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MONITORING INDEPENDENT DIRECTORS: WHO WILL GUARD THE GUARDS?

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ABSTRACT

Since the introduction of the concept through the Companies Act, 2013, independent directors are perceived as an easy remedy to poor corporate governance. Their efficacy in effectively monitoring company management is often taken at face value. Studying recent instances of corporate governance lapses provides an insight into the efficacy of independent directors. To plug these gaps, regulators constantly strive to raise the bar on the relevant criteria for determining the independence, and the procedure for the appointment, of independent directors. However, the changes affected do not appear to address the problem at hand. The ability of independent directors to effectively monitor company management has been questioned in the United States. Unlike in India, shareholders have often pursued derivative claims against independent directors. While these derivative actions are not always successful, they function as an additional check on independent directors' actions. Derivative actions are also pursued by shareholders in India. However, they: (a) are rarely pursued against independent directors; and (b) typically arise out of situations where directors have committed a fraud on the shareholders rather than when they have simply failed to perform their duties. For independent directors in India to function as an effective check on management, the threat of shareholder action needs to be a real one.

Keywords: Corporate Governance, Independent Directors, Shareholders.

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I. INTRODUCTION

Independent directors form a cornerstone of corporate governance regulation across the world. In India, a large number of companies are required to appoint independent directors to their boards. Such directors are expected to act as a check on promoters and executives. In this article, the authors examine the efficacy of independent directors in performing this expected role.

The legislature is cognizant of the fact that independent directors may not be functioning as an effective form of control over management – this is evident from the spate of amendments that have been passed over the years concerning the appointment and qualification of independent directors. The authors examine such regulations and consider if they have achieved their desired result. The authors also examine regulations relating to the degree of liability that can be attributed to independent directors and the consequence of such regulations.

In addition to regulatory action, another way in which independent directors can be held to account is through shareholder-led litigation. The authors consider how such litigation has been pursued in the United States and whether such litigation will assist with strengthening corporate governance in India.

II. REGULATIONS CONCERNING APPOINTMENT AND QUALIFICATION

The predecessor legislation to the Companies Act, 2013, i.e., the Companies Act, 1956, did not expressly require companies to appoint independent directors to their boards (although the stock exchange listing agreement prescribed certain requirements in respect of publicly listed companies). With the notification of Section 149 of the Companies Act, 2013, every listed company as well as unlisted public companies whose share capital, turnover or borrowings exceed certain specified thresholds are required to appoint a minimum number of independent directors. A minimum number of independent directors are also required on certain committees of the board, such as the audit committee. Additional requirements are also prescribed under the SEBI's Listing Obligations and Disclosure Requirements Regulations, 2015 ("**LODR Regulations**") and under the listing agreement executed with the stock exchanges, in respect of listed companies.[1]

The criteria for determining who can be appointed as an independent director under the Companies Act are fairly extensive. Independent directors are required to be persons who *inter alia*: (a) are not related to the relevant company's promoters; (b) do not receive remuneration or otherwise have any pecuniary relationship with the relevant company exceeding certain thresholds; (c) are not related to persons who hold securities of the relevant company or have any pecuniary relationship exceeding thresholds; (d) do not or have not previously served as the relevant company's auditors or consultants; (e) do not hold securities in the relevant company exceeding certain thresholds; or (f) do not hold a position in a non-profit organization that receives significant receipts from the relevant company.[2] They are also required to be persons who, in the opinion

[1] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 16, 17, 18 & 19 (Sep. 2, 2015).

[2] Companies Act, No. 18 of 2013, § 149(6) (Ind.).

of the board, are persons of integrity and possess relevant experience.[3] Additionally, independent directors are required to complete a test organized by the Indian Institute of Corporate Affairs.[4] The Companies Act also prescribes limits on the tenure of independent directors and the number of consecutive terms for which a person may be appointed as an independent director.[5] Further, in the case of listed companies, the LODR Regulations require independent directors to be appointed by a special resolution of the company's shareholders (i.e., a 75% majority).[6]

These checks and balances have made the process for the appointment of independent directors a rigorous one. However, they have not entirely worked out in the way that one would have hoped in ensuring that independent directors act in the best interests of the company and not on behalf of promoters or other vested interests. In 2002, Vice Chancellor Strine of the Delaware Chancery Court famously portrayed controlling shareholders "*as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support).*"[7] This statement remains relevant for India in 2022 despite all the checks and balances that have been instituted; controlling shareholders or promoters remain as powerful and assertive as they were before the concept of independent directors was introduced.

To understand why certain independent directors may continue to act for vested interests, one needs to examine what sanctions follow for such behaviour. The scope of such sanctions is set out in the rules concerning

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[3] *Id.*

[4] Companies (Appointment and Qualification of Directors) Rules, 2014, Gazette of India, pt. II sec.3(i), Rule 6 (Sep. 18, 2014).

[5] Companies Act, No. 18 of 2013, § 149(10) (Ind.).

[6] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 25(2A) (Sep. 2, 2015).

[7] In re Pure Res. S'holders Litig. - 808 A.2d 421 (Del. Ch. 2002).

the liability of independent directors.

III. REGULATIONS CONCERNING INDEPENDENT DIRECTORS' LIABILITY

Independent directors are offered a significant degree of immunity under the Companies Act. Section 149(12) of the Companies Act states that independent directors "*shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.*"[8]

The Ministry of Corporate Affairs has also reiterated this in its circular dated March 2, 2020, which states that "*in case lapses are attributable to the decisions taken by the board or its committees, all care must be taken to ensure that civil or criminal proceedings are not unnecessarily initiated against independent directors or non-executive directors unless sufficient evidence exists to the contrary*".[9]

Similarly, Regulation 25(5) of the LODR Regulations states that "*an independent director shall be held liable, only in respect of such acts of omission or commission by the listed entity which had occurred with his/her knowledge, attributable through processes of the board of directors, and with his/her consent or connivance or where he/she had not acted diligently with respect to the provisions contained in these regulations.*"[10]

Courts too have cautioned against attributing liability to independent (and even non-executive) directors – they reason that independent directors are not responsible for the conduct of the company's business.[11]

These rules attempt to strike a balance between the responsibility of

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[8] Companies Act, No. 18 of 2013, § 149(12) (Ind.).
[9] Ministry Corp. Affairs, Gov't of Ind., General Circular No. 1/2020 (Jan. 1, 2020).
[10] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 25(5) (Sep. 2, 2015).
[11] *See* Pooja Ravinder Devidasani v. State of Maharashtra, (2014) 16 SCC 1; Chintalapati Srinivasa Raju v. Securities and Exchange Board of India, (2018) 7 SCC 443; Sunil Bharti Mittal v. Central Bureau of Investigation, (2015) 4 SCC 609.

independent directors and avoiding unnecessary prosecutions which might discourage well-qualified candidates from acting as independent directors. While the rules themselves cannot be faulted, their application to specific fact situations has left much to be desired.

IV. LAPSES IN CORPORATE GOVERNANCE AND THE ROLE OF INDEPENDENT DIRECTORS

Lapses in corporate governance have hardly ceased after the requirement to appoint independent directors to the boards of companies. Companies such as Yes Bank, Videocon, and CG Power and Infrastructure continue to carry the burden and stress caused by maladministration and in some cases alleged fraud by their erstwhile promoters. Independent directors did not act as an effective safeguard in any of these cases.

The reason for this, in many cases, is that independent directors themselves do not have the complete picture of the company's affairs and find it difficult to monitor promoters. Further, they often find it difficult to pinpoint wrongdoing even when they are aware that the company affairs are not what they are portrayed to be. In a number of such cases, independent directors may have no option but to resign. A recent study found as many as 1344 independent directors to have resigned from the boards of listed companies during the financial year ended March 31, 2020.[12] Such resignations can serve as an effective way to highlight issues in a company. For example, in the case of PTC India Limited, an independent director resigned from the board citing "serious governance issues with several defaults of the Companies Act and the SEBI LODR Regulations".[13] Such resignation followed the resignations of three other independent directors from the board of the company's subsidiary, PTC Financial

[12] K. Vijayaraghavan et al., *Exodus of Independent Directors Gains Pace on Reputational and Legal Concerns,* ECON. TIMES (Sep. 7, 2020) http://www.primedatabasegroup.com/newsroom/M486.pdf.

[13] Letter from Rakesh Kacker et al., Independent Director, PTC India Ltd., to National Stock Exchange of India Ltd. (Jan. 21, 2022) https://www.bseindia.com/xml-data/corpfiling/AttachHis/f8ce1c15-1bcd-45b4-8ded-258d0c945c79.pdf [hereinafter Rakesh Kacker].

Services Limited, who had flagged issues in loans that had been granted by PTC Financial Services and complained that the management of the company did not pay heed to the independent directors' advice or share relevant information with the board.[14]

There are examples at the other end of the spectrum as well. For example, in the case of Future Retail, Amazon intervened in Reliance's proposal to acquire the company and successfully brought an end to the acquisition through litigation proceedings.[15] Subsequently, independent directors on Future Retail's board wrote to the Competition Commission of India ("**CCI**") requesting the CCI to revoke the approval that it had granted to Amazon for its investment in Future Coupons Private Limited (Future Retail's promoter entity).[16] Notably, these representations have been made almost three years after Amazon's investment in Future Coupons Private Limited – the timing of the representations alone leads one to question the motives of the independent directors.

Independent directors also have a duty to hold other directors to account and question them when they believe that such directors' actions are not in the best interests of the Company. For instance, in the case of Zee Entertainment, the company's managing director has admitted that when he had received an acquisition offer in February 2021, he did not present the offer to the board (or even keep the board informed of the offer) because "in his considered view, the deal was not in the best interests of the public shareholders"[17]. When the February 2021 proposal become public in October 2021, the managing director's reasoning seems to have been accepted by the board on the face of it without any questions being

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[14] *Id.*

[15] Utkarsh Anand, *Decoding the multilayered Amazon-Future-Reliance legal drama*, HINDUSTAN TIMES (Jan. 10, 2022) https://www.hindustantimes.com/india-news/decoding-the-multilayered-amazon-future-reliance-legal-drama-101641839370846.html.

[16] Indu Bhan, *CCI suspends Future deal, fines Amazon*, FIN. EXPRESS (Dec. 18, 2021) https://www.financialexpress.com/industry/cci-suspends-future-deal-fines-amazon/2382815/.

[17] Rakesh Kacker, *supra* note 13 at 36.

raised as to his disclosure obligations to the rest of the board.

Such examples underscore that in many instances, independent directors may be independent in name only. They are brought on to companies' boards only for the purpose of meeting the requirements set out in the Companies Act and LODR Regulations and do not, in reality, serve as a check on the promoters or the executive management.

V. EXPERIENCES FROM THE UNITED STATES

In the United States as well, the efficacy of having independent directors on companies' boards has been questioned including the very belief that "outsiders are well-equipped to monitor insiders and that independent supervision is the best way to increase the company's performance".[18]

Regulators have generally not pursued actions against independent directors for a failure to act although, in certain instances, they have held independent directors liable for wilful neglect. For example, in the case of DHB Industries, a supplier of body armour to the U.S military, the Securities and Exchange Commission ("**SEC**") brought an enforcement action against certain independent directors. In this case, DHB had been found guilty of accounting and disclosure fraud, and certain executives of DHB were found to have misappropriated the company's assets. The SEC found that the company's executives were able to carry out their scheme for over three years because its independent directors and audit committee members were "*were willfully blind to numerous red flags signalling accounting fraud, reporting violations and misappropriation at DHB...they ignored the obvious and merely rubber-stamped the decisions of DHB's senior management.*"[19]

However, in addition to regulatory action, checks and balances take

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[18] S Burcu Avci et al., *The Elusive Monitoring Function of Independent Directors*, 21(2) U. PA. J. BUS. L. (2018).

[19] SEC v. Krantz, Chasin, and Nadelman, No. 0:11-cv-60432-WPD (S.D. Fla. filed Feb. 28, 2011).

another form as well in the United States – that of shareholder derivative actions. Essentially, a derivative action is a suit brought by a shareholder on behalf of a company to assert a cause of action against a person (usually a director) who has committed a wrong against the company where the company itself has failed to sue for its injuries. Note that such actions are different from remedies such as oppression and mismanagement available under the (Indian) Companies Act since: (a) they are meant to address wrongs against the company itself rather than against its shareholders (b) are common law remedies not codified in legislation.

Such actions against directors are quite common in the United States and act as a threat to ensure that directors discharge their duties with diligence.

For instance, in the case of Boeing, the company's shareholders sued its directors in connection with two airline crashes involving Boeing Max 737 aircrafts which resulted in the death of 346 passengers and the grounding of all 737 Max aircrafts. The shareholders alleged that the company's directors and officers had breached their fiduciary duties by failing to effectively supervise the aircraft's design and development. They further argued that the directors had ignored various safety-related red flags.[20] The derivative claims, in this case, were pursued by the New York State Common Retirement Fund and the Fire and Police Pension Association of Colorado, who were institutional shareholders in the company. The directors against whom the claims were pursued included several independent directors who were retired executives as well as former employees of various US government bodies. The proceedings ultimately concluded with the filing of a settlement agreement which included a $237 million cash pay-out. The directors further agreed to implement an

[20] *Verified Amended Consolidated Complaint*, IN RE THE BOEING COMPANY DERIVATIVE LITIG., CONSOL. C.A. NO. 2019-0907-MTZ (DEL. CH.) SETTLEMENT WEBSITE (Feb. 5 2021), https://boeingderivativesettlement.com/wp-content/uploads/2021/12/02-05-21-Boeing-Public-Version-Amended-Complaint.pdf.

ombudsman program providing employees with a channel to raise safety-related issues.[21]

In the case of ***Blue Bell Creameries***,[22] one of the USA's largest ice cream manufacturers, a listeria outbreak in 2015 caused the company to recall all of its products, shut down production at all of its plants, and lay off over a third of its workforce. The outbreak also resulted in the death of three persons. Less consequentially (but significantly to the litigation), Blue Bell suffered a liquidity crisis that forced it to accept a dilutive private equity investment. The derivative claim brought by one of the company's shareholders alleged that two of the company's officers had knowingly disregarded contamination risks and failed to oversee the safety of Blue Bell's food-making operations and that the directors had failed to exercise their duty of care. The court found that "*the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed consumers to listeria-infected ice cream, resulting in the death and injury of company customers*".

Derivative actions themselves are, however, not always successful. For example, in the case of Capital One, the shareholders of the company brought an action against its directors for failing to monitor Capital One's compliance with anti-money laundering laws.[23] This was preceded by a consent order passed by the Office of the Comptroller of Currency which found that Capital One had failed to adopt and implement a compliance program and that it had an inadequate system of internal controls and ineffective independent testing. The Court of Chancery in Delaware, however, ultimately dismissed the derivative claim against the company's directors stating that directors can be held liable only when they had actual knowledge of corporate misconduct and consciously disregarded their duty

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[21] *Stipulation and Agreement of Compromise, Settlement, and Release*, IN RE THE BOEING COMPANY DERIVATIVE LITIG., CONSOL. C.A. NO. 2019-0907-MTZ (DEL. CH.) SETTLEMENT WEBSITE (NOV. 5, 2021), https://boeingderivativesettlement.com/wp-content/uploads/2021/12/boeing-settlement-agreement.pdf.

[22] Marchand v. Barnhill, C.A. No. 2017-0586-JRS (Del. Ch. June 19, 2019).

[23] Reiter v. Fairbank, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016).

to address that wrongdoing.[24]

Irrespective of the success or failure of individual cases, the larger point remains that the threat of shareholder litigations looms large in the United States. This potentially acts as an important factor in incentivizing directors to exercise care and due diligence in discharging their duties.

VI. DERIVATIVE ACTIONS AGAINST DIRECTORS IN INDIA

Derivative actions against directors are not uncommon in India. However, they tend to be pursued in instances where directors have defrauded the Company, such as by siphoning off funds. For example, in the case of ***Genelec***,[25] an action for winding up was pending against the company. Before any order could be passed for the appointment of a provisional liquidator, certain properties were sold by Genelac's directors to other companies at a significant discount to the properties' market value. The plaintiff who was a shareholder in the company was able to successfully pursue a derivative action against the directors before the High Court of Bombay.

In the case of ***Paramount Coaching***,[26] the plaintiff was a shareholder who held 50% of the share capital of the company. The derivative action was filed by him against his wife who was a director of the company and who owned the remaining 50%. It was alleged that she had incorporated another company for the purposes of competing with Paramount and had diverted business, staff, customers and funds, from Paramount to such company. The Delhi High Court held that a derivative action was maintainable against the director and that she had breached her fiduciary duties to the company. It further issued an injunction against her and her new enterprise preventing them from using the mark "Paramount" and

[24] *Id.*
[25] Nirad Amilal Mehta v. Genelec Limited, [2008] 146 CompCas 481(Bom).
[26] Rajeev Saumitra v. Neetu Singh, CS(OS) No.2528/2015.

from competing with the company.

In the case of ***Gharda Chemicals***,[27] a derivative action was pursued against one of the directors of the company for registering certain patents in his name rather than in the name of the company. The Supreme Court, while holding that a derivative action would be maintainable, ultimately dismissed the case since it found that the plaintiff, who had pursued the claim as a minority shareholder, was in fact a competitor who did not appear to be acting in good faith.

From these cases, what is evident is that derivative actions in India tend to arise in cases where executive directors have committed fraud or deceit and, in some instances, are used by shareholders to settle personal scores. There have not been any significant derivative litigations where shareholders have attempted to hold directors of companies liable for losses faced by the company for lapses in management – there have been several instances of corporate governance failures where such actions would have been appropriate. This can, perhaps, be attributed to a few factors. First, litigation in India can be time-consuming. The judicial system is difficult to navigate and shareholders (especially retail investors) have little incentive in spending time and money on pursuing such actions. There is a significant amount of uncertainty in recovery as well. Secondly, derivative actions require several minority shareholders to cooperate – and accordingly, suffer from a collective action problem. Shareholders are thus, more likely to dispose of their stake in companies that have generated losses for them rather than try to recover them.[28]

VII. CONCLUSION

In the absence of a better remedy to poor corporate governance, the role of independent directors remains a crucial one – oversight is necessary

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[27] Darius Rutton Kavasmaneck v. Gharda Chemicals Limited, 2014 AIR(SCW) 6441.

[28] Umakanth Varottil & Vikramaditya S. Khanna, *The Rarity of Derivative Actions in India: Reasons and Consequences*, in THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH (D.W. PUCHNIAK et al ed., Cambridge University Press 2012).

from within companies since regulators and the general public are only aware of what is disclosed to them. While criminal and regulatory sanctions may be possible in certain cases, the threshold for imposing such sanctions should be high.

So far legislative efforts have focused on strengthening the process for appointment of independent directors and narrowing the criteria for establishing independence. However, this has not yielded the desired results. This is evident from recent instances of corporate governance failures.

In situations of lapses in management which may not reach the level of criminal wrongdoing, shareholders need to take up the mantle of holding directors to account in cases where companies face losses on account of mismanagement. While individual or retail shareholders may not have the resources to pursue such litigations, institutional shareholders are well placed to play this role. There have been emerging trends of institutional shareholders playing a more active role in India than has been so far the case; the authors submit that this trend will become significantly more pronounced in the foreseeable future.

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