concern with no influence or prejudice from the executive directors which guarantees them to provide an outsider perspective in the interest of the company.

The Higgs Review lays down the foundation of the role played by a Senior Independent Director, as a link between the shareholders and the Board of a company. The Review identifies the basic contours of an independent director as essentially being an external decision making individual, uninfluenced by any internal movements. Though the review provides a non-exhaustive lists of possible independent directors, yet every annual general report must provide the detail of the non-executive director with due justification to substantiate the independence of the director.

The nature of such directors being regulatory in nature requires that they have the required skill to undertake such an initiative and grant paramount consideration to the interest of the company. Consequentially, the confidence of the shareholder must also be respected and as per the recommendation of the review, they must be duly informed about the criterion which represents the independence of such directors.

The Company is duty bound to provide adequate, recent and relevant data to the Directors to ensure that the decision are undertaken by giving due regard to the best information available which ultimately guarantees an effective implementation of their skills and expert commercial knowledge. While a non-executive director cannot undertake the same position in another company without a due notification to the chairman of the company. Besides this, the non-executive director in case of any altercation with the Board intends to resign, then he is duty bound to notify the Chairman as the resignation is considered as the last resort in issues where the director is against the actions of the Board. Acting in fiduciary capacity, the review requires the non-executive director to record his justification in the form of minutes to be released to the shareholders to ensure that their viewpoint is represented to them in their interest.

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[10] The Myners Report on Institutional Investment (2001), available at http://archive.treasury.gov.uk/docs/2001/myne rs_report0602.html (last visited on February 15, 2012)

IV. Committees Set up in India for Independent Directors

The concept of "independent directors" is new to India; it was first brought to India by the 1999 Kumar Mangalam Birla committee on corporate governance. Three years later the Naresh Chandra committee gave governance more thought. Finally, in 2004 the Narayan Murthy committee affected changes to clause 49 of the listing agreement. As it stands today, the existing company law has no mention of independent directors. They can't magically prohibit the scams from happening in a company; the very purpose behind appointing independent directors is to put checks and balances on each and every activity of the company and bring independence, impartiality and wide experience.

It has been decided in *Central Government Sterling Holiday Resorts (India) Ltd. and Ors*[11] that "the Board of directors should be strengthened by appointing independent directors."

A. *Kumar Mangalam Birla Committee (1999[12])*

This committee has tried to define what exactly Independent directors are. Many say that this report introduced the word "Independent Director" into the Indian legal scenario with the introduction of Clause 49 of the Listing Agreement. The Committee has said that in its view, it was important that independence be suitably, correctly and pragmatically defined, so that the definition itself does not become a constraint in the choice of independent directors on the boards of companies.

The Committee gave the following definition of "independence". Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.

The Committee has said in categorical terms that it is the calibre of the independent Directors that matter, and not the number. The Committee mandatorily recommends that the board of a company have an optimum

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[11] [2006] 131 CompCas 6 (CLB)

[12] Kumar Mangalam Birla Report (1999), available at http://web.sebi.gov.in/commreport/corpgov.html (last visited on February 15, 2012)

combination of executive and non-executive directors with not less than fifty percent of the board comprising the non-executive directors. The number of independent directors (independence being as defined in the foregoing paragraph) would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise of independent directors and in case a company has an executive chairman, at least half of board should be independent.

B. *Naresh Chandra Committee (2002)*[13]

This Committee tried to give a wider definition of Independent Directors by laying down who can and who are qualified to be independent directors. The Report also stated that they should be made a part of the Audit Committee. It also fixed the percentage of Independent directors on the Board of a company at not less than 50% of the Board of any listed company. The remuneration of independent directors was first discussed in this report. There was a provision which exempted them from certain liabilities. It also provided for the training of independent directors.

C. *Narayan Murthy Committee (2004)*[14]

This committee gave certain amendments to Clause 49 with regard to their number, as they felt that there is a clear shortage of Independent directors in India. Also there are certain other proposed amendments with relation to remuneration and their term of office.

D. *Irani Committee (2006)*[15]

This committee was headed by noted Manager J.J. Irani. A minimum one third independent directors recommended for a company having public interest. It proposes that independent directors hold one-third seats on boards of listed firms, at variance with SEBI's proposal to reserve 50 per cent of board positions on all firms for independent directors.

It states that the nominees of institutions should not be considered "independent" as they represent sectional interests. Independent directors

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[13] Naresh Chandra Committee Report (2002), available at www.acgaasia.org/public/files/ IndiaNareshChandraExecSum.doc (last visited on February 15, 2012)

[14] Narayan Murthy Committee Report (2003), available at http://www.sebi.gov.in/cms/sebi_ data/attachdocs/129309 4958536.pdf (last visited on February 15, 2012)

[15] Irani Committee Report (2006) available at www.primedirectors.com/pdf/JJ%20Irani%20R eport-MCA.pdf (last visited on February 15, 2012)

should make self-declaration of eligibility to be so appointed. Also like all other reports, it also tries to come up with a definition based on pecuniary interest that may affect "independence".

An independent director is expected to act as watch dog of the board and protect the interest of shareholders. Since they are handpicked by the promoters, they prefer to be a friend of the promoters rather than be the watch dog of the board. Though independent director is paid by the company, it must be borne in mind that the company is not only owned by its promoters, but all shareholders so they are supposed to represent the interest of the minority shareholders. There are circumstances where independent directors are not independent, which broadly includes:-

a) their selection procedure
b) no age limit
c) no specific qualification is required
d) no right to interfere in the day-to-day operations
e) no time limit for replacement of an independent director

Independent directors are still the only hope to instill discipline in the murky world of corporate finance, provided their independence is not being compromised. If they are no more independent then their appointment in a company will be meaningless. This position deserves to be corrected by empowering SEBI and the Indian government.

On March 11, 2011, SEBI passed an order in relation to Pyramid Saimara Theatre Limited ("PSTL") restraining three of its independent directors from being independent directors or members of audit committees of any listed company for a period of two years from March 11, 2011.[16]

The order was passed on the ground that these independent directors of PSTL failed to perform their role in preventing false and misleading disclosures made by the company in its accounts, which were found to contain inflated profits and revenues through fictitious entries. In its order, SEBI has made strong observations regarding the role of independent directors in listed companies:

"While the extent of responsibility of an independent director may differ from that of an executive director, an independent director has the duty of care. This duty calls for exercise of independent judgment with reasonable care,

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[16] The Economic Times (PTI), *Pyramid Samaira Case: SEBI confirms ban against Keynote and others* , available at http://articles.economictimes.indiatimes.com/2010-07-07/news/27600348_1_sebi-letter-sebi-order-market-regulator (last visited on February 15, 2012)

diligence and skill which should be reasonably exercised by a prudent person with the knowledge, skill and experience which may reasonably be expected of a director in his position and any additional knowledge, skill and experience which he has."

SEBI's warning signals to independent directors seems loud and clear. While this enunciates the importance of the monitoring role of independent directors, it remains to be seen whether SEBI's order operates as a serious disincentive to otherwise competent and capable individuals from taking up or continuing with their board positions.

While in other Asian countries like Singapore, the treatment met out for non-executive directors seem more severe where Peter Madhavan, a former independent director at scandal-hit air cargo firm Air ocean, was sentenced to four months' jail for his part in making a misleading statement to the Singapore Exchange and was fined $120,000.

Considering the debate associated with the liabilities of the Non-executive directors, the Corporate Affairs Secretary has declared that Independent directors will not be hauled up for the acts undertaken by companies without their consent or knowledge. Accordingly they have directed the Registrar of Companies (RoC) not to take any penal action against those independent directors who are not actively involved in the decision making process of the company. Consequentially, under the new norms, no action can be taken against independent directors and nominee directors for acts of companies undertaken without their "consent or connivance or where he has acted diligently in the Board process".

Under the existing provision, penal actions for defaults committed under the Companies Act, 1956, are taken against an "officer in default" or "directors" or "persons" as specified in the Act. The role and responsibility of independent directors have been a topic of constant public debate, especially after the move of Satyam Computer Services to buy out Maytas Infra and Maytas Properties, promoted by kin of the founder B. Ramalinga Raju,[17] was rejected by the shareholders.

[17] Krishnan Thiagarajan, Satyam Computers: books Profits, Business Line, available at http://www.thehindubusinessline.in/iw/2003/07/27/stories/2003072700530800.htm (last visited on February 15, 2012)

E. Conclusion

Independent directors are a very powerful part of the company as they have rich experience and they play a very vital role in securing interests of shareholders as well as they are expected to give inputs for the benefit of management. For securing the independence of independent director, there is a need to break the nexus between the independent directors and promoters who sponsor them. For that, nomination of independent director must be done by SEBI and government.

A company should have a clearly laid out policy in which there should be a specified role played by him at board, their tenure and age limit, qualification required, etc. The focus must be on the quality of person who is going to be appointed. Selection of independent directors by SEBI and government would be fair and bring transparency in the selection procedure as well as can secure their independence to some extent. So far as age limit is concerned which must be review, minor should not be considered eligible for the chair of independent director; the minimum age limit for an independent director must be between 30-35. In this regard, it is submitted that the Higgs Review proposition of training the existing employees and identifying the specific skills of the potential directors ensures that the most appropriate directors are duly selected for the interest of the Company.

Company must clearly lay down the qualification and experience required for the post of independent directors. The appointed director must be rotated periodically to ensure the transparency and fairness in their decision. Legal protection must be provided to independent directors so that they can raise their voice against the management and force their views in the interest of shareholders. There have been suggestions that the institution of Independent Directors must be scrapped. It would politically be a controversial move to scrap the very institution of ID, as it has been invoked for the protection of minority shareholders. Moreover, it is now a universally acclaimed regulation. India should warm up to the idea of independent directors who actually contribute to the Board, and can actually become the 'will' of the company.

Surveillance for Probe into Credibility and Accountability of Independent Directors

Renu Sirothiya[*]

Lately, the Housing Loan Scam and the Bhopal Gas Leak Verdict and before that, the Satyam Fiasco raised the issue of the extent of liability of independent directors and then the recent 2G Scam and Abhijeet Group Scam and revelations regarding rampant wirings resulted in debate not only over the validity of phone tapping for exploring corporate activities but also on the legality of raiding the premises of independent directors. In this backdrop, the question that emerges is that how ethical and acceptable it is to subject the independent directors to the so called corporate surveillance. Knowingly, independent directors represent one of the pillars of corporate governance and ought to have absolutely untainted image and approach and thereby it seems only reasonable to not let them be completely shielded from scrutiny and a possible liability. But at the same time, it appears bizarre to visualise scrutinizing those officials who are themselves meant for ensuring maintenance of corporate governance. Hence, it is essential to analyse as to how far independent directors can be permissibly and productively subjected to scanners.

This paper presents a holistic picture; bringing in perspective the varied forms and facets of such scrutinies, and further explaining both practical and legal dimensions.

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CONTENTS

I. Introduction

In today's scenario of corporate consciousness, amid uncertainties and upheavals, independent directors who are seen as insignia of integrity are increasingly getting exposed to scrutinies. Their links, lobbies, portfolios, professional involvements, accounts, interests, tax records, trading patterns and even those of their allies and ties are one or the other way under scanners. Situation is such that on one hand, for checking earnestness regulators, committees, investigators and insurers probe into their activities and on the other hand, for getting investment indications, analysts and investors also closely watch them.

The office of independent director is subject to authorised appraisals but is at times scanned without due approvals. In the former case, the scans are referred to as *warranted monitoring* while in latter they amount to *unwarranted probes*. Then there are *overt* and *covert* categories of scans. Further, such scans include both *pre-appointment scrutinies* and *post-appointment scans*. Besides, there are *direct* and *indirect* variants of corporate scrutinies where in the case of latter, primary subject of scan are companies but independent directors fall very much within the loop. Facilitators and even companies themselves, venture into *Pre-Appointment Probes* for the assessment and ascertainment of credibility and qualifications of the person by way of screening of the antecedents. This is a method of ensuring qualitative review. This is significant as quality should be the focus while appointing independent directors.[1] And as far as *Post-Appointment Surveillance* is

[1] Prithvi Haldea, *Independent directors: Does the Debate Need An About-Turn?*, The Economic Times, available at http://articles.economictimes.indiatimes.com/2007-07-

concerned, it aims at assessment of accountability as well as the determination of liability. Government scans to prevent scams and tax evasions; regulators scan to check insider trading, money laundering, embezzlements and other frauds and to uphold the high level of corporate governance; investors scan to get investment tips; analysts scan to determine the current level and also to forecast the trend; rating agencies scan to benchmark; media scans to explore the other side and investigators and committee scan to trace the truth.

Prior to appointing an independent director, the antecedents are thoroughly checked and even afterwards regular compliance and quality checks follow. Also, for case investigations independent directors are subjected to raids, interrogations, etc. Further, not only to check insider trading but also as an anti-money laundering move independent directors are kept within purview of scanners. In addition, credit rating agencies, stock exchanges, regulators, financial analysts, research firms, apparent or proxy investing activists and even information activists, whistleblowers, investigative journalists and of course general media, also keep an eye on the activities of independent directors. Besides, there are scans by institutional investors and by companies providing insurance to them in form of the liability covers.[2]

Direct surveillance and indirect scrutinies; formal scans and informal observations; authorised probes and unauthorised examinations and apparent investigations and undercover snooping are few approaches and in any of the cases phone tappings, off the record bytes, trade screening, cyber surveillance, monitoring of activities on networking sites, relations audit, movement monitoring, sting operations, bugging of premises and searches, seizures and raids, etc. may be varied ways towards scrutinies. Nevertheless, extreme and evident ways are to be used only when deviation on part of independent director is apparent and clearly mere suspicion or mere conjecture can't be the premise of any intervention.

17/news/27678362_1_independent-directors-promoter-companies-companies-act (last visited on February 15, 2012)

[2] Souvik Sanyal and Paramita Chatterjee, *Companies Rushing For Liability Cover To Protect Independent Directors*, Economic Times, available at http://economictimes.indiatimes.com /news/news-by-company/corporatetrends/Companiesrushingforliabilitycovertoprotectindependentdirectors/articleshow/6225361.cms (last visited on February 15, 2012)

II. 2G Spectrum Scam: An Example Of Corporate Probe

One prominent example that shows the phenomenon of corporate probes relating independent directors is raids in context of 2G Spectrum Case. During investigations of this case not only home and office of corporate lobbyists Neera Radia were raided but also that of many independent directors. Many reports and studies state that independent directors are in many cases actually *interested insiders*. Quite observably these findings are based on information obtained by some one or the other. Thus, these reports also constitute the evidence on the basis of which it can be stated that practice of probes on independent directors exists. Reportedly, from 2006-2011, only one telecom subscriber namely Reliance Communication intercepted 1.51 Lakh phone numbers.[3] On the basis of this numerical data it can be clearly inferred that out of approximately 2400 calls a month even if few persons are independent director then clearly toll goes high.

III. Regulatory Framework To Scan Acts Of Independent Directors

Under various corporate laws regulations of the country, certain authorities have the power to conduct a probe in case of existence of certain circumstances. Examples of such provisions are discussed below.

A. Scans against Insider Trading and Independent Directors

Independent directors fall within the purview of the definition of insider as enshrined in the Section 2(e) of the *Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992*. If any independent director transacts and avails benefits on the basis of unpublished price sensitive information then that amounts to insider trading and subsequently investigations are legitimate.

B. Scans against Trade Secrets Leaks and Independent Directors

Very often independent directors serve on multiple boards and even without any contract it becomes their fundamental obligation to maintain

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[3]Dhananjay Mahapatra, *Over 1 L Phones Tapped Every Yea*r, Times of India available at http://articles.timesofindia.indiatimes.com/2011-02-15/india/28545822_1_lakh-phonessubscriber-base-provider (last visited on February 15, 2012)

confidentiality in terms of trade secrets.[4] And thereby scans to find breach of that obligation are advocated as valid.

C. Scans for Credit Rating and Independent Directors

For Corporate Governance Rating (CGR), the Credit Rating Agencies (CRAs) assess standard of companies on one yardstick of level and repute of its independent directors but invariably this is statistics based and reports based assessment and as per the best practices, no undue interventions are made. For instance, there are, Association of Credit Rating Agencies in Asia (ACRAA) best practices to which CRISIL, CARE, ICRA and others abide by while making any examinations and statements. Further in pursuance of *SEBI (Credit Rating Agencies) Regulations, 1999* these agencies have to be fair in their work and can neither debase nor inflate the findings.

D. Phone Tapping and Independent Directors

Though it is argued that for bringing out the corrupt practices in corporates, phone tapping may be highly instrumental yet as per the *Indian Telegraph Act,1885* it isn't a permissible practice in general circumstances. The primary reason of impermissibility of phone tapping in context of independent directors is that the Independent Director in question may be on several boards and any phone tapping may result in leak of trade secret(s) and other confidential information. Moreover, it would be infringement of personal as well as corporate privacy which would amount to clear violation not only of Article 21 of the *Constitution of India* but also of Article 17 of the *International Covenant On Civil And Political Rights, 1966* and Article 12 of the *Universal Declaration of Human Rights, 1948*, to both of which India is a party. In addition, telephonic conversation in private without any interference is a fundamental right, [5] and thus, it is apparently corporate wiring to record words of independent directors as a practice derogatory to their right of liberty guaranteed by the part third of the Constitution. Besides, such kind of wiring is an unethical practice and corporates invariably do not appreciate such interventions.

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[4] Vandana Pai and Ramya Seetharaman, *Legal Protection of Trade Secrets*, 1 SCC (Jour) 22 (2004)

[5] *PUCL* v. *UOI*, (1997 1 SCC 301); *R. Rajagopal and Another* v. *State of Tamil Nadu*, [(1994) 6 SCC 632]; *Govind* v *St.of Madhya Pradesh*, [(1975) 2 SCC 148]; *Kharak Singh* v. *St.of UP and Ors*, (1964) 1 SCR 332

However, authorized tapping under order from the home secretary and telecommunication ministry is feasible in exceptional cases when evidence is to be gathered and alternate ways aren't available to suffice the cause, provided there are justifications to the act of tapping. But even then, it is to be assured that privacy invasion is minimum and that within two months the records are destroyed. But again tapping by whistleblowers remains a contentious issue. Another grey area is tapping by media by way of sting operations and investigative journalism, etc. and not to mention that purview of such questionable tapping may by corollary cover any tapping by the investigative web sites viz. wiki leaks, etc.

IV. Raison D'être Of Probes On Independent Directors

Scrutiny by the regulators appears rational as they may be instrumental in ensuring that the independent directors do not misuse information they have access to.[6] Further such surveillance may help check whether the directors are value directors or merely home directors [7] and to trace if there is any closet relation or lure like very high compensation. Besides scans may help in locating alarms like mass quitting and can also aid determination of existence and extent of liability. In addition, the probes are essential tools in hands of insurers, investigators and analysts.

V. Issues Relating to Probes On Independent Directors

Investors, rating agencies, watch bodies, regulators, insurers and committees may aver that in order to check how independent the independent directors are, some kind of probes must be made but factually there may be varied implications and not necessarily favorable ones. One of the profound issues is that despite the fair aim of transparency, such investigations may be felonious; they may be against corporate confidentiality and detrimental to the identity of individuals and may draw condemn from the concerned corporates and persons. Mostly probes are parallel to suspecting integrity and that may deteriorate image. Moreover, anything affecting the goodwill of company has direct impact on the investors' confidence so the phenomenon may not practically be instrumental for balanced governance. Other issues include *inter*

[6] Ravina Enrichetta and Sapienza Paola, *What Do Independent Directors Know? Evidence From Their Trading*, available at http://www.nber.org/papers/w12765 (last visited on February 15, 2012)

[7] PTI, *75% of Independent Directors 'home' members: Report*, Economic Times available at http://economictimes.indiatimes.com/CorporateTrends/75ofindependentdirectorshomemembersReport/articleshow/4555476.cms (last visited on February 15, 2012)

alia whether such probes are ethical and legal; whether they amount to breach of privacy and whether it is expedient to exhaust time and resources for governance of the officials themselves involved in the corporate governance.

Any scans relating to any independent director is valid only if it is an authorised surveillance; if it is part of ensuring the compliance of disclosure norms; if it is mechanism for review, control and monitoring; if it is meant for performance appraisal and audit; if it is carried by committee appointed for that very purpose; if it is part of probe against white caller crimes; if it is a criminal investigation; if it targets examination of tax status or if it is legitimately conducted for corporate governance rating (CGR). Nevertheless, extent and ways of scan in each case are to be determined subjectively and as per the related law. But again in all the cases it is essential that there is fulfilment of procedural requirements and that if there is any phone tapping or cyber scrutiny then it is duly approved by the government and furnished only for the approved purpose.

VI. A Few Examples Of Scans On Acts Of Independent Directors

A. Case of Check by Company Itself

In case of its own kind in January 2008, *Infosys* which is known for its high ethics, slammed fine on one of its independent directors for not fairly following norms against insider trading. In this case penalty of $2000 was imposed on one Jeffery Lehman, for failure to correctly follow the procedure on sale of shares.[8] Obviously fault would have been traced by internal scrutiny. So this is one case that shows how monitoring on independent directors can be part of self corporate governance.

B. Case of Search by IT Authorities

In January 2011, in an Investigation relating Abhijeet Group, a team of the Income Tax Department raided the premises not only of the promoters but

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[8] Kris Gopalkrishnan, *Infosys Fines its CEO for Violating Insider Trading Rules*, January 2008, The Economic Times available at http://economictimes.indiatimes.com/news/news-by-company/corporatetrends/Infosys-fines-its-CEO-for-violating-insider-trading-rules/articleshow/2722623.cms (last visited on February 15, 2012)

also that of the independent directors.[9] In this case relating benami capital infusion to find all layers of people involved it was deemed important to probe categorically.

C. Case of Probe by CBI

In December 2011, in relation to investigation of 2G Scam, Central Bureau of investigation even probed directors. Evidently, investigation of this multi-crore scam involving many lobbies and high profile people could only be exhaustive so to ensure that culprits from all quarters are brought under the scanner.

D. Justification of Scrutiny

In certain cases, it may be understood that the scan was required and justfied. Such cases include the very recent case of *Vedanta Resources.* It presents an example of warranted situation for scan on independent directors. This company had environment clearance to set up only a one-million tonne alumina refinery at Lanjigarh in Orissa but without any further approvals it expanded its capacity six-fold. In light of these facts in September 2010, *N.C. Saxena Committee Report* raised questions on the role of independent directors.[10] In case of Satyam fiasco, wherein books of accounts were inflated manifold an apparent case surfaced where it seemed fully rational to probe on independent directors. [11] In the said case the government expanded the mandate of the Serious Fraud Investigation Office (SFIO) to launch a formal investigation against independent directors as their role *prima facie* looked dubious.

The Verdict of Bhopal Case raised questions on liabilities of independent directors. [12] Many argued that given the massive loss caused by the menace not only the liability of company follows but even scrutinies on

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[9] TNN News, *Raids Yield Rs 2cr Cash, Gold from Abhijeet MD*, Times of India available at http://articles.timesofindia.indiatimes.com/20110120/nagpur/28359864_1_taxsleuthsabhijeetgroupunaccounted-money (last visited on February 15, 2012)

[10] Sarkar Ranju, *Vedanta's Silent Independent Directors*, available at http://smartinvestor.in/market/story-41296-storydet-Vedantas_silent_independent_directors.htm (last visited on February 15, 2012)

[11] Hamsini Amritha, *Directors, Independent And Interdependent*, Business Line available at http://www.thehindubusinessline.in/iw/2009/01/18/stories/2009011850740700.htm (last visited on February 15, 2012)

[12] Rajeev Chandrasekhar, *Are Independent Directors Liable?*, Business Standard available at http://www.business-standard.com/india/news/are-independent-directors-liable/399821/ (last visited on February 15, 2012)

independent directors appear logical and making them liable does not represent a rigid stance as after all these professionals are not meant to be not accountable.

In a case of 2008, despite having the board comprising of two former senior regulators and a former top bureaucrat, Sahara India Financial Corporation (SIFCL) repeatedly violated the Reserve Bank of India (RBI) Guidelines and thereby questions on the credibility of directors were raised. This instance of utter passiveness presents another example of situation where probes against directors are justified. In January 2005, a case of pecuniary ties of *Reliance Industries Limited* with its so-called Independent Directors came in the lime light. It was reported three independent directors on the RIL board have had a financial relationship with the company and its associate companies like Reliance Capital and Reliance Infocomm. This case manifested that there may be situations where independent directors are not independent in true sense and in such cases scrutinies seem warranted.

In certain cases, the probe may be unjustified and unnecessary. Case of Nagarjuna Finance Ltd, Hyderabad is one such case in which the acclaimed merchant banker Nimesh Kampani was brought under scanner as before some years of alleged fraud he was on the board of the company. In 1999, he resigned from the post and three years later, the company defaulted on repaying deposits worth Rs. 100 crore.[13] In this case Kampani could have been asked to cooperate to yield clues but strangely his arrest was ordered as under *Andhra Pradesh Protection of Depositors of Financial Establishments (APPDFE) Act*. Apparently, this case shows very extreme stance, in the context of liability of independent directors, which make them susceptible to unacceptable levels of scrutinies.

VII. Suggestions

In light of the discussion, provisions and need of the hour it is proposed by the author:

a) That there should be *monitoring mechanism but not unwarranted scans* as regulation of the office of independent directors is crucial in interest of investors and companies but undue scans will only be in detriment as amid

[13] Bhaskar RN, *Why is India's Biggest Investment Banker in Exile?*, Forbes India Magazine available at http://forbesindia.com/article/investigation/why-is-indias-biggest-investment-banker-in-exile/212/1 (last visited on February 15, 2012)

very close watch and under too high obligations and accountabilities, professionals would not be willing to join the boards;

b) That *governance* on independent directors should be there but *only in right ways and for right reasons*. Letting independent directors fully free may create gaps in the system of corporate governance thereby, only *qualified monitoring* should be supported;

c) That there should be *law in place* for monitoring independent directors in rational and exceptional circumstances. For instance there should be clear provision relating scrutinies linked to independent directors and there should be prescribed limits of interventions in office of independent directors;

d) That the *office of independent directors shouldn't be unduly meddled with* and there should be *check on unwarranted wirings and cyber scans* on the activities of independent directors. It is high time that formal body should be set up to check phone tappings and other forms of surveillance so that unauthorised probes can be prevented and corporate and individual privacy can be protected;

e) That if high amounts are at stake, great manipulations are being done, the quantum of evasions is colossal and chances of unawareness seem very low then independent directors should be taken within the purview of probes. These paradigms may be used as *test to assess necessity of surveillance* on independent directors;

f) That on revelation of frauds or just prior to it if there are resignations by independent directors then it should be construed as an alarm and it should be permitted to take them within the purview of probes as this can certainly help yield important information in the interest of investors and regulators; and

g) That *every undue scan* that discourages duties observation, whistle blowing and activism by independent directors *should be severed from the system* of corporate regime of India.

VIII. Conclusion

As per the popular practices of corporate jurisprudence in the interest of corporate governance and growth of independent directors, they are to be let free of liabilities so as to ensure that the expert persons of repute and integrity are not restrained from stepping in on the boards of the companies. However, pragmatic stance clarify that 'power corrupts and the absolute power corrupts absolutely' so accordingly in such given situation of very low or no liability there may be propensities that are not warranted from such officials of governance. Therefore, even when maximum cases are of 'upright approach' yet it would only be prudent to at least have some check and balance and thereby it is concluded that if fully shielded system may get tainted, therefore, it is better that the system is subjected to scanners, though judiciously so that it remains what it ought to be and its very substance is not jeopardized.

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Extent of Immunity to be Granted to Independent Directors against Criminal Prosecution

Shipra Padhi[*] *and Pallavi Sharma*[**]

Having regard to the nature of the functions performed by IDs, it is important to see whether such directors can be equated to executive directors who are involved in the day to day management of the company, in terms of the extent of liability. The Companies Bill, 2011 includes express provisions pertaining to IDs. In the past, laws regulating independent directors were restricted to Clause 49 of the Listing Agreement. The Parliament Standing Committee in its report has also made many relevant suggestions with regard to IDs which includes a declaration to be made by IDs to the effect that they are familiar with their responsibilities and obligations and accepts the consequences of failure to fulfill their obligations.

In this paper, the authors seek to analyze the relevant provisions of the Negotiable Instruments Act, 1881; the Companies Act, 1956 and other legislations under which IDs may be prosecuted and convicted for criminal offenses such as corporate fraud, etc. Lately, there has been much deliberation over the position of independent directors. This paper shall deliberate over the possibility of making changes to the current legal framework to provide certain protection to IDs. The main question that is sought to be answered through this paper with regard to the nature of protection to be given to IDs and whether providing them with blanket protection similar to sovereign immunity to government appointed directors would help them in acting freely?

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CONTENTS

I. Introduction

Independence denotes the ability of a person to exercise reasonable judgment without being constrained or unduly influenced by the management or any dominant shareholder. Thus, the main function of an independent director on the Board is to supervise and monitor the working of the Board of directors, and also to provide executives with sound advice on matters of corporate policy[1.] Although the companies Act, 1956 does not define the term 'independent director' and no distinction has been made between executive and non-executive directors, the position of an independent director is different from that of an ordinary director. Independent Director has been defined in Clause 49 of the Listing Agreement which provides for eligibility criteria for independent directors.

As defined under Clause 49, '*Independent Director' means apart from receiving director's 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] The liability of an Independent Director has been a topic of debate due to the uncertainty and ambiguity associated with it. The conviction of Keshub Mahindra in the Bhopal Gas Tragedy case has ignited discussion on the liability of independent directors. In the Bhopal Gas Tragedy, it was a case of absolute liability. This is because independent directors are not directly involved in the management of the company, and thus, they are less likely to use their position against the interests of the company or law. Therefore, there is a need to amend the present legislation to include

[1] BR Cheffins, *Company Law: Theory Structure and Operation* (Oxford, Clarendon Press, 1997), Pg. 604-605

[2] Dilip Kumar Sen, *Clause 49 of Listing Agreement on Corporate Governance*, available at http://www.icai.org/resource_file/10980dec04p806-811.pdf (last visited on February 15, 2012)

independent directors and provide exemption from liability to independent directors.

II. The Existing Legal Framework

The Companies Act, 1956 does not mention anything about independent directors. Provision for independent director was inserted by Clause 49 of SEBI's listing agreement which mandated the appointment of independent directors in the board of directors. Clause I, sub clause (ii) of annexure-1 of clause 49 mandates that "*where the chairman of the board is a non-executive director, at least one-third of the board, should comprise of independent directors and in case the chairman of the board is an executive director at least half of the board should comprise of independent directors.*"

The case of *Central Government* v. *Sterling Holiday Resorts* [3] reiterates the need of appointing independent directors. In this case the Court held that "*the Board of directors should be strengthened by appointing independent directors*."

The archaic Companies Law of 1956 has been amended 23 times[4] but still there are no provisions regarding the selection process, independence or qualifications of an independent director. The Companies Bill, 2011 if enacted will change the functioning of companies in India but there are ambiguities in the bill too. At present we need laws which precisely define the roles, qualifications, functions, duties, responsibilities of an independent director. The appointment of independent directors in case of listed companies governed by SEBI, but in case of an unlisted company there is no such requirements.[5]

Clause 49 of the Listing Agreement is inspired by the Sarbanes Oxley Act passed in the United States by the Bush Government in 2002 which brought sweeping changes in financial reporting in the United States. This inspired India to frame a code for corporate governance. In furtherance of this Kumar Mangalam Birla Committee was appointed by SEBI which gave recommendations on corporate governance. The recommendations were

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[3] [2006] 131 CompCas 6 (CLB)

[4] Saikat Neogi, *Open and Free*, Financial Express available at http://www.financialexpress.com/news/open-&-free/362807/ (last visited on February 15, 2012)

[5] Tarj Anarai , *Independent Directors and their Independence in Corporate Governance Practice*, available at http://jurisonline.in/2010/01/independent-directors-and-their-independence-in-corporate-governance-practice/ (last visited on February 15, 2012)

accepted by SEBI in December 1999 and now enshrined in Clause 49 of the listing agreement of every Indian Stock Exchange.

With reference to *Sections 291 to 293 of the Companies Act, 1956*, it would be evident that what the Board of Directors of a company is empowered to do would depend upon the roles and functions assigned to the directors as per the Memorandum and Articles of Association of a company. But the question as to what is the role of a Director in a company is a question of fact which needs to be properly defined in the legislation so as to remove ambiguity. If we analyze the definition of "*officer who is in default*" as given in *Section 5*[6] *read with Section 633*[7] *of the Companies Act, 1956*, it can be

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[6] Meaning of "officer who is in default":- For the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise, the expression "officer who is in default" means all the following officers of the company, namely:-
(a) the managing director or managing directors;
(b) the whole- time director or whole- time directors;
(c) the manager;
(d) the secretary;
(e) any person in accordance with whose directions or instructions the Board of directors of the company is accustomed to act;
(f) any person charged by the Board with the responsibility of complying with that provision: Provided that the person so charged has given his consent in this behalf to the Board;
(g) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors: Provided that where the Board exercises any power under clause (f) or clause (g), it shall, within thirty days of the exercise of such powers, file with the Registrar a return in the prescribed form.

[7] (1) If in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an officer of a company, it appears to the Court hearing the case that he is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the Court may relieve him, either wholly or partly, from his liability on such terms as it may think fit:
Provided that in a criminal proceeding under this sub-section, the Court shall have no power to grant relief from any civil liability which may attach to an officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust.]
(2) Where any such officer has reason to apprehend that any proceeding will or might be brought against him in respect of any negligence, default, breach of duty, misfeasance or breach of trust, he may apply to the High Court for relief and the High Court on such application shall have the same power to relieve him as it would have had if it had been a Court before which a proceeding against that officer for negligence, default, breach of duty, misfeasance or breach of trust had been brought under sub-section (1).
(3) No Court shall grant any relief to any officer under sub-section (1) or sub-section (2) unless it has, by notice served in the manner specified by it, required the Registrar and such

inferred that such officials of the company who have given ‘consent’ and have also exercised necessary due diligence, care and caution while performing their function as a director can escape the rigors of liability to only a certain extent. Thus, even in this section there is no immunity provided to an independent director per se.

As far as liability of directors is concerned, there are certain other statutes apart from the Companies Act that discuss this issue. Section 138 of the Negotiable Instruments Act is used as the basis for the vicarious liability of directors. When a Company commits offence under Section 138 then Section 141 of the Act applies. The Supreme Court in *K.K. Ahuja* v. *V.K. Vora*[8] held that, “to be vicariously liable under Sub-section (1) of Section 141, a person should fulfill the ‘legal requirement’ of being a person in law (under the statute governing companies) responsible to the company for the conduct of the business of the company and also fulfill the ‘factual requirement’ of being a person in charge of the business of the company. Moreover, the complaint must have a specific averment regarding the role played by the director in the particular case.”

III. Proposed Changes

A complete and blanket protection or immunity to independent directors is not a viable option because independent directors form an integral part of the Board, receive adequate remuneration, etc. Thus, if they don’t perform their functions dutifully and there is prima facie evidence against them, they must be made liable. However, it is important to outline the role and responsibilities of independent directors and the extent of their liability. In this section of the paper, the authors have attempted to compartmentalize the different sections of the Companies Act, Negotiable Instruments Act, etc. under which independent directors or directors should be held liable, and cases where they should be completely exempted from liability. Although the extent of liability of any director depends on the facts and circumstances of each case, ensuring some sort of protection to independent directors is important for the growth of the institution of independent directors.

Under the Companies Act, 1956 statutory liability of a director exists in case of issue of a misleading prospectus containing untrue statements. However, under the companies act, criminal prosecution can be done only for

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other person, if any, as it thinks necessary, to show cause why such relief should not be granted.]

[8] [2009] 152 CompCas 520 (SC)

'officers in default' as defined under section 5 of the Act. Lately we have seen that independent directors are being booked for offences apart from those mentioned in the Companies Act, like technical infractions, bounced cheques, defective products, late provident fund payments, violation of factories act, etc. when they have nothing to do with the day to day running of the company.

A. Absolute liability/ Vicarious Criminal Liability

It has been argued that in the Bhopal Tragedy case, there was no question of vicarious liability as each individual has been held guilty based on their individual rash and negligent act. It is pertinent to note that the non executive chairman who was convicted i.e. Keshub Mahindra was in its true sense, an independent director as he owned no shares of the company, received only sitting fees, etc[9]. In this context, the question that arises is that is it right for Independent Directors / Non- Executive Directors (NEDs) to be held liable for non-compliance and lapses on the part of the management, including the whole-time directors?

With regard to vicarious liability, the Supreme Court in the *S. Alagh case*[10] held "in absence of any provision laid down under the statute, a Director of a company or an employee cannot be held to be vicariously liable for any offence committed by the company itself". Thus, for criminal offences the concept of vicarious liability does not exist in India.

B. Liability under section 141 of the Negotiable Instruments Act, 1881

Section 141 of the Negotiable Instruments Act was amended to exempt nominee directors from prosecution for dishonor of cheques issued by the companies.[11] Although such protection is not absolute, it grants some assurance to such nominee directors[12]. Similar provisions ought to be

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[9]Omkar Goswami, *The Case For Legal Sanity*, Business World, available at http://www.businessworld.in/bw/2010_06_26_The_Case_For_Legal_Sanity.html (last visited on February 15, 2012)

[10] AIR 2008 SC 1731

[11]Provided further that where a person is nominated as a Director of a company by virtue of his holding any office or employment in the Central Government or State Government or a financial corporation owned or controlled by the Central Government or the State Government, as the case may be, he shall not be liable for prosecution under this Chapter.

[12] RS Loona, *Independent directors can't escape accountability*, Economic Times, available at http://economictimes.indiatimes.com/opinion/commentsanalysis/independentdirectorscantescapeaccountability/articleshow/3958229.cms (last Visited on February 15, 2012)

introduced for independent directors as well. Since the exception is not absolute, in exceptional cases independent directors can be prosecuted and convicted. Nimesh Kampani, an independent director in Nagarjuna Finance Limited was proceeded against, for corporate fraud , cheque bouncing. Although he was acquitted at a later stage as he had already resigned at the time of commission of offence, he had to suffer the turmoil of being criminally prosecuted.

In the case of *Asith Kumar Mukherjee and Ors* v. *TTK Pharma Limited and Anr.*[13], the High Court held that where the directors are responsible for the affairs of the company and the day to day management, they are liable to be prosecuted under section 141 of the Act. The court further observed that the literal meaning of section 141 is not to be construed but circumstantial evidence is enough to prove liability.[14]

Section 633 can be invoked for protection of independent directors against legal proceedings arising out of defaults and breaches committed by the company. Thus, under this section the Court can grant immunity to such director, who though technically is guilty of negligence, has acted honestly and reasonably. In this regard, the High Court of Delhi[15] opined that, "*it is, therefore, unreasonable to fasten liability on directors for the defaults and breaches of a Company where such directors are either the nominee directors or are appointed by virtue of their special skill or expertise*."

Role of Independent director: In order to ascertain the extent to which immunity must be granted to an independent director, it is important to look into the role and functioning of an independent director.

IV. Recommendations of Various Authorities

Parliamentary Standing Committee Report

The Committee reviewed the Companies Bill, 2009 and recommended that the position of independent directors should be made different from that of normal directors. Also the committee said that "*the appointment of*

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[13] 2000 (1) ALD Cri 891

[14] Sara.R.Khan and Amol Shrivastava, *Criminal Liability of Directors*, available at http://jurisonline.in/2010/08/criminal-liability-of-directors-co-authored-by-amol-shrivastava (last visited on February 15, 2012)

[15] *Om Prakash Khaitan* v. *Shree Keshariya Investment Ltd and Ors* [1978] 48 CompCas 85 (Delhi)

independent directors should not be a case of mere technical compliance reduced to the letter of the law"[16] Thus, the government ought to prescribe the role, responsibilities and liabilities of independent directors. Parliament Standing Committee in its report has also made many relevant suggestions which include a declaration to be made by independent directors to the effect that they are familiar with their responsibilities and obligations and accepts the consequences of failure to fulfill their obligations.

Confederation of Indian Industries

CII is also of the opinion that due to the limited involvement of independent directors in the day to day management of the company, their liability should be limited. CII went on to recommend that Non-executive directors should not be made to undergo the ordeal of a trial for offence of non-compliance with a statutory provision unless it can be established prima facie that they were liable for the same on behalf of the company.

ASSOCHAM

The ASSOCHAM recommended the knowledge test for determining liability of independent directors. As per the knowledge test, if an independent director upon knowledge of any wrong doing or irregularity that has come to his notice or he has given consent to or connived against, does not initiate action, then such director should be held liable. They must not be held liable for day-to-day affairs of a company if they have acted diligently.

Institute of Chartered Accountants of India

ICAI's recommendation on liability of independent director is similar to that of Parliamentary Standing Committee. It recommended that there should be differentiation between the liability of the non-executive director and that of an executive director. Also as far as accountability is concerned, Independent director spends lesser time with the company and are not involved with the day to day functioning so they should not be held accountable for operational matters. The liability of the independent directors needs to be defined based on their roles and responsibilities that are assigned to them.

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[16] Pratip Kar, *Director's Dilemma*, Business Standard, available at http://www.business-standard.com/india/news/pratip-kar-directors-dilemma/407867/ (last visited on February 15, 2012)

Institute of Companies Secretaries of India

Although the ICSI has not made any recommendations specifically in the context of liability of independent directors, they have made certain recommendations regarding the tenure, appointment and remuneration of Independent directors. According to the ICSI, the tenure should be fixed to six years. Also, there should be fixed remuneration subject to a ceiling or a percentage of net profits of the company[17].

V. Conclusion

Independent directors are serving an important role on the Board; their role has been even more emphasized upon after the Satyam scandal. At the same time, proper regulatory measures should be made to ensure that all independent directors are aware of their rights, duties, responsibilities and liabilities. There are various sections in the Companies Act to protect the interest of an independent director with respect to offences committed under the Companies Act. Section 5 of the Companies Act, 1956 defines 'officer in default' to include only whole-time director. However, it is concerned only with offences under the Act, while for all criminal offences, there is no prescribed rule.

Thus, amendments should be made to the Companies Act, 1956 in order to limit the liability of independent directors for criminal offences. Hence, no criminal prosecution should take place unless there is prima facie proof of involvement on the part of the independent director. With regards to criminal offences against a company, it has been a common practice that all directors are charge-sheeted[18]. This practice needs to change and only directors involved in the day to day management of the company should be prosecuted against. For this purpose, we suggest the following recommendations:

Firstly, the Companies Act must differentiate between the two types of directors based on the functions performed by each class of directors. The

[17] *Guidelines for independent directors sought by ICAI and ICSI* , available at http://taxguru.in/company-law/guidelines-for-independent-directors-sought-by-icai-and-icsi .html <Last visited on February 15, 2012>

[18] MR Umarji , *Shield independent directors from hasty criminal prosecution*, Economic Times, available at http://economictimes.indiatimes.com/opinion/money--banking/Shield-independent-directors-from-hasty-criminal-prosecution/articleshow/4461575.cms (last visited on February 15, 2012)

liability of directors should be based on the function carried out by them. Although the Companies Bill provides for appointment, remuneration etc of independent directors, it is silent on their liability.

Secondly, a non-obstante clause should be included in the Companies Act which will have an overriding effect on other laws[19] so as to exclude independent directors from any criminal offences committed by the company. Such a clause will bring about clarity and reduce the ambiguity that is often associated with determining the liability of directors. This is because independent directors are not involved in the day to day management of the company. However, it is pertinent to note that this does not mean that independent directors shall be exempted from all kinds of liability. In cases where independent directors have consented and have not performed their functions diligently, they can be held liable.

Thirdly, under the Negotiable Instruments Act, independent directors should be exempted from criminal prosecution. Independent directors should only be held liable when the requirement of 'mens rea' is fulfilled. Vicarious liability cannot be passed onto Independent directors. In cases of 'offences by companies' under the negotiable instruments act unless and until it is proved that the offence was committed with the knowledge of the independent director in question, he cannot be held liable for that offence. It is suggested that independent directors should be excluded from directors under section 141. And, cases where they have given consent or acted outside their scope, etc. should be treated as exceptional cases. Thus, the general rule should be that independent directors are not responsible for offences committed by the company.

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[19] *CII not for mandatory rotation of audit firms*, Hindu Business Line, available at http://www.thehindubusinessline.in/2010/10/22/stories/2010102251931200.htm (last visited on February 15, 2012)

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Effective Implementation of Whistleblower Policy *Vis - A- Vis* The Leniency Approach

Neha Jain[*] and Sindhu V. Reddy[**]

With the increasing number of corporate scams and frauds and a large number being unreported, the regulatory authorities across the globe have introduced the concept of a whistleblower policy where persons who observe some unlawful practice can approach a Whistleblower Committee without having the need to inform their higher-ups. The paper thus, aims to discuss the various nuances of whistleblower policy. It would provide an insight into its background, position in comparative jurisdictions, and an emphasis upon the legal framework relating to the whistleblower policy currently prevalent in India.

In India, the provision enabling whistleblower policy can be found in clause 49 of Listing Agreement and it is intriguing that the Narayan Murthy Report on Corporate Governance suggests the incorporation of the policy within the company. Though the recent literature on the subject largely focuses on the significance and need of making the policy mandatory, the authors would however, like to differ in their stand by shifting the focus of making the policy effective to be synonymous to making it mandatory and instead suggest an alternative approach.

The paper would discuss why it would be extraneous to make the policy mandatory. Further, it will go on to suggest the need to adopt a more effective alternative approach which is akin to the concept of corporate leniency as understood in competition law as well as other mechanisms such as increasing the role which could be played by stock exchanges in order to make the policy implementation successful and in order to derive optimum benefits in furtherance of the objectives that the policy aims to achieve. The paper would also in detail deal with the structuring of such an approach by discussing the various facets attached to it.

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I. Introduction

In recent years, by recognizing the value of good corporate governance, India has made efforts to incorporate good governance practices in the country. But the fact remains that the scams exposed unveil the loopholes in the system. In fact, the increasing number of scams, such as the Satyam scandal that emphasized upon vulnerabilities of a corporation due to external parties; and the Wipro scam that exposed vulnerabilities of a company's internal control system, has made corporate India realize that good corporate governance system can be achieved not by sticking to the compliance approach but by becoming more conscience-driven towards stakeholders of the company as there does exist a direct (or indirect) relationship between business governance and business valuation. Authorities such as the ICAI believe these scams are beneficial to corporate India as they help to improve the level of corporate governance in the country. Though the government moved fast to protect investor interests after the Satyam promoters' fraud came to light in 2008, India's image as a lucrative investment destination was hurt. This led experts to question the effectiveness of Clause 49 of SEBI's listing guidelines in protecting investor interest. Significantly, it is still not mandatory for listed companies to implement the whistle blower policy in India although; companies like ONGC and GAIL, India have adopted it on a voluntary basis. But, the government is seriously considering making it mandatory for the PSUs.[1]

When Clause 49 of the Listing Agreement was introduced, it was considered as the Indian version of the Sarbanes Oxley Act (the "SOX Act") and most important piece of legislation introducing good governance practices. One of the key policies in that clause was the Whistle Blower Policy

[1] *Whistleblower Policy the Best Way to Check Frauds*, The Financial Express, February 22, 2010 (Print Edition)

which was aimed to encourage the employees and others including former employees, or members of an organization, especially a business or government agency, who report unethical or improper practice (not necessarily a violation of law) to approach the independent audit committee without necessarily informing the Board.[2] An important aspect of this policy is that the identity of the informer should be kept secret and they must be safeguarded from unfair termination and other unfair or prejudicial employment practices. A clear policy and procedure for raising issues will help reduce the risk of serious concerns being mishandled, whether by the employee or by the organisation.[3] The policy sets out the company's strategy for preventing, detecting, deterring and investigating fraud, corruption and other wrong doing.[4]

First adopted by the US in 1863 under United States False Claims Act (revised in 1986),[5] Whistleblower Policy was aimed to encourage the whistleblowers by promising them a percentage of the money recovered or damages won by the government and protects them from wrongful dismissal although other adverse consequences such as alienation of the whistleblower by his colleagues, discrimination by future potential employers, or physical harassment is not uncommon.

In India the whistleblower protection caught attention of the entire nation only after the death of the IITian engineer in National Highways Authority of India (NHAI), Satyendra Dubey, who reported corruption in the construction of highways, hence, making India fifth to join an elite club of just four democracies[6] which have whistleblower protection. However, it was only in 1989 that the US introduced the law on Whistleblower followed by the meager number of 4 other democracies. In this paper, the whistleblower policy and protection under various jurisdictions and the concept of corporate leniency shall be dealt with and, how it can be compared and incorporated with the concept of whistleblower Policy to effectively implement it.

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[2] Securities and Exchange Board of India, *Report of the SEBI Committee on Corporate Governance* (February 8, 2003), available at www.sebi.gov.in/commreport/corpgov.pdf (last visited on February 15, 2012)

[3] *Whistle blowing Policy*, Wales Council for Voluntary Action, available at http://www.wcva-ids.org.uk/wcva/1178 (last visited on February 15, 2012)

[4] *Whistle Blowing, Fraud And Corruption – Strategy And Policy Documents*, http://www.eastsussex.gov.uk/you rcouncil/finance/guide/fraud/download.htm (last visited on February 15, 2012)

[5] The act was aimed to combat fraud by suppliers of the United States government during the Civil War.

[6] The other 4 nations are USA, UK, Australia and New Zealand.

II. Whistle Blower Regulations in Different Jurisdictions

The protection of whistleblowers is an international requirement, for instance, under the United Nations Convention against Corruption of 2003[7] and the Council of Europe Civil Law Convention on Corruption of 1999, which are both "hard law" instruments. The need for an international legal instrument to promote protection of whistleblowers was seen by the Council of Europe member states and some other countries in 1996 itself.[8] Also, ratified by 37 nations, the OECD Convention on Bribery of Foreign Public Officials in International Business Transactions Convention aims "to address the supply side of bribery by covering a group of countries accounting for the majority of global exports and foreign investment," and Whistleblower regulations are a core part of the Convention where countries are mandated to establish complaint procedures, and to protect whistleblowers in the public and private sector.[9]

A. United States of America

The protection accorded under the whistleblower policy differs in the United States based on the subject matter and sometimes the state in which the case arises. In passing the 2002 SOX Act, the Senate Judiciary Committee found that the whistleblower protections were dependent on the "patchwork and vagaries" of varying state statutes.[10] The SOX Act is applicable even to employees in the public listed companies.[11] It prohibits publicly traded corporations from taking any adverse employment action against an employee that has blown the whistle.[12]

Companies with a class of securities under Section 12 of the Securities Exchange Act of 1934 are specifically subject to SOX's whistle-blowing

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[7] Enforced in December, 2005 the Convention has 140 signatories and amongst them, 93 states have ratified the provisions. Article 8, 13 and 33 of the Convention enumerate the duties of public officials to report matters in case of non-performance of functions by other officials. It further lays protection regime for honest reporters and ensures the maintenance of their anonymity.

[8] *Protecting the Whistleblowers–Asian and European Perspectives*, 13th International Anti-Corruption Conference Workshop Session II, available at http://www.asef.org/images/docs/1265-ChristopheSpeckbacher.pdf (last visited on February 15, 2012)

[9] *Whistleblowers*, Transparency International, available at http://www.transparency.org/news_room/in_focus/2007/whistleblowers (last visited on February 15, 2012)

[10] Congressional Record p. S7412; S. Rep. No. 107–146, 107th Cong., 2d Session 19 (2002)

[11] Section 806, SOX Act, 2002

[12] 118 U.S.C. § 1514A(a)

provisions. For the Act to apply, the Courts have applied the test of "objective reasonableness" under which the employee must attribute the business practice to a fraud.[13] The extent of the Act is such that even foreign citizen working abroad for a United States subsidiary of a foreign company which is listed on the New York Stock Exchange gains protection by the whistle-blowing provisions of SOX.[14] The SOX Act also criminalises retaliation against whistle blowing[15] and title VIII consists of seven sections, referred to as the "Corporate and Criminal Fraud Act of 2002".

The federal Whistleblower Protection Act of 1989 was enacted to remove any chilling effect on whistle blowing that might result from reprisals. The Act prohibits the punishment of public officials for reporting of violations of law, rule, or regulation, gross mismanagement, gross waste of funds, abuse of authority, or a serious danger to public health or safety. Under the Whistleblower Protection Act,[16] a public official who believes that s/he has suffered retaliation for making a protected disclosure, may file a complaint with the United States Office of Special Counsel, an independent investigative and prosecutorial agency. That Office will investigate the complaint and, where it finds that an improper reprisal has occurred, will seek voluntary corrective action from the employing agency. It may also ask the employing agency to take disciplinary action against the agency official who engaged in retaliation.

On July 15, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter called the "Act") were enacted. Under the new legislation, the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) was amended by inserting a new Section 21F, which includes provisions dealing with whistleblower incentives and protection.[17] The term "whistleblower" includes any individual who provides, or two or more individuals who jointly provide, information relating to a violation of the securities laws to the SEC, in a manner established by rule or regulation by the Securities Exchange Commission (hereinafter called the "SEC"). The SEC had 270 days after the date of enactment of the Act to issue final regulations implementing section

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[13]*Livingston* v. *Wyeth Inc*., 520 F.3d 344 (4th Cir. 2008); *Day* v. *Staples Inc.*, 2009 WL 294804 (1st Cir.)
[14]*O'Mahony* v. *Accenture Ltd.*, 537 F. Supp.2d 506 (S.D.N.Y. 2008)
[15]Section 1107, SOX Act, 2002
[16] 5 U.S.C., section 2302(b)
[17]Reuben Guttman, *The Dodd- Frank Wall Street Reform and Consumer Protection Act: The SEC Whistleblower Provision*, Whistleblower Laws, July 26, 2010, available at http://www.whistleblowerlaws.com/the-dodd-frank-wall-street-reform-and-consumer-protection-act-the-sec-whistleblower-provision/ (last visited on February 15, 2012)

21F of the Securities Exchange Act of 1934. A broad definition of "original information" that may be presented by the whistleblower has been provided. Public information may be included, provided that the information leading to the SEC action is derived from the independent analysis of the whistleblower. The original information cannot be exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information. Likewise, the information is not "original information" as defined by the Act if it is known to the SEC from any other source, unless the whistleblower is the original source of the information.[18]

While the Act provides whistleblower protection against retaliation, the information may be offered anonymously if the whistleblower is represented by counsel. The identity of the whistleblower will be disclosed to the SEC prior to the payment of the award. The whistleblower policy seeks to ensure confidentiality with regard to the identity of the whistleblower, unless and until required to be disclosed to a defendant in connection with a proceeding instituted by the SEC or by certain entities specifically identified and the same shall not be subject to civil discovery, or other legal process, and shall not be subject to disclosure under the Freedom of Information Act.[19]

B. Other Nations

In UK, the Public Interest Disclosure Act, 1998, protects whistleblowers from victimization and dismissal and Norway has a similar law in place since January 2007. The Protected Disclosure Act, 2000 of New Zealand covers employees who report serious wrongdoings including bribery which violate the general public interest. While in Korea, Anti-Corruption Act protects whistleblowers in state-owned companies, but no law encourages whistle blowing or protects them against reprisals for exposing corruption in the private sector. Hence, the reporting of bribery in private sector remains largely low.[20]

The Public Interest Disclosure Act, 1994 of Australia also aims at preserving the anonymity of the whistleblower and safeguarding him/her

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[18] Arpinder Singh & Vinay Garodiya, *Whistle blowers Can Earn A Bounty*, The Economic Times, September 5, 2010 (Print Edition)

[19] Iswarya B. & Geetanjali Sharma, *Need for Mandatory Whistleblowers Policy for Companies*, NSE Newsletter, January, 2011, available at http://www.nseindia.com/content/press/JAN.pdf (last visited on February 15, 2012)

[20] *Ibid.*

against unfair treatment within the organization. In Canada, legislation was enacted to create a new employment-related intimidation offence, protecting employees who report unlawful conduct within their company. The Unfair Competition Prevention Law enacted in 2004 which came into effect in 2006, in Japan, protects whistleblowers who file complaints regarding foreign bribery.[21]

The Transparency International report, *Alternative to silence: Whistleblower protection* in 10 European countries shows that with the exception of Romania, nations such as Bulgaria, the Czech Republic, Estonia, Ireland, Italy, Latvia, Romania and Slovakia, currently have stand-alone whistleblower protection legislation. Hungary and Lithuania are in the process of drafting legislations. Further, in many countries, the act of reporting may be superseded by other laws which prohibit the release of information while libel and defamation regulations deter whistle blowing, the report found.[22] Advanced nations like Germany and France have no specific laws enforced in this regard currently.

III. Whistleblower Policy in the Indian Scenario

In India, the issue of protection for whistleblowers caught the attention of the entire nation when National Highways Authority of India (NHAI) engineer Satyendra Dubey was killed after he wrote a letter to the office of the then Prime Minister A.B Vajpayee detailing corruption in the construction of highways. India thus, became the fifth country to have a law to protect whistleblowers who give information on corruption in public life.[23] Ministry of Personnel notified a resolution on April 21, 2006 empowering the Chief Vigilance Commission (CVC) as the designated agency to receive all complaints alleging corruption in public life pertaining to the Central Government. The notification made the leakage of the name of the whistle blower an offence and gave power to the CVC to conduct preliminary inquiry into the complaint and initiate appropriate proceedings against the government employees.[24] A similar case is that of Manjunath Shanmugham, a sales

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[21] *Ibid.*

[22] *Inadequate laws expose whistleblowers and impede fight against corruption*, Transnational International, available at http://www.transparency.org/global_priorities/other_thematic_issues/towards_greater_protection_of_whistleblowers/assessment_of_whistleblowing_frameworks_in_10_european_countries (last visited on February 15, 2012)

[23] *India Fifth Country To Have Whistleblowers Law*, The Deccan Herald, April 27, 2004, available at http://archive.deccanherald.com/Deccanherald/apr272004/n6.asp (last visited on February 15, 2012)

[24] *Ibid.*

manager of the IOC. He was killed in 2005 for uncovering a racket that dealt in petrol adulteration. Following the public outrage surrounding his murder, the government proposed a bill pertaining to the matter. The Department of Personnel and Training (DOPT) developed the Public Interest Disclosure and Protection to Persons Making the Disclosures Bill, 2010. The bill provides that anyone can file a complaint of corruption, with the Central Vigilance Commission (CVC), against any employee of the Central Government or organizations backed by the Central Government.[25]

The Indian law restricts the whistle blower policy to public servants or in works connected with the Central Government. The policy is of a non-mandatory nature for listed companies which are governed by Clause 49 of the Listing agreement, where whistle blowers policy is non-mandatory in nature. It reads that listed companies may establish a mechanism to enable disclosure of unethical behavior, actual or suspected fraud or violation of company's code of conduct or ethics policy. In fact, Satyam had a whistle blower scheme since 2005,[26] which speaks a lot about India's enforcement mechanism. The Limited Liability Partnership Act, 2008 also incorporates provisions to protect the interests of whistleblowers and ensure that they are not subjected to harassment, termination of employment or any such treatment, to enhance transparency and promote an anti-corruption tendency within the company.

The Reserve Bank of India (RBI) has introduced a whistleblower policy for private and foreign banks that allows customers, shareholders, NGOs and other members of the public to complain in confidence.[27] RBI has now formulated a scheme called 'Protected Disclosures Scheme' for private and foreign banks. The policy will not cover anonymous/pseudonymous complaints. The RBI will be the nodal agency to receive complaints under the scheme. However, the complainants' identity would be revealed if complaint turns out to be frivolous and action has to be initiated against the complainant. According to the scheme, the complainant should ensure the issue raised by him involves dishonest intention/immoral angle. The RBI says if the

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[25] Law Commission of India, *179th Report on The Public Interest Disclosure and Protection of Informers*, available at http://lawcommissionofindia.nic.in/reports/179rptp1.pdf (last visited on February 15, 2012)

[26] Vikas Dhoot, *Satyam had a whistle-blower policy since 2005*, The Financial Express, March 29, 2008 (Print Edition)

[27] Reserve Bank of India, *Annex - Protected Disclosures Scheme for Private Sector and Foreign Banks*, April 18, 2007, available at http://www.rbi.org.in/commonman /English/scripts/Content.aspx?id=702 (last visited on February 15, 2012)

allegations are substantiated, it will recommend appropriate action. These could include: appropriate action to be initiated against the concerned official, administrative steps to recover the loss caused to the bank as a result of the corrupt act or misuse of office.[28]

Based on the 179th report of The Law Commission and recommendations of the Second Administrative Reforms Committee (SARC), the Protection of whistle blowers and the Public Interest Disclosure and Protection of Persons Making Disclosures Bill, 2010 (Whistleblower bill), has been drafted to protect the interest of whistleblowers and ensures punishment for whistle blowing with a mala fide. The bill, accepting the recommendations states that anonymity of the whistle blower is a must and this will be an important determinant in improving the instances of whistle blowing by honest men. However, the Bill contains a provision[29] which enables Central Vigilance Commission and similar competent authorities to reveal the identity of the whistleblower to the Head of the Department while seeking comments or explanations in the course of an inquiry. The authority is further barred from disclosing the identity of the whistleblower to anybody else. The Whistle Blowers Bill has not yet been passed, so it is wiser to incorporate whistle blower policies in the current bill to encourage employees to come out with information which may help in the early detection of a future big corporate scam.

The Narayana Murthy Report also suggested the incorporation of whistle blowers policy within the companies to enable the employees to approach the audit committee when they observe unethical or improper practice with informing their superiors and also protect them from unfair termination and other prejudicial practices.[30]

IV. Recommendations

Corporate crime, which is a type of white-collar crime,[31] is "conduct of a corporation, or of employees acting on behalf of the corporation, which

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[28] *RBI Kicks In Whistleblower Policy For Pvt, Foreign Banks*, The Economic Times, April 19, 2007, available at http://articles.economictimes.indiatimes.com/2007-04-19/news/28384346_1_foreign-banks-public-sector-banks-whistleblower-policy (last visited on February 15, 2012)

[29] The proviso to Section 4(5)

[30] *Supra* Note 2.

[31] Sally S. Simpson, *Corporate Crime, Law and Social Control*, (Cambridge University Press, New York, 2002) p. 47-48

is prescribed and punishable by law".[32] Three essential features of corporate/organized crime which distinguish them from individual crimes are[33]: cooperation among the several agents/partners in crime, "ongoing relationships" i.e. flows of present and expected future benefits and costs and the information, the cooperating wrongdoers acquire about each other's misbehavior while acting together. The third feature is very crucial as it can be used to breakdown the unlawful union by reporting this information to third parties. The combination of high sanctions and guaranteed amnesty has created strong incentives for corporations to come forward spontaneously.[34]

Whistle blowing was incorporated as a mechanism to detect corporate crimes. But it is often seen that the whistleblowers have experienced a terrible working, social, and private life after reporting, with employers of all the industry, colleagues, friends, neighbors, and even often family turning against them or they being killed and on the other hand the rewards for whistleblowers may also induce a bad climate in organizations reducing trust, cooperation, and efficiency.[35] This suggests they need to be rewarded and protected very well. One such incident in India was brought in light when the NHAI engineer was killed for exposing corruption in the construction of highways.[36] This incident invoked India to take tentative step towards a full-fledged law to protect whistleblowers. However, there is a strong need to adopt an alternative approach to mandatory compliance and make the system inculcate the good corporate governance practice voluntarily and discourage the wrongdoings going on within the firm and promote the employees, members and others to come forward and report the wrongdoing fearlessly.

United States first established the Leniency program in 1978 which soon became popular around the world as an effective tool for early detection of cartels. The Corporate Leniency programme, also known as corporate amnesty or corporate immunity policy, introduced by the United States

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[32] John Braithwaite, *Corporate Crime in the Pharmaceutical Industry*, (Routledge and Kegan Paul, London, 1984, 1st edn.), p.6

[33] Polinsky, Mitchell, et al., *The Economic Theory of Public Enforcement of Law*, Journal of Economic Literature, March, 45-76 (1988)

[34] Giancarlo Spagnolo, *Handbook of Antitrust – Chapter 7 - Leniency and Whistleblowers in Antitrust* (MIT Press, 2008), p. 259-304

[35] Dworkin, Terry Morehead et al., *A Better Statutory Approach to Whistle blowing*, 7 Business Ethics Quarterly, p. 1-16 (1997)

[36] *India Doesn't Have A Law To Protect Whistleblower*, The Times of India, March 29, 2010, available at http://articles.timesofindia.indiatimes.com/2010-03-29/india/28135662_1_public-interest-disclosures-cvc-protection (last visited on February 15, 2012)

Justice Department Antitrust Division (hereinafter called the "DOJ") in 1978 and substantially revised in 1993 provides for a model to detect anti-competitive activities of the company (like illegal cartels) by according "leniency"[37] to corporations reporting their illegal antitrust activity at an early stage, if they meet certain conditions.[38] After this programme proved to be a huge success with US DOJ able to collect fines over US $2.5 billion for antitrust crimes since 1997, with over 90% of this total tied to investigations assisted by leniency applicants,[39] and record-breaking fines in the Canada, the EU,[40] the Leniency programs were adopted across the world by France, Germany, New Zealand, the UK, Sweden and Brazil and Japan.[41] In India, an increasing number of Competition Authorities has started to operate leniency program as a key tool to detect cartel infringements.[42]

The US DoJ has listed certain conditions to be fulfilled before a corporation can avail leniency.[43] The OECD has listed three essential elements to make this programme a success.[44] These include severe sanctions for corporate and individuals (financial penalties needs to be severely punitive to effectively attract leniency applicants)[45]; increased risk of detection; and clear and transparent enforcement policies.

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[37] "Leniency" means not charging such a firm criminally for the activity being reported.

[38] United States of America Department of Justice, *Corporate Leniency Policy,* available at http://www.justice.gov/ atr/public/guidelines/0091.htm (last visited on February 15, 2012)

[39] Scott D. Hammond (Director of Criminal Enforcement Antitrust Division U.S. Department of Justice), *Cornerstones Of An Effective Leniency Program*, 2004 available at http://www.justice.gov/atr/public/speeches/2066 11.htm (last visited on February 15, 2012)

[40] *Ibid.*

[41] Organisation for Economic Cooperation and Development, *Report on the Nature and Impact of Hard Core Cartels and Sanctions against Cartels under National Competition Laws*, 9 April, 2002, available at http://www.oecd.org/ dataoecd/16/20/2081831.pdf (last visited on February 15, 2012)

[42] G.R. Bhatia, *Combating Cartel In Markets – Issues & Challenge*s, available at http://www.competition-commission-india.nic.in/speeches_articles_presentations/GR.BhatiaArticle.pdf (last visited on February 15, 2012)

[43] United States of America Department of Justice, *Corporate Leniency Policy,* available at http://www.justice.gov/ atr/public/guidelines/0091.htm (last visited on February 15, 2012)

[44] Organisation for Economic Cooperation and Development, *Report on the Nature and Impact of Hard Core Cartels and Sanctions against Cartels under National Competition Laws*, 9 April, 2002, available at http://www.oecd.org/dataoecd/16/20/2081831.pdf (last visited on February 15, 2012)

[45] Scott D. Hammond (Director of Criminal Enforcement Antitrust Division U.S. Department of Justice), *Cornerstones Of An Effective Leniency Program*, 2004 available at http://www.justice.gov/atr/public/speeches/2066 11.htm (last visited on February 15, 2012)

Also if the immunity is made full and automatic subject to the first reporting wrongdoer's cooperation and other conditions as mentioned, Leniency programme can be more effective. The Corporate Leniency Policy requires appointment of a senior officer who will receive "leniency applications," interview applicants, and report findings to the Chairman of the Board's Audit Committee in a confidential manner.[46]

Leniency and whistleblowers schemes introduce a more efficient type of deterrence of multi-agent dynamic criminal relationships that acts through the same dynamic mechanisms that sustain the criminal relationship in the first place. The consequences faced by the whistle blowers may be in the form of very harsh sanctions from their former business partners, peers, and from the business community in general, from exclusion from future business and social relations to physical harassment which might continue for the several years during which prosecution takes place. This is probably the main reason why when directed at individuals, only programs with very high expected rewards, like the US False Claims Act, appear able to induce informed parties to spontaneously blow the whistle.[47] If we could borrow some of these conditions to whistleblower policy, we can effectively implement the policy and achieve the desired results.

A. Conditions of Corporate leniency vis-à-vis whistleblower Policy

Following are the conditions of corporate leniency:

1. A self-reporting employee automatically receives amnesty/protection if there is no pre-existing government investigation or he is the first individual to come forward and report the illegal conduct after an investigation has started, should receive complete protection
2. The employee takes prompt and effective action to terminate his or her part in the illegal conduct.
3. The employee reports the wrongdoing with candor and completeness and provides full, continuing and complete cooperation to the authority (audit committee) throughout the investigation;
4. Where possible, the corporation makes restitution to injured parties;
5. The employee did not coerce another party to participate in the illegal activity and clearly was not the leader in, or originator of, the activity.

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[46] Donald C. Klawiter And Jennifer M. Driscoll, *A New Approach To Compliance: True Corporate Leniency for Executives*, Antitrust, Vol. 22, No. 3 (Summer 2008)
[47] *Supra* Note 34.

6. Another requirement which is very essential in order to make sure more enterprises make disclosures and ensures continuous cooperation and that the regulator provides for confidentiality of the information disclosed as well as the enterprise making the disclosure i.e. the identity of the applicant should be kept hidden.

V. Suggested Procedure

On receipt of the complaint by any employee/member or any person reporting the wrongdoing, the independent audit committee must forward the same to the registrar of the Companies, central Government and SEBI who will conduct the investigation akin to the investigation under section 235-239 based on the information disclosed by the whistleblower which should be completed within a set time period. During the period of time the complaint is under seal and the name of the whistleblower should be kept anonymous. Once the preliminary investigation is completed, the central Government or SEBI will, on the basis of this investigation and the evidences and witnesses examined and the results analyzed, determine whether it will dismiss the action, or to settle it before a formal investigation or join the lawsuit.[48]

VI. Conclusion

A country cannot achieve good corporate governance system by making number of bodies exercising oversight, but by making corporations adopt these practices voluntarily with guidance and minimum control from the government. For any policy to be successful, it must be clear and predictable. Well designed and implemented whistleblower policy can be expected to fetch results as corporate leniency against cartels. When the DOJ Leniency Policy was announced in 1978 and 1993, self-reporting to the very agency charged with prosecuting cartels seemed, at best, an "alien concept" but now early self-reporting under the DOJ Leniency Policy, in conjunction with appropriate internal corporate risk management, has the potential to reduce drastically the criminal and civil consequences for the company whose employees have engaged in illegal activity.

In light of the fact that DOJ Leniency Program has been largely effective, our proposal of the Corporate Leniency Program will be a huge leap forward towards better corporate governance. The main distinguishing

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[48] United States of America Department of Justice, *Antitrust Division Manual* (4th edn.), available at http://www.justice.gov/atr/public/divisionmanual/chapter3.pdf (last visited on February 15, 2012)

feature between a company which is likely to escape criminal liability and the one which is likely to be a part of antitrust litigation, is the employee who proves to be a whistleblower. Steps must be taken to make the executives aware of the serious breaches of corporate compliance occurring at the workplace, since the same would act as an incentive to the self reporting executives who would otherwise choose to not take such an initiative on account of the fact they would have the potential loss of their livelihood.

The role played by a company is all encompassing in a nation like India which has set itself the goal of being a "Welfare State" and its law been formulated accordingly. Hence, the key is to attain a balance between the freedom from interference granted to a company as opposed to its rightful enjoyment of absolute autonomy. Considering the significant role that companies play in today's world, it becomes imperative to provide them with the corresponding necessary benefits, concessions and privileges, which is not synonymous to complying with unnecessary technical formalities and instead the approach should be making "corporate governance" more effective by voluntarily adopting more liberal and simplified procedural formalities.

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