The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer

Vikramaditya Khanna * and Shaun J. Mathew **

The role of independent directors has come under the scanner following the Satyam debacle, and the en masseresignation of independent directors that followed. Professor Khanna and Mr. Mathew argue, on the basis of extensive interview evidence, that there is no clear understanding of the role that an independent director is expected to play in the boardroom. Further, they demonstrate that doubts over the applicability of civil and criminal liability laws to independent directors are often a cause of concern, and argue that these concerns must be addressed in the proposed reform to India's company legislation.

---

* Professor of Law, University of Michigan Law School. S.J.D. Harvard Law School, 1997. Email: vskhanna@umich.edu.

** Associate, Wachtell, Lipton, Rosen & Katz, New York, NY. J.D. Harvard Law School, 2007. Email: sjmathew@wlrk.com. The views expressed herein are solely our own and should not in any way be attributed to others, including Wachtell, Lipton, Rosen & Katz or its clients. We thank Rajiv Luthra for his invaluable suggestions and guidance. We also thank Umakanth Varottil and Eric Robinson for helpful comments and suggestions on earlier drafts.

I. Introduction

In 2009, the pendulum swung both ways for India Inc. There was much good news – corporate India came out of the global financial crisis smelling like a rose, with the Sensex surpassing its pre-crisis heights and India's economic growth rates far exceeding most estimates.[1] However, 2009 was also a watershed year in the "bad news" category, with revelations of the biggest scandal in corporate India's history at Satyam Computer Services and the travails of Nimesh Kampani relating to his service as an independent director at Nagarjuna Finance dominating the headlines and eroding confidence in corporate India both domestically and overseas.[2]

These events attracted significant public attention to and invited the scrutiny of India's independent directors, and many of these independent directors took notice: at least 620 independent directors resigned from the boards of Indian companies in 2009 – a figure that is, to our knowledge, by far without precedent globally.[3] This exodus of independent directors highlighted a deep discomfort within corporate India with the very institution of independent directors in the context of companies controlled, directly or indirectly, by corporate founders, or promoters.[4]

---

1 *See*, A. Satapathy & A. Bharadwaj, *Business Diary 2009*, Zeenews.com, Dec. 28, 2009, *available at* http://www.zeenews.com/news589650.html.

2 *See*, P. Banerji, *Scandal Jolts Confidence of Global Investing Community*, The Financial Express, Jan. 8, 2009, *available at* http://www.financialexpress.com/news/scandal-jolts-confidence-of-global-investing-community/407876/. See Part II below for more detail on these events.

3 Tabulated based on data available at http://directorsdatabase.com. For our purposes, we only counted cessations listed in the database for which the reason listed was "resignation."

4 Explanation I of sub clauses (k) and (l), Clause 6.8.3.2, Securities and Exchange Board of India (Disclosure and Investor Protection), 2000, defines the term 'promoter' to include: (a) the person or persons who are in over-all control of the company; (b) the person or persons who are instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public; (c) the persons or persons named in the prospectus as promoter(s). Provided that a director/officer of the issuer company or person, if they are acting as such merely in their professional capacity, shall not be included in the Explanation.

But what exactly is the appropriate role of an independent director in a controlled company? The academic literature suggests at least two distinct, but not necessarily mutually exclusive, roles: (i) independent directors may be seen as watchful monitors of promoters and management on behalf of public shareholders or (ii) independent directors may be viewed as reservoirs of strategic advice intended to aid promoters and managers in maximizing overall firm value.[5] While Indian listing standards require that the boards of listed companies include independent directors,[6] neither the listing standards, nor the Companies Act, prescribe a particular role for independent directors vis-à-vis the executives, promoter-affiliated directors or the public shareholders, or define the contours of their liability with any real precision. In light of this uncertainty, we decided to examine the role of independent directors in Indian companies firsthand. Through interviews with independent directors, at both controlled and dispersely held firms in India (and also some in the United States), Indian promoters, and some of India's leading corporate lawyers and board advisors, our project intends to understand firsthand what the role of independent directors in India *is* today and what these groups think such role *should* be going forward.

While our interview research remains preliminary – and forms part of a much larger project on which we are collaborating with Rajiv Luthra, the founder and managing partner of Luthra & Luthra Law Offices in New Delhi – we have already observed some interesting results:

(i) All of the independent directors viewed their role principally as that of strategic advisors to the promoters.

(ii) Relatedly, most independent directors did not perceive their role to be that of a "watchdog" over the promoters and management. Reasons cited by directors against such a role ranged from the practical (lack of time or resources or training) to the philosophical (not good for board collegiality and functioning). Moreover, many of them believed that any legal requirement imposing such a role would be highly inappropriate given that the current scope for independent director liability was perceived to be very high (and included a bona fide, nontrivial risk of criminal liability), sometimes arbitrarily imposed, and not offset by adequate remuneration and directors and officers insurance coverage.

---

5 *See generally*, J.N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2007).

6 *See*, Clause 49(I)(A) of the Listing Agreement *available at*: http://www.bseindia.com/downloads/Listagree.zip [hereinafter "Listing Agreement"].

(iii) With respect to liability, almost all of the independent directors desired seemingly basic protections against being served arrest warrants based on claims of corporate malfeasance clearly outside the independent directors' control, such as bounced checks and factory accidents, and clear safe harbors that would insulate them from liability for reliance on information provided by auditors and management.[7]

(iv) Particularly in light of the liability risk, every one of the directors and advisors we interviewed found independent director compensation to be grossly inadequate and incommensurate to the attendant risks.

(v) Most of the independent directors described the boardroom environment as being receptive of their viewpoints, particularly in the post-Satyam era; indeed, several directors relayed anecdotes in which boards and promoters took action initiated or driven by the independent directors. While many of these situations involved the proposal of new strategic initiatives, rather than conflict situations, directors did share experiences in which independent director opposition to a promoter's plan caused a reconsideration or even abandonment of such plans.

(vi) Many of the independent directors agreed that selecting independent directors through an independent nominating committee could help counteract the promoter's influence on independent directors, although most agreed this would only operate to a very limited extent.

(vii) Changes in the post-Satyam environment included more fulsome board discussions (accompanied by more presentation and discussion of data) and a perceived greater appetite for seeking out and listening to alternative and dissenting viewpoints by promoters.

(viii) Most directors and advisors suggested that the mass independent director resignations of 2009 were indicative of a panic overreaction. Directors differed, however, in their views of the potential signaling effect and impact of the threat by an

7 Although the actual imposition of such criminal or civil liability by the government was infrequent, the risk of arrest and the concomitant delay, anxiety, distraction, harassment, and reputational harm was quite substantial.

independent director to resign; while most agreed a director resignation sends a clear signal to the market, particularly in the current environment, most also viewed the Indian financial press (and their readers) as having very short memories, thereby diminishing what would otherwise be an effective signal of conflict in the boardroom.

(ix) The directors described their communication with minority shareholders (if any took place at all) to be extremely limited, with the vast majority of any such communication taking place with foreign institutional investors.

(x) Some independent directors found training materials and resources, both internally and externally, to be insufficient for purposes of induction and keeping abreast of current developments and best practices.

Although these findings are preliminary, they suggest that directors view their primary role as being strategic advisors and that imposing a serious monitoring duty on them would be almost unequivocally opposed and perceived as impractical, detrimental to board functioning, and, perhaps most importantly, contrary to the realities of modern board service. Our findings also highlight the very strong and universal desire of independent directors to have relatively clear guidance on their duties together with some constraints on liability (especially the power to arrest and criminal liability). We hope these findings – supplemented by the more detailed and rigorous findings we expect will accompany our broader report – will help directors, regulators, promoters and investors in better understanding the institution of independent directors in the context of controlled firms and in crafting regulations, board governance policies and norms that better serve the interests of both promoters and public shareholders in controlled Indian firms.

This paper is organized as follows. Part II chronicles the mass resignations of Indian independent directors in 2009 and the Satyam and Nimesh Kampani episodes that precipitated them. We then, in Part III, commence our search for understanding the role of independent directors in the corporate governance literature of the United States and India. Part IV investigates how Indian law views the role of independent directors, and briefly explores current reform efforts that have been spawned out of the post-Satyam and Nimesh Kampani era. Parts V and VI describe our interview process and our preliminary results. Part VII concludes our study.

II. Mass Resignations of Indian Independent Directors in 2009

In the wake of two major scandals, corporate India witnessed an unprecedented exodus of independent directors from the boards of Indian companies in 2009. This Part briefly chronicles these events and sets forth some potential implications of the mass resignations.

On January 7, 2009, B. Ramalinga Raju, the founder and then-chairman of Satyam Computer Services, confessed to having orchestrated an accounting fraud on Satyam's books that the Indian Government now estimates may have cost investors as much as Rs. 14,000 crore (approximately US$3 billion based on current exchange rates).[8] Dubbed "India's Enron"[9] and now widely perceived as the biggest fraud in the history of corporate India, Raju's alleged malfeasances included the fabrication of approximately US$1 billion in cash on Satyam's balance sheet.[10] In the wake of Raju's confession, Indian authorities arrested Raju, Satyam's managing director and its chief financial officer as well as two PricewaterhouseCoopers auditors.[11] The State of Andhra Pradesh charged Raju and the others with criminal breach of trust, criminal conspiracy, cheating, falsification of records and forgery,[12] and investigations were separately launched by the Securities & Exchange Board of India (SEBI), the Ministry of Company Affairs, the Government of India and the Serious Frauds Investigation Office (SFIO), among others.[13] At the time of this writing, Raju and the other defendants await trial in Indian prison.[14]

---

8 *See,* C.R. Sukumar, *Rs 4,739 cr more fraud in Satyam: CBI*, Livemint, Nov. 25, 2009, *available at* http://www.livemint.com/2009/11/25001310/Rs4739-cr-more-fraud-in-Satya.html; S. Tibken, *Satyam Scandal Shocks IT Sector*, Wall Street Journal, Jan. 8, 2009, *available at* http://online.wsj.com/article/SB123135583835961599.html.

9 *See*, *India's Enron: Corporate Governance*, The Economist, Jan. 10, 2009, at 57. Although the monicker as "India's Enron" captures the scale and surprise of the wrongdoing, there are important differences between the Enron scandal and Satyam. *See,* V.S. Khanna, *Corporate Governance in India: Past, Present & Future?,* 1 Jindal Global Law Review 171 (2009).

10 *See,* G. Anand, *How Satyam was Saved*, Wall Street Journal, Apr. 14, 2009, *available at* http://online.wsj.com/article/SB123960834835313077.html.

11 *See,* R. Guha and J. S. Kumar, *Satyam's Raju Brothers Jailed*, Wall Street Journal, Jan. 10, 2009, *available at* http://online.wsj.com/article/SB123157680420571007.html.

12 *See,* Sukumar, *supra* note 8; *see also,* V. Umakanth, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) Nat. L. Sch. Ind. Rev. 1, 33 (2009).

13 *See,* Sukumar, *supra* note 8; Umakanth, *supra* note 12, at 33.

14 *See,* Sukumar, *supra* note 8; *Satyam moves on; Raju awaits trial*, The Economic Times, Jan. 6, 2010, *available at* http://economictimes.indiatimes.com/infotech/software/Satyam-moves-on-Raju-awaits-trial/articleshow/5416988.cms.

Notably absent from those immediately charged and imprisoned in connection with the scandal were Satyam's independent directors.[15] However, this gold-plated group, which included a Harvard Business School professor, the then-dean of the Indian School of Business and a former Indian cabinet secretary, all either resigned or were replaced by the Indian Government in December 2008 and early 2009.[16] Without doubt, Satyam's independent directors have suffered substantial reputational harm and have faced significant public scrutiny for their failure to detect such a large and ongoing fraud and for their unanimous approval of the controversial and later-abandoned transactions to acquire two firms controlled by Satyam's promoters.[17]

The reputational damage, coupled with the nontrivial risk that these independent directors may still face liability,[18] led to significant angst among India's several thousand other independent directors.[19] The aftermath of Satyam left many independent directors terrified by the perception – correct or not – that they could be held liable for the bad acts of a rogue promoter that were undertaken without their knowledge.[20]

Compounding the fears of Indian independent directors in 2009 was the experience of Nimesh Kampani, one of India's leading investment bankers. Kampani, the billionaire founder of the JM group of companies, served as an independent director on the board of Nagarjuna Finance from 1998 to 1999.[21] The promoters and executives of Nagarjuna were later charged under the Andhra

---

15 *See,* Sukumar, *supra* note 8.

16 *See*, *Three Satyam Directors Resign, More may Quit*, Livemint, Dec. 29, 2008, *available at* http://www.livemint.com/2008/12/29144505/Three-Satyam-directors-resign.html

17 *See*, *Satyam's Independent Directors had Raised Concerns over the Deal,* Hindu Business Line, Dec. 19, 2008, *available at* http://www.thehindubusinessline.com/2008/12/19/stories/2008121951600400.htm; Umakanth, *supra* note 12, at 35-36.

18 *See*, *Corp lawyers, CAs hit out at Satyam Independent Directors for Quitting,* Livemint, Dec. 30, 2008, *available at* http://www.livemint.com/2008/12/30164617/Corp-lawyers-CAs-hit-out-at-S.html.

19 *See, Why Independent Directors are Quitting in Droves,* Rediff News, Apr. 27, 2009, *available at* http://www.rediff.com/money/2009/apr/27why-independent-directors-are-quitting-in-droves.htm.

20 In the context of controlled firms, directors may also be concerned that much of the information they receive is provided by promoters and management. It is not clear that this needs to be so.

21 *See,* C.R. Sukumar and B. Kalesh, *Kampani Surprised at Nagarjuna Probe,* Livemint, Dec. 23, 2008, *available at* http://www.livemint.com/2008/12/22234706/Kampani-surprised-at-Nagarjuna.html.

Pradesh Protection of Creditors Act for failing to repay depositors nearly Rs. 100 crore (~US$20 million) during 2001-2002.[22] Notably, the Andhra Pradesh law provided for significant jail time as a punishment:

> where any financial establishment defaults in the return of a deposit either in cash or kind, or defaults in the payment of interest, every person responsible for the management of the affairs of the financial establishment including the promoter, manager or member of the financial establishment *shall be punished with up to 10 years' imprisonment* and with up to Rs 100,000 fine.[23] (emphasis added)

Surprisingly, in addition to charging and arresting the founding promoter and another affiliated director, the Government also charged Kampani, who had left the board prior to any of the allegations surfacing.[24] Kampani managed to avoid arrest and jail time by remaining in Dubai for nine months until a ruling by an Andhra Pradesh court in October 2009 stayed the proceedings against him.[25]

While many have deemed Satyam to be a "one-off" blemish with respect to India's corporate governance,[26] and while the Nimesh Kampani incident could be framed as more politically motivated than reflective of a broader trend in liability of Indian independent directors,[27] the events in Hyderabad in late 2008 and early 2009 had a tremendous and palpable impact on hundreds of independent directors at Indian companies. Worried that they could be put in jail, held financially liable and have their reputations tarnished for actions

---

22 *See, Govt to Probe Nagarjuna Finance Fraud On 'Top Priority' Basis,* Livemint, Jan. 5, 2009, *available at* http://www.livemint.com/2009/01/05181016/Govt-to-probe-Nagarjuna-Financ.html.

23 § 5, Andhra Pradesh Protection of Depositors of Financial Establishments Act, 1999.

24 *See*, Sukumar & Kalesh, *supra* note 21.

25 *See,* C.R. Sukumar, *Kampani Gets Relief from Andhra Court*, Livemint, Oct. 15, 2009, *available at* http://www.livemint.com/2009/10/15010515/Kampani-gets-relief-from-Andhr.html.

26 *See,* Corporate Governance: Recommendations for Voluntary Adoption, Report of the CII Task Force on Corporate Governance (2009) [hereinafter "CII Report"] at 1, *available at* http://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf and compare to: P. Haldea, *The Naked Truth about Independent Directors*, May 2009, *available at* www.directorsdatabase.com/IDs_Myth_PH.pdf.

27 *See, Govt. Targeting Kampani for Eenadu Links*, Times of India, Feb. 21, 2009, *available at* http://timesofindia.indiatimes.com/city/hyderabad/Govt-targeting-Kampani-for-Eenadu-links/articleshow/4160853.cms.

perpetuated without their knowledge by promoters, many of these independent directors began resigning *en masse*.[28]

Indeed, from the date of Raju's confession through January 8, 2010, 935 of India's independent directors left the boards of Indian companies, of which 619 departures were classified as resignations.[29] News reports citing the same database reported nearly 300 departures by late May, indicating that the rate of departure hardly abated over the course of the year.[30]

These mass resignations highlight a significant problem for corporate India: the roles of independent directors in Indian companies and their attendant liability risks are not well understood. The next Part attempts to explore how the role of independent directors in controlled companies is envisaged from an academic perspective.

III. Academic Perspectives on the Role of Independent Directors in Controlled Companies

This Part examines the academic literature on the role of independent directors at controlled companies. After identifying the unique governance concerns raised at controlled companies, we explore various frameworks for understanding the value and role of independent directors at controlled companies.

A. Governance Concerns at Controlled Firms

It has long been recognized that the kinds and magnitude of governance concerns vary with the ownership structure of the firm.[31] In the corporate context, most commentators envision two broad types of concerns. Where, as is common

---

28 *See, Reputation at Stake? 340 Independent Directors Quit in 2009*, Business Standard, May 14, 2009, *available at* http://www.business-standard.com/india/news/reputation-at-stake-340-independent-directors-quit-in-2009/08/06/61615/on [hereinafter "*Reputation at Stake*"]; *340 independent directors quit in 2009*, Indian Express, May 14, 2009, *available at* http://www.indianexpress.com/news/340-independent-directors-quit-in-2009/459282/ ("*Independent directors know they are not in control of happenings in the company. Post-Satyam they are apprehensive about their role and resigning from their positions*," Prime Database Managing Director Prithvi Haldea said).

29 *See*, the Directors Database Chronological Cessation Index, *available at* http://www.directorsdatabase.com/t_ceased_ind.asp.

30 *See*, *e.g.*, *Reputations at Stake, supra* note 28.

31 *See,* J. Armour, H. Hansmann & R. Kraakman, *What is Corporate Law? in* The Anatomy Of Corporate Law: A Comparative And Functional Approach 31 (R. Kraakman et al. eds., 2nd edn., 2009); R.J. Gilson & J.N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785, 785 (2003); R. La Porta, F. Lopez-de-Silanes & A. Shleifer, *Corporate Ownership around the World*, 54 J. Fin. 471 (1999).

in India, companies have a controlling shareholder, the principal corporate law concern is that the controlling shareholder may be able to expropriate the assets of other shareholders or behave in some other opportunistic or non-value maximizing manner.[32] On the other hand, as is more common in the United States, where companies are dispersely held without a controlling shareholder or group, the worry is that the management of the firm may be able to expropriate assets of the shareholders or behave in an opportunistic or non-value maximizing manner.[33] Therefore, in exploring the academic literature concerning the role of independent directors, the important differences in governance concerns between countries with mainly dispersely held companies, versus those with mainly controlled companies, must be acknowledged.

For example, in controlled firms, the controller oversees managerial behavior, and we are therefore less concerned with entrenchment (a matter relevant at dispersely held firms) and more concerned with the controller extracting value from minority shareholders through transactions like "freezeout" mergers (the controller merging the controlled firm with a firm in which the controller already has a 100% ownership stake) or other self-dealing transactions.[34] In a similar vein, in controlled firms there are concerns surrounding related party transactions, separation of cash flow from voting rights (e.g., dual class structures), and the relationships between board members and controlling shareholders. However, at dispersely held firms the concerns are over restrictions on control contests (and entrenchment), shareholder voting procedures, rules governing the balance of power between shareholders and the board, executive compensation, and director independence from management.[35] These kinds of differences have led

---

32 *See,* S.J. Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, 3 Colum. Bus. L. Rev. 800, 833 (2007) (noting that as of December 31, 2006, average ownership percentage of BSE 500 companies was 49.55%).

33 *See,* B.R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, 23 Oxford J. Leg. Stud. 1, 12 (2003).

34 *See,* V.S. Khanna, *Corporate Governance Ratings: One Score, Two Scores, or More?*, 158 U. Pa. L. Rev. 39, 42-43 (2009); *see also,* Umakanth, *supra* note 12, at 14-15; R.J. Gilson & J.N. Gordon, *Controlling Controlling Shareholders* 152 U. Pa. L. Rev. 785, 787 (2003); L. Bebchuk & A. Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263, 1284 (2009); R. Kraakman, et al., *Agency Problems, Legal Strategies, and Enforcement*, *Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series*, 3 *available at* http://www.law.harvard.edu/programs/olin_center/papers/644_Kraakman.php.

35 *See,* Bebchuk & Hamdani, *supra* note 34, at 1284; Khanna, *supra* note 34, at 42; S. Bhagat & R. Romano, *Event Studies and the Law—Part I: Technique and Corporate Litigation,* Yale Law School *John M. Olin Center for Studies in Law, Economics, and Public Policy Working Papers, Paper 259 (2001)* *available at* http://digitalcommons.law.yale.edu/lepp_papers/259.

scholars and policy makers to suggest that although some concerns of controlled and dispersed firms overlap, many do not, and the appropriate governance devices are likely to vary significantly across these kinds of firms.

The differences in controlled and dispersely held firms also spill over into the kinds of frauds most likely to be seen at these firms. For example, frauds like Enron and WorldCom – where management misrepresents financial performance to cover up poor performance or to cash in on executive compensation programs – are more likely at dispersely held firms, while frauds like Parmalat and Satyam – where the controller covers up expropriation of corporate funds or opportunities through financial misstatements – are more likely at controlled firms.[36] Here too, the methods of addressing these concerns may vary across controlled and dispersely held firms.

In the context of controlled or promoter-dominated firms in India, we now seek to explore what roles independent directors play at such firms that may, among other objectives, help address the unique governance concerns presented by controlled companies.

B. The Role and Potential Value of Independent Directors

The academic literature identifies several distinct roles for independent directors at controlled firms, some of which may address the governance problems unique to controlled firms identified above, while others address very different objectives. We address two broad, and sometimes opposing, roles that independent directors may play in the context of controlled companies: (1) serving a monitoring, or "watchdog," function on behalf of public shareholders and (2) serving as a strategic advisor to the controlling shareholder.

"Watchdog" for Public Shareholders. One direct means of addressing the potential expropriation problem presented by controlled firms is to enlist independent directors to monitor the behavior of management or controlling shareholders to reduce the chances that either of them will expropriate or misuse firm assets in some unfair manner. Academic literature suggests that independent directors exercise vigilance on behalf of minority shareholders in contexts such as potential self-dealing transactions involving the controlling shareholder and the company, as well as minority freeze-out transactions proposed by the

36 *See,* J.C. Coffee, *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*, 21 OXFORD REVIEW OF ECONOMIC POLICY 198 (2005); Khanna, *supra* note 34, at 44.

controlling shareholder.[37] In these contexts, the independent director serves as the "watchdog" for the company's public shareholders. Even though the director may not have the voting power to stop these types of activities, he or she has the power to make public any wrongdoing, and while the controlling shareholder could remove the director or take other retributive measures, such actions would likely cause unwanted public scrutiny.[38]

Outside the purely transactional context, independent directors may also be well suited to maintain standards of professionalism within the boardroom and promote adherence to best practices of corporate governance.[39] This additional type of monitoring provides public shareholders with added confidence that the board and the company are not being run informally and casually at the behest and solely for the interest of the controlling shareholder.

Strategic Advisor to the Controlling Shareholder. Independent directors may also be viewed as strategic advisors who can provide their expertise and experience on business matters to the firm's management or controlling shareholder.[40] In this role they may serve to enhance firm value by helping the firm make better business decisions and by helping the firm tap into the director's wealth of business and political connections.

(i) Competing Roles?

The roles noted above pitch independent directors as trusted strategic advisors to management or a controlling shareholder (suggesting these directors

---

37 *See,* D.C. Clarke, *Three Concepts of the Independent Director*, 32 Del. J. Corp. L. 73, 80, 81 (2007) ("*In the United States, the [independent director] has traditionally been seen as the solution to the problem of managerial domination of the board*".); *see also*, B.S. Black, R. Kraakman, A. Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 Stan. L. Rev. 1731, 1750-51 (2000); Bebchuk & Hamdani, *supra* note 34, at 1284; D.A. DeMott, *Guests at the Table?: Independent Directors in Family-Influenced Public Companies*, 33 J. Corp. L. 819, 847 (2008); Gilson & Gordon, *supra* note 34, at 787; Gordon, *supra* note 5, at 1506.

38 *See,* Clarke, *supra* note 37, at 80.

39 *See,* DeMott, *supra* note 37, at 857; Gordon, *supra* note 5, at 1513.

40 *See,* Clarke, *supra* note 37, at 81 (noting that a common function of independent directors is to serve as a "brain trust" or consultant); *see also,* Gordon, *supra* note 5, at 1506. Gordon generally describes the boards of the typical 1950s American corporation as "*knowledgeable parties*" who could "*serve as a useful sounding board for the CEO, a kitchen cabinet, and could provide expertise in the face of increasing complexity*". *Id*., at 1514. Note, however, that both Gordon and Clarke question whether independent consultants might perform this role more effectively and without the encumbrance of independence. *See id*., at n.185 and Clarke, *supra* note 37, at 81.

are supportive to management and controllers) as well as "watchdogs" (who might be perceived as less supportive and more antagonistic). These roles are not easy to balance and indeed may run at odds with each other at times.[41] This can be a particular problem if the law is written somewhat vaguely, as then the line between legitimate business decisions and illegitimate ones could become blurred.

Further, the time needed to be a strategic advisor may differ considerably from that needed to be a "watchdog". The latter likely requires more ongoing and consistent oversight, whereas the former may require only more limited and discrete time commitments. Despite the general perception in the public that independent directors ought to serve as watchdogs, it would appear that the strategic advisory role may be more suited to the actual functioning of boards, given that few boards meet more than once every two months.[42]

Historically, in the United States, independent directors appeared to be more like strategic advisors to the management of a firm.[43] However, with the passage of time, the increasing influence of corporations in social, political and economic life, and an increasing focus on shareholder wealth maximization, independent boards took on more of a monitoring role (along with having "tighter" definitions of independence).[44] Gordon suggests that the move toward having more independent directors, and increasing their tasks to include more monitoring of management, was related to two developments. First, as firms moved from a general conception of "stakeholders" to shareholder wealth maximization, there was increasing focus on share prices as an indication of how well the firm was doing. Second, this increasing reliance on share prices might have created a strong short-term bias in management (e.g., to maximize share price right now). The

---

41 *See*, *e.g*., Gordon, *Supra* note 5, at 1514 ("*On this view, a 'monitoring board' would inject dissonance and distrust. How could the CEO trust and thus confide in directors whose ultimate mission was to hold him to account?*"); *see also*, R.C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, 6 Theoretical Inquiries in Law 413 (2005) (suggesting that independent directors should play only the monitoring role, rather than an advisory role, because attempting to do both would lead to conflicts and inability to perform the monitoring function, which he deems more natural for independent directors).

42 Clause 49 of the Listing Agreement, the Companies Act and the proposed Companies Bill require a minimum of four meetings a year. The recent Grant Thornton/FICCI survey indicates that 47% of boards meet 6-8 times a year, 44% meet 4-5 times a year and 9% greater than 8 times a year. *See,* FICCI Grant Thornton Corporate Governance Review 2009, *available at* http://www.wcgt.in/html/publications/ficci_gt_cgr.php.

43 *See,* Gordon, *supra* note 5, at Part III.

44 *See, id*.

presence of an increasingly independent board can help to counteract this tendency (as independent boards are less dependent on the CEO than inside directors). Gordon argues further that independent directors can create value not simply by enhancing their firm's value, but also – as part of a larger system focused on shareholder wealth maximization – their presence helps other firms to perform better too.[45]

There is clearly tension among the various roles independent directors may play. We now explore the tension embedded in the concept of independence in the controlled company context and how it manifests itself in the director selection process.

(ii) Independence and Director Selection

The nomination and selection of independent directors in controlled companies presents an inherent conflict with the very independence of so-called independent directors. Because the controlling shareholder either has majority control or effective voting control, it has the power to nominate, vote for and replace at its discretion the entire board of directors, including the independent directors.[46] To an outside observer, the products of such a process, the independent directors, may appear less than fully independent by way of their dependence on the support of the promoter.[47] This section explores the concept of independence and director selection in the controlled company context.

Countries are increasingly defining independence in similar ways.[48] Usually, someone is independent if that person has no financial inter-connectedness with management or controlling shareholder(s) of a firm.[49] In addition, someone who has worked for the firm may not be considered independent due to both monetary and collegial relationships that have existed while that person was at the firm.[50]

---

45 *See, id*. Indeed, the importance and sheer number of independent directors increased over time as well. In the 1950s, roughly 20% of a board was composed of independent directors, whereas by the mid-2000s roughly 75% of a board was composed of independent directors.

46 *See,* Umakanth, *supra* note 12, at 14-15.

47 *See, id*., at 22.

48 *See*, Institute of Company Secretaries of India, *ICSI Recommendations to Strengthen Corporate Governance Framework (2009)*, *available at* http://www.mca.gov.in/Ministry/latestnews/ICSI_Recommendations_Book_8dec2009.pdf [hereinafter "ICSI Report"].

49 *See,* R. Kraakman & B.S. Black, *A Self-Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911, 1949 (1996).

50 *See, id*.

Finally, someone who has business dealings with the firm may not be considered independent due to the potential conflict of interest that some of those business dealings might generate.

Although this version of independence (centered on "financial" independence) appears to be the global norm, there are developments in case law in the United States suggesting that the definition of independence may be becoming broader. In the *Oracle* decision, the Delaware Chancery Court held that independence is not limited to "financial" independence, but also invokes an inquiry into other measures of independence, such as social ties and connections.[51] The key matter for the Court was whether the director can make a decision based solely on the best interests of the firm, without being influenced by financial, social or other considerations that are not germane to the firm's best interests.[52]

A similar concern has recently been echoed by former SEBI Chairman, M. Damodaran. Although friendships are not defined as material relationships that would compromise independence, Damodaran points out, "*[a friend] might be the person who is most affected by being on my board and not thinking independently*".[53]

Moreover, if independent directors are to serve as "watchdogs" for public shareholders, then the concept of independence should be meaningful. One may think of independence as requiring "*both the willingness and ability to sustain…'rigor and skeptical objectivity' when its object is sponsored by or especially beneficial to the [controlling shareholder]*".[54] Technical satisfaction of the various independence requirements set forth by regulations, of course, does not guarantee this type of performance-based independence.[55] It is therefore critical that the process of selecting independent directors is attentive to such concerns.

However, this broadened definition of independence provides quite a demanding test and may result in it being more difficult to find independent directors who are also competent. The concern is that if a company wants a director who is well versed in business (especially in the business the firm is

51 The decision is technically relevant to a Special Independent Litigation Committee, but may portend a broader approach to independence in Delaware in other contexts, too. *See*, *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 939-44 (Del. Ch. 2003).

52 *See, id* at 944-48.

53 M. Damodaran, *Former SEBI Chairman: ''The Courage of Conviction is More Evident Today*", India Knowledge@Wharton, *available at* http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4429 [hereinafter "India Knowledge"].

54 DeMott, *supra* note 37, at 844.

55 *See, id*.

conducting) then that probably means it needs to find someone with experience. Such experience usually comes by working in the industry, which means such director will have social connections to some people at the firm. Even if one ventures away from a particular industry, it is likely that the most talented people will be known and are likely to have social and other connections to many people (it is rare to find a very talented business person who knows no one). At some level, this version of independence may make it difficult to find competent and talented directors who can also be independent.

There has been considerable debate on whether one should allow shareholders (or some kinds of shareholders) to nominate directors to be on the board;[56] however, as one commentator has put it, "*it is hard to see how directors representing minority shareholders could be elected to the board in the first place, unless basic principles of director selection were changed*".[57] An alternative to modifying the controlling shareholder's ability to predetermine the director elections – one that has been adopted at many Indian companies already – is to delegate the director nomination process to an independent, or at least a majority independent nominating committee.[58] While director candidates nominated by such a committee would, of course, ultimately need to be acceptable to the controlling shareholder to be elected to the board, the fact that nomination of independent directors is directed solely by independent directors may provide more comfort that the independence of such independent directors is not compromised by the director selection process.

(iii) Value of Independent Directors

Although the debate over the role, selection and definition of independent directors has become a much discussed corporate governance topic, there has also been an increase in the number of academic studies attempting to quantify the value of independent directors to firms.[59] The studies do not provide consistent results across countries or sometimes even within countries.[60]

---

56 For general background on this debate, *see generally,* L. Bebchuk and S. Hirst, *Private Ordering and the Proxy Access Debate* (November 2009), BUSINESS LAWYER (forthcoming); Harvard Law and Economics Discussion Paper No. 653, *available at* http://ssrn.com/abstract=1513408.

57 Clarke, *supra* note 37, at 80.

58 The South Korean approach used to provide another method of trying to select independent directors – it used to require that controlling shareholders' votes would become worth much less when it came to selecting members for the audit committee. *See,* Khanna, *supra* note 34, at 50.

59 *See, e.g.*, B.S. Black, H. Jang & W. Kim, *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J.L. ECON. & ORG. 366 (2006).

60 *See, id.*

In the United States, studies have often found little to no effect of board independence on firm value;[61] some studies even demonstrate negative correlations between additional independence and corporate performance.[62] Of course, given the preponderance of dispersely held firms in the United States as compared to typically promoter-dominated companies in India, US-centered studies on the value of independent directors may be of limited value – independent directors indeed may have different effects in such companies.[63]

The results of similar studies in other countries, especially those with more controlled firms, are surprisingly somewhat mixed. In Russia and Korea, it appears that board independence is important to firm value.[64] In India, studies have so far provided either somewhat or weakly positive or inconclusive results, and in Brazil it appears there is either no effect or perhaps even a negative effect.[65] Although there are plausible explanations for each of these results, the core point is the same: the value of a particular governance mechanism (e.g., independent boards) is likely to vary across firms and across institutional backgrounds and countries.

---

61 *See,* Clarke, *supra* note 37, at 75-77 (and footnotes for citations).

62 *See, id*. at 75-76.

63 *See,* Khanna, *supra* note 34, at 42; Bebchuck & Hamdani, *supra* note 34, at 1306-16. Moreover, most firms in the United States follow similar rules and practices and thus it may be the case that there is not enough variation in US firm practices to find any effect. Further, one can view an independent board as just one step in an entire system of corporate governance and hence finding specific effects of one part of the system is unlikely. Further, if independent directors have systemic effects (improving the overall governance system at all firms in a country) then that would not be picked up in studies that are snapshots of a country at a particular point in time. Moreover, it is possible that it may be optimal for different firms to have different board structures so that the differences that might exist are perhaps optimal or tending toward it. *See,* Gordon, *supra* note 5, at 1508.

64 *See,* Khanna, *supra* note 34, at 48.

65 *See,* B.N. Balasubramaniam, B.S. Black & V.S. Khanna, *Firm-level Corporate Governance in Emerging Markets: A Case Study of India* (Draft, on file with authors)(2009) at 32–33; K.P. Prasanna, *Corporate Governance - Independent Directors and Financial Performance: An Empirical Analysis*, INDIAN INSTITUTE OF CAPITAL MARKETS 9TH CAPITAL MARKETS CONFERENCE PAPER, *available at* http://ssrn.com/abstract=877807 (finding independent directors had little effect); A. Chakraborty et al., *The Relationship Between Incentive Compensation and Performance Related CEO Turnover*, 61 J. OF ECON. AND BUS. ELSEVIER 295 (2009) (finding a greater effect); B.S. Black, A. Gledson de Carvalho & E. Gorga, *Does One Size Fit All in Corporate Governance? Evidence from Brazil,* 24-25 (Northwestern Univ. Sch. of Law, Law & Economics Research Paper No. 09-20, 2009), *available at* http://ssrn.com/abstract=1434116 (Brazil).

This suggests that one needs to examine the institutional and cultural context of a country before deciding what roles and liabilities independent directors should have, and how independent directors may be of value to firms. Part V of this paper begins this exploration by surveying independent directors at Indian firms, to learn what they perceive to be their roles and what "value added" they believe they bring.

IV. How Indian Law Envisions the Role of Independent Directors in Controlled Companies[66]

We next examine how Indian corporate law, listing standards and regulations envision the role of independent directors in Indian companies.

A. Overview of Corporate Governance Requirements in India

Although there have been a number of reforms related to corporate governance, perhaps the single most important for the growth of independent directors was the promulgation of Clause 49 of the Stock Exchange Listing Agreement in 2000 by SEBI.[67] Clause 49: (i) sets out the requirement for having independent directors on corporate boards, (ii) defines independence (although with amendments over the years), and (iii) lays out some specific duties and obligations of independent directors.[68]

(i) Requirements

Under Clause 49, all publicly traded Indian firms with paid up capital above Rs. 3 crore (~US$ 600,000) are required to have a board composed of at least one-third independent directors.[69] Further, publicly traded firms, where the chairman of the board is an executive of the firm, are required to have a board composed of at least 50% independent directors.[70]

(ii) Definition of Independence

Clause 49 Article I(A)(iii) states that an independent director is a non-executive of the firm who:

---

66 *See,* Khanna, *supra* note 9.

67 *See,* S.N. Ananthasubramanian, *New Obligations on PSBs*, Hindu Business Line, Jan. 13, 2006, *available at* http://www.blonnet.com/2006/01/13/stories/2006011302040500.htm.

68 *See,* Clause 49, Article I(A)(1) Explanation(i) of the Listing Agreement, *supra* note 6.

69 *See,* Clause 49, Article X(1)(ii) of the Listing Agreement, *supra* note 6.

70 *See,* Clause 49, Article I(A)(i) & (ii) of the Listing Agreement, *supra* note 6.

a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

b. is not related to promoters or persons occupying management positions at the board level or at one level below 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;

g. is not less than 21 years of age.[71]

Although this definition bears substantial similarity to standards in many industrialized countries, including the United States, there has been considerable discussion in India about whether such a tight definition might foreclose Indian firms from finding independent and competent directors.[72] This issue becomes more critical as one considers the plethora of tasks laid at the feet of directors.

Clause 49 sets out some duties for directors, including reviewing company efforts to comply with all applicable laws and laying down a general code of conduct.[73] However, Clause 49 imposes the most specific requirements for independent directors who also serve on the audit committee. Specific duties for

---

71 *See,* Clause 49, Article I(A)(iii) of the Listing Agreement, *supra* note 6.

72 *See, Wanted, Women Directors* HINDU BUSINESS LINE, Oct. 29, 2007, *available at* http://www.thehindubusinessline.com/mentor/2007/10/29/stories/2007102950361200.htm.

73 *See,* Clause 49, Article I (C) of the Listing Agreement, *supra* note 6.

audit committee members include overseeing the financial reporting process, matters related to the appointment of the statutory auditor, reviewing financial statements with management before submitting them to the board, reviewing the internal control systems, reviewing internal investigations on suspected fraud, reviewing the whistle blower mechanism (if any), reviewing disclosure on use of proceeds from public issuance of securities, reviewing disclosures on related party transactions, and other related matters.[74] The aforementioned is not intended to be an exhaustive list of independent directors' responsibilities, but simply an indication of the breadth of their tasks.

(iii) Liability

Violations of Clause 49 could result in the de-listing of the firm under the Stock Exchange Listing Agreement. Moreover, violations of the listing agreements could generate both financial penalties imposed by government and criminal sanctions for directors under the Securities Contract (Regulation) Act 1956. Although not yet imposed on any directors in India, the prospect of these higher sanctions is likely to serve as a signal that more serious enforcement is an increasing possibility.[75]

Outside of Clause 49, there are a number of provisions that can be used to impose liability on directors. These include provisions targeted at directors and other general provisions for which directors may be prosecuted or otherwise pursued (this is not meant to be an exhaustive list): [76]

1. The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, contains various prohibitions on manipulative, fraudulent and unfair trade practices in securities (section 4), and a prohibition on dealing in securities in a fraudulent manner or using any manipulative or deceptive device (or scheme to defraud or deceit, etc.) in connection with the purchase or sale of securities (section 3).

---

74 *See,* Clause 49, Article II (D), Article IV (A) & (D) of the Listing Agreement, *supra* note 6.

75 *See,* D. Dharmapala & V.S. Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India,* U. of Michigan Law & Economics, Olin Working Paper No. 08-005, 3rd Annual Conference on Empirical Legal Studies Papers, 2008, *available at* http://ssrn.com/abstract=1105732.

76 Many of the items listed below do not provide a private cause of action for shareholders (neither do violations of Clause 49).

2. Sections 12A and 15G of the Securities and Exchange Board of India Act, 1992, [SEBI Act] prohibit insider trading.[77]

3. Sections 62 and 63 of the Indian Companies Act, 1956, could hold directors liable for certain misstatements in a prospectus to raise capital.[78] There are also sanctions that SEBI can impose for similar behavior under the Takeover Code.[79]

4. Provisions of the Indian Penal Code (IPC) that cover breach of trust (section 406) and theft and cheating (section 420).

A number of the above can be criminal violations and hence may trigger arrests and, potentially, convictions for directors. However, private rights of action for securities fraud are not presently available in India.[80] Although this provides a fairly broad list of things for which directors might be held liable, there have, to date, been very few findings of director liability, either criminal or civil. However, after the Satyam incident and the arrest of auditors and executives of Satyam, the perceived risk of potential arrest and liability for directors has increased.[81]

---

77 Both the Securities Contract (Regulation) Act, 1956 [Hereinafter "SCR Act"] and the Securities and Exchange Board of India *Act*, 1992 [Hereinafter "SEBI Act"] also provide for penalties when firms fail to address investor grievances sent to them by SEBI or a stock exchange (§ 23C, the SCR Act and § 15C, the SEBI Act).

78 To establish liability, the moving party must prove actual reliance on the misstatement (without the use of the "fraud on the market" theory). *See,* Peek v. Gurney, (1873) 43 LJ Ch 19 (HL); Al-Nakib Investments (Jersey) Ltd. v. Longcroft, [1990] BCLC 7 (Ch D); Possfund Custodian Trustee Ltd. v. Diamond, [1996] 2 BCLC 665 (Ch D). *See,* A. Ramaiya, Ramaiya's Guide to the Companies Act: Part 1 586-587 (Dr. S.M. Dugar ed., 1998); Avtar Singh, Company Law 113 (2001). In addition, these provisions are available only for misstatements in a prospectus, not misstatements generally.

79 *See,* § 45(5) and 45(6), SEC. and Exch. Bd. of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (SEBI Takeover Code).

80 *See*, Reserve Bank of India, *India's Financial Section: An Assessment*, *available at* http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FRSAIV.pdf. For which alleged wrongdoing over which SEBI is not empowered to act there may be the availability of the tort action of deceit or a fraud claim under the Indian Contract Act, 1872. However, both actions require proof of individual reliance without being able to use the 'fraud on the market' presumption. In context where breach of fiduciary duty is available that might be pursued, but chances of success are small in India where few cases have ever been successful. Moreover, for certain breaches of duties directors may be able to rely on a statutory provision that insulates them from liability. *See*, section 633(2) of the Indian Companies Act, 1956. *See*, Ramaiyya, at 777-779.

81 *See*, *Satyam taught India to fear*, Livemint, Jan. 4, 2010, *available at* http://www.livemint.com/2010/01/04205958/Satyam-taught-India-to-fear.html.

B. Recent Reform Efforts

In the wake of the Satyam and Nimesh Kampani episodes, calls for corporate governance and director liability reform have abounded.[82] In February 2009, the Confederation of Indian Industry (CII) convened the CII Task Force on Corporate Governance to "*recommend ways of further improving corporate governance standards and practices in both letter and spirit*".[83] The Task Force, chaired by former Cabinet Secretary Naresh Chandra, released its findings and recommendations in November 2009.[84] The report included recommendations to Indian industry in four areas: (1) the board of directors, (2) auditors, (3) regulatory agencies and (4) external institutions.[85] Similarly, the Council of the Institute of Company Secretaries of India (ICSI) subsequently promulgated a set of recommendations to reform corporate governance in light of the events at Satyam.[86] Its findings arose out of its analysis of corporate governance best practices, committee reports and rules and regulations from around the world and within India.[87] In December 2009, drawing upon the findings of the CII Task Force and the ICSI report as well as suggestions from various other stakeholders, India's Ministry of Corporate Affairs produced a set of voluntary corporate governance guidelines for Indian companies.[88] While the guidelines are strictly voluntary, the Ministry expects that Indian corporations that do not adopt these measures in whole or in part will explain the reason for their non-adherence in disclosure to their shareholders. We briefly highlight below some of the findings of these reports.[89]

Nomination Committees. All three of the reports recommend that boards should select independent directors through a nomination committee comprising

---

82 *See, Shocked at Satyam Affair, Chambers Call for Blocking Corporate Loopholes*, Hindu Business Line, Jan. 8, 2009, *available at* http://www.thehindubusinessline.com/2009/01/08/stories/2009010851250300.htm.

83 CII Report, *supra* note 26.

84 Other members of the nine-member task force included J.J. Irani, Uday Kotak, Y.H. Malegam, Omkar Goswami, Deepak M. Satwalekar, Shardul Shroff, Amal Ganguli and Ajay Bahl.

85 *See,* CII Report, *supra* note 26, at 3.

86 *See,* ICSI Report, *supra* note 48.

87 *Id*.

88 *See,* Corporate Governance Voluntary Guidelines, 2009, Ministry of Corporate Affairs, Government of India, 24 December 2009; *available from* http://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf [hereinafter "Ministry Guidelines"].

89 Note that the proposed amendments to India's Companies Act does not address the concerns discussed herein.

a majority of independent directors, including the chairman.[90] They also recommend that this committee evaluate and recommend individuals for executive director positions.[91] Current Indian law only requires that companies maintain independent audit committees, and does not mandate the creation of independent nomination committees although several companies have established such committees voluntarily.[92] Irrespective of a promoter's potential ability to *de facto* reject or remove any board appointees using its voting power, independent directors nominated by an independent committee and without the influence of controlling shareholders or promoters may instill greater confidence in the market that independent director nominees remain effectively independent of promoters.

Executive Sessions. The CII report recommends that independent directors meet at regularly scheduled executive sessions outside the presence of management, and that the audit committee should also hold executive sessions with both internal and external auditors.[93] Regular meetings among independent directors without the presence of management and the promoter may help encourage independent directors to engage in critical, independent debate about the company in a setting that eliminates or at least diminishes promoter interference or intimidation.

Access to Management and Other Resources. The Ministry's Voluntary Guidelines suggest that independent directors have the option and freedom to meet with corporate management on a periodic basis. Moreover, these guidelines recommend that boards make available to independent directors the systems, procedures and resources necessary to enable independent directors to make informed, quality decisions about the company and otherwise effectively discharge their duties.

Remuneration. The Ministry's Guidelines recommend that independent directors be paid "adequate sitting fees" based both on the company's net worth

---

90 *See,* ICSI report, *supra* note 49, at 23; CII Report, *supra* note 26, at 6; Ministry Guidelines, *supra* note 92.

91 *See,* CII Report, *supra* note 26, at 6.

92 *See,* Clause 49 Article II Section A, *available at* http://www.bseindia.com/whtsnew/amend_lstagr.asp. Although, in a recent Grant Thornton/FICCI poll at mid-market listed companies, 56% of the respondents indicated that the appointment of independent directors was not led by a nomination committee. *See,* FICCI Grant Thornton, *supra* note 42.

93 *See,* CII Report, *supra* note 26, at 13.

and turnover. However, in an effort to prevent a director's independence from being compromised, these Guidelines expressly discourage the issuance of stock options or profit-linked compensation. The CII report, on the other hand, would permit stock options, but would prohibit an independent director from exercising any such options until a full year after his or her departure from the board.

Related Party Transactions. The CII committee also suggested that the audit committee preapprove all related party transactions not undertaken in the ordinary course of business or transacted at arm's length. While the recommendation and its supporting text do not provide any reason for investing this power in the audit committee other than the fact that it is a majority independent committee, in light of the events at Satyam and the general concern over controlling shareholder expropriation of resources, deliberation by an independent committee or even an executive session of all independent directors could prove a useful protective measure.[94] Indeed, this may be more useful than a full board meeting and vote in which the powerful influence of the controlling shareholder could very well diminish the capacity or likelihood of a full and vigorous debate over the transaction. Recall, the entire board of directors of Satyam, following an allegedly heated deliberation, voted unanimously[95] to approve the later aborted Maytas related party transactions that precipitated Raju's confession.[96]

Independent Director Liability. The CII Task Force recommends to regulators and lawmakers that non-executive directors not be subject to trial for non-compliance with statutory provisions unless a prima facie case can be established demonstrating that the non-executive director was liable for the non-compliance on the part of the company, i.e., that the director had knowledge of such non-compliance on the part of the company.[97] Along the same lines, a private members' bill proposing amendments to the Companies Act submitted by the Indian Merchants' Chamber in February 2009 provides for the insulation of independent directors of Indian listed companies from liability based on acts or omissions of

---

94 *See,* CII Report, *supra* note 26, at 14; note that the audit committee, however, may not be the best place since it is already overloaded with responsibilities.

95 *See, Satyam Board Minutes Details Maytas Decision*, India Express, Jan. 17, 2009, *available at* http://www.indianexpress.com/news/satyam-boards-minutes-details-maytas-decision/411946/0.

96 N. Sheth & J. Range, *Satyam Minutes Show Directors Raised Questions*, Wall Street Journal, Jan. 19, 2009, *available at* http://online.wsj.com/article/SB123201784133485275.html.

97 *See, id*.

the companies on whose boards they sit (or by any officers thereof).[98] The amendment also specifically provides that arrest warrants for independent directors are not to be issued without authorization of at least a District Court judge who must provide the independent director an opportunity to be heard prior to issuance of such authorization.[99] The only exceptions provided are for breaches or violations of law for which the independent director was "*directly involved in or responsible for*" or committed with his knowledge or consent, or where he was guilty of gross fraud or willful negligence.[100] Both the Naresh Chandra recommendation and the draft bill attempt to very directly address the concerns of directors arising out of the criminal charges levied against Nimesh Kampani.

Shareholder Activism. The CII Task Force also appeals to institutional shareholders in particular to be more active in their oversight capacities.[101] The Satyam promoters effectively controlled the company with only approximately 8% ownership of the company's equity.[102] This may have been enabled by a lack of pressure or effective oversight (until the very end) by institutional investors. While dispersed shareholders generally have little incentive to invest the significant resources required to effectively monitor managements, institutional shareholders, private equity funds, and hedge funds with significant holdings have been shown in the United States (and to a lesser, but still significant, extent in Europe) to be powerful players in shaping governance norms as well as

98 Proposed amendment on file with the authors. *See also,* R.K. Luthra, *Retaining talent on company boards*, ECONOMIC TIMES, Apr. 29, 2009, *available at* http://economictimes.indiatimes.com/Opinion/Editorial/Retaining-talent-on-company-boards/articleshow/4461613.cms.

99 *See, id*.

100 *See, id*.

101 *See,* CII Report, *supra* note 26, at 24.

102 *See,* M. Vyas, *Beyond Promoter Power*, FINANCIAL EXPRESS, Feb. 2, 2009, *available at* http://www.financialexpress.com/printer/news/417788/; *see also,* Mathew, *supra* note 32, at 836 (identifying Satyam Computer Services, with its then-reported 9.11% promoter stake, as the BSE 500 company "*most vulnerable to a hostile takeover*"). Note that Ramalinga Raju identified the potential threat of a hostile takeover as one of the reasons he manipulated Satyam's accounts: "*Since about seven years we wanted to show more income in the accounts to avoid others from involving in the company affairs and any possible hostile acquisition and hence manipulated the balance sheet to attract more business and showed unavailable amount as available cash on hand*." *Raju's Confession: We manipulated balance sheet to avoid acquisition*, ECONOMIC TIMES, Jan. 12, 2009, *available at* http://economictimes.indiatimes.com/infotech/software/Rajus-Confession-We-manipulated-balance-sheet-to-avoid-acquisition/articleshow/3969850.cms.

company-specific reforms. While many institutional investors in the United States remain passive (due to statutory requirements, their own governing documents or standard practices), proxy consultants such as RiskMetrics (formerly ISS) put together voting guidelines based on corporate governance policy positions that often play a significant role in shaping corporate governance norms across US corporations. There is perhaps a significant opportunity for such institutions to develop in India alongside potentially "activist" investors.

Director Training. Both the Ministry's Voluntary Guidelines and the ICSI report recommend that boards make mandatory training programs for newly inducted directors and should also develop training programs for the ongoing development of all directors.[103] The ICSI report suggests that director training is especially important so that directors become sufficiently technically competent to perform their duties, including in the area of financial expertise, which the report suggests is critical to a director's comprehension of the workings of the audit committee.[104] With respect to continuing director development, the ICSI report suggests directors be kept abreast of recent developments in corporate governance, technologies, products, markets, etc. through ongoing education, site visits, seminars and courses.[105]

V. Interviews of Independent Directors

The discussion of academic literature, law and recent reform efforts in the last few Parts helps to conceptualize and operationalize the roles of independent directors in Indian firms. We now turn to our most direct means of assessing the business and institutional context, as well as the practical realities on the ground through interviews with directors themselves. Through our interviews, we seek to understand what the role of an independent director in a promoter-controlled company really is in practice and how it could be improved to serve the goals of both public and promoter shareholders.

We designed our questions to help us understand the role of independent directors in India from various perspectives, including the below:

- ***Selection Process.*** How are independent directors selected? Through a nomination committee? By the promoter? What makes a good candidate?

103 *See,* ISCI Report, *supra* note 48.

104 *See, id*.

105 *See, id*.

- ***Independence in Action***. Provide examples of instances where independent directors spoke out against an idea or action submitted by promoter.
- ***Board Decision-Making Process***. Describe the role of the independent director vis-à-vis the promoter and affiliated directors in board decision-making. Are the voices of independent directors heard and solicited?
- ***Strategic Advisor or Watchdog***? How do independent directors in promoter controlled companies view their roles – as strategic advisors, watchdogs, both, others? How do promoters view the roles of independent directors on their boards?
- ***Director Liability***. What are your most palpable concerns about liability? How have things changed since the Satyam and Nimesh Kampani incidents? What motivated directors to resign? What worries directors today? What can bring them back?
- ***Director Compensation***. Is the current level of independent director compensation adequate in light of the attendant liability risks?
- ***Communication with Public Shareholders***. How often, if at all, do you communicate with public shareholders? Who initiates the conversation? What is the standard profile of public shareholder with whom you communicate (foreign institutional investors mainly)?
- ***Suggestions for Enhancing the Functioning of Independent Directors in India***. What are your suggestions for things that might help – whether by private or government initiative – to lead to the more efficient functioning of independent directors in Indian firms?
- ***Signalling Effect of Director Resignations***. To what extent does the resignation of an independent director signal to shareholders and/or the market that there may be a conflict on the board?
- ***Changes in the Boardroom post-Satyam/Nimesh Kampani***. What changes have you observed in the boardroom environment after the Satyam and Nimesh Kampani episodes?

Our interview project remains very much in its early stages. To date, we have conducted interviews with several independent directors at leading BSE 100 companies as well as a number of advisors to corporate boards. Together with Rajiv Luthra of Luthra & Luthra Law Offices, we plan to expand the pool of interviewed directors to a minimum of 50 directors, from varying industries. We also expect to interview promoter directors, independent directors at controlled companies in the United States and independent directors at non-controlled companies in India. We will also seek the advice of India's leading corporate lawyers, who often advise these promoters and independent directors, as well as their counterparts in the United States.

Note that our findings below are reported without reference to director names or company affiliation; we agreed, as a means to encourage open and frank discussions with our interviewees, to keep their names and any company identifying information confidential.

VI. Preliminary Findings and Implications

We set forth below the preliminary findings of our initial subset of interviews. These are not meant to be construed as definitive conclusions, but instead only as initial observations that may be helpful as the project and other similar projects continue.

Watchdog or Strategic Advisor? All of the independent directors considered themselves, first and foremost, strategic advisors to the promoters and management. While several directors indicated "*a growing consciousness that you need to be on the lookout*," in the context of a controlled company, as one director put it, "*independent directors are not there to prevent management from taking decisions*". Indeed, directors and advisors alike saw the role of the independent director to be that of a seasoned advisor who could draw on his vast industry or other business or strategic expertise in helping to advise the company management on both corporate development and direction, as well as in conflict situations.

While at least one director acknowledged that service on the audit committee likely required a "watchdog" mentality, all of the independent directors we interviewed expressed the strong sentiment that they could not be expected to serve as "watchdogs" in an environment where the potential for significant reputational damage and the scope of liability – indeed, potentially severe, and haphazard, criminal liability – is so high and undefined. "We are damn scared," summed up one director. The example of Nimesh Kampani was raised on multiple occasions.

Director Liability. Our interviewees emphasized that independent directors need to be able to rely on the information provided by auditors and management to some extent; without clear legal protection for reliance on certain types of information, they stated emphatically that directors would not be comfortable serving as watchdogs.[106] This sentiment was often mentioned specifically in the context of members of audit committees.

The interviews made clear a tremendous uncertainty and confusion as to the proper role of independent directors in controlled firms and the liabilities and risks of service. Directors do not appear to have confidence as to whether their action or inaction while serving on a board could subject them to arrest and imprisonment for technical violations made by accountants, auditors or members of management; or even for acts of fraud by any of the foregoing. Several directors and advisors repeated the startling fact that *most* independent directors had probably been served arrest warrants arising out of such claims – this "nuisance value," as one director put it, had the effect of encouraging director resignations and discouraging many potentially well-qualified candidates from joining boards. Providing them with a safe harbor for good faith reliance on certain materials prepared by management or advisors may be a good start and was recommended by several directors – "we need clarity in law," said one director. One director noted that relying on technical rules may not be the best way to solve the problem. Clear principles that attempt to replicate some of the fiduciary duty concepts drawn from Delaware law leave less room for technical workarounds and provide regulators and courts with more flexibility and directors with more comfort that their good faith service as directors will not land them in prison.[107] Directors and officers (D&O) insurance is another means for limiting director liability (at least for State enforced civil liability) – and reports have indicated that over 500 Indian companies applied for D&O insurance coverage in 2009, further reflecting director concern over the risks of service.[108]

Director Compensation. The independent directors all felt that current compensation levels for independent directors were grossly insufficient and incommensurate both to the ever-present "nuisance" risk of arrest for corporate actions outside a director's control and the increased liability risks – perceived or real – post-Satyam and Nimesh Kampani. Reports indicate that companies are adopting D&O insurance for directors with rapid frequency; we will be interested to see in subsequent interviews what changes directors have observed in compensation, as well as the views of promoters.

106 *See,* Umakanth, *supra* note 12, at 29-30.

107 *See,* Mathew, *supra* note 32, at 843.

108 *See,* S. Mody, *Companies take cover for CEO fraud*, Times of India, March 4, 2009, *available at* http://timesofindia.indiatimes.com/biz/india-business/Companies-take-cover-for-CEO-fraud/articleshow/4220513.cms.

Boardroom Environment. The independent directors we interviewed described the boardroom environment as being receptive of their viewpoints, and all of them felt that the promoters genuinely valued their input. Many directors shared experiences in which boards and promoters took action initiated or driven by independent directors. While these anecdotes mostly involved strategic initiatives proposed by the independent directors, we did hear from directors about instances in which an independent director's opposition to a promoter's plan caused a reconsideration or even abandonment of such plans. But as one director pointed out, in situations where the promoter's views and those of the independent director diverge, while the promoter should listen with respect, given the promoter's significant shareholding position, his view must ultimately prevail at the end of the day. We hope during the course of our future interviews to hear and learn more about additional examples of boardroom conflicts between promoters and independent directors and how they were resolved.

Selection Process. Most directors agreed that independent nominating committees were important to counteract the impact of promoter hiring and affinity in the independent director selection process. That said, each director we interviewed was approached in at least one of his directorships by the promoter directly, typically in the absence of any process involving a nominating committee or any independent directors. Moreover, as one director emphasized, to be effective, boards need to be collegial and therefore cannot select strangers.

The progress and effectiveness of existing nominating committees received mixed reactions. One director noted that the selection process, while increasingly delegated to nominating committees, remains effectively a process driven by individuals rather than the nominating committee. Another noted that while many well-run companies have nominating committees, management retains a significant hand in the process.

Changes after Satyam and Nimesh Kampani. The principal boardroom changes identified by directors post-Satyam and Nimesh Kampani included the perception that promoters have generally become more active in welcoming and seeking out the viewpoints of independent directors. Further, independent directors are asking questions far more frequently during board meetings and doing much more to understand the business and actions taken by the board. This is particularly so when they may not understand the concept being deliberated – some directors noted that they knew of several directors on other boards who never truly understood important concepts such as derivatives, an observation some attribute to the mass resignations of independent directors post-Satyam and the replacement of such directors with people who may have less expertise in such matters. Board discussions, we learned, are now generally longer, more data-driven, and fulsome. Of course, as mentioned above, this increased vigilance comes with increased discomfort over playing a watchdog role for which independent directors feel they are not being adequately compensated or protected.

Signaling Effect of Resignations. The directors and advisors agreed that the resignation of an independent director sends a signal to the market of some conflict in the boardroom. They differed, however, in their appraisal of how enduring and therefore how effective such a signal would be. On one side, we heard that the financial press would pick up on any such resignation, play out the story, and likely push deeper into any semblance of conflict or other reason for the director's departure. The resignations of independent directors at Satyam prior to the Raju confession and the subsequent press coverage and investigation are paradigmatic examples of this viewpoint. The power to threaten to resign is from this perspective a critical factor in encouraging promoters to take into account the views of independent directors and in deterring promoters from taking actions perceived as self-interested. In a sense, even if independent directors do not necessarily have tools to take direct action to block or deter promoter activity they consider inappropriate, the power to resign enables them to exercise a quite powerful "watchdog" function. On the other hand, we heard that while the press would likely pick up on such resignations, its and its readers' memories were too short, and absent a blockbuster event such as Satyam, it is unlikely that any serious investigation or significant coverage would be dedicated to such event. In this view of the world, the indirect watchdog power of the independent director is decidedly less effective.

Communication with Public Shareholders. Many of the independent directors reported that they had communicated with public shareholders, but on a fairly *ad hoc* and infrequent basis and not through any formal channels. Instead, these interactions typically took place through networks of their own, or meetings initiated by investors. One interesting finding was that all of the interactions were with foreign institutional investors – not one had any communication with domestic shareholders, including institutions.[109]

Training. Some directors expressed concern that they were not getting sufficient training or updates on current developments in corporate governance. While some directors noted that there were resources available, including conferences and company offsites, some thought those resources were both scarce and generally

109 Note that this does not apply to nominee directors representing banks or other financial institutions – but we are not considering these to be "independent directors" for our purposes.

of poor quality. And, unlike in the US, law firms do not appear to be providing corporate governance and other update presentations to corporate boards.[110]

We expect that as we increase the sample size of our interview pool, we will gain a better and more comprehensive understanding of the concerns of India's independent directors. Our hope is that this compendium of empirical data – the first of its kind in India – would prove useful to the Government of India, the Ministry of Corporate Affairs, SEBI and also to promoters, independent directors and investors, as they think about how best to define the role of independent directors in India in the future.

VII. Conclusion

As we saw with Enron, WorldCom and Parmalat and with the global economic crisis we face today, catastrophic events often present lawmakers with the exceptionally rare political opportunity to reshape entire areas of law and regulation. Indian lawmakers may well have a similar opportunity today with regard to reshaping corporate governance in India in the aftermath of the events at Satyam and Nimesh Kampani. This awesome power must, however, be wielded thoughtfully and with the knowledge that the general applicability of legislative creation will likely endure for generations (or at least until the next crisis).

In this study we lay out the findings from our preliminary interviews of directors. Although these provide useful indicia, they also raise several matters for further thought and discussion that we intend to address in our broader survey of independent directors. In particular, we hope to delve more deeply into what directors consider to be their "value added" to the firm and society, how that should influence their roles and liability risks now and over time, and what sorts of other facilities may be useful to them to enhance their functioning and efficiency so that there are both fewer frauds and better firm performance in the future. We are hopeful that the results of these interviews will provide the Indian government and regulators with a balanced, but effective, approach to reforming corporate governance practices in India that will both address the public's desire to see that severe corporate frauds are detected in advance and prevented, and help India to retain a flexible corporate governance framework that enables managers and boards of Indian corporations to continue to foster the dramatic increases in wealth and standards of living that have characterized India Inc. since economic liberalization.

---

110 Although the recent Grant Thornton/FICCI survey indicated that 53% of directors thought there was a process in place to ensure newly appointed directors got formal and tailored induction upon joining the board and 57% thought the company trains directors on the business model and risk profile of the firm. *See,* FICCI Grant Thornton, *supra* note 42.