INDEPENDENT DIRECTORS: A FLAWED PRESCRIPTION FOR CORPORATE GOVERNANCE

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Abstract

This paper examines the concept of the independent director with reference to the agency theory of corporate governance. In the Indian post independence business scenario, events leading to the current situation in corporate governance, the development of demands for independent directors and their role form the basis for the discussion. Arguments for and against independent directors and factors affecting their efficacy are analyzed in depth. Some possible suggestions which might help in mitigating the effects of the factors hindering the effective functioning of independent directors are discussed, clearly recognizing the systemic changes which might be required. Some suggestions also appear to be worse than the problem itself. Finally the effectiveness of independent directors is studied. Ultimately, while some solutions are recommended for the Indian situation the conclusion is that independent directors are also agents and cannot ensure corporate governance.

Key words*: corporate governance, Indian business, role of independent directors, motivation of independent directors*

1. Introduction

Prior to independence, British corporate practices were generally followed in India. Before the concept of joint stock companies spread and became popular, businesses were generally proprietary or family owned and run. The earliest companies (such as The East India Company) had a board of governors, who were later called directors. Businesses ran more on trust rather than excessively formal control systems. For a long time Indian family businesses were operated through managing agencies, which was also based on the British practice. In such groups, any company's directors' roles were nominal.

Indian Corporates Post Independence

Till the late 1950s there was little distinction between private and public limited companies, until the Companies Act 1956 came into force. (It may be noted that even though the act was passed in 1956, the rules and regulations by which the act was actually implemented in practice would have taken some more time to be framed and therefore the full effect of the act would have been felt only after some time lag, perhaps by about 1960.) Most businesses were still run under the managing agency structure till 1970 when the managing agency system was abolished completely. When the managing agency was abolished, the companies in the family businesses at least notionally became independent of each other, providing a greater role to the management. Almost at the same time, 14 major banks belonging to the private groups were nationalized in 1969. In addition, borrowings by private groups from the nationalized banks were severely restricted. Then, with the passing of FERA in 1973 many MNC companies were forced to offer their shares to the Indian public thereby becoming listed on the stock exchanges.

Finally, Dhirubhai Ambani going directly to the public to raise funds in 1977, established a new paradigm in the Indian financial markets.

Subsequently, based on the debt-equity ratio norms, borrowings became easier and substantial amounts were involved. Listed public companies benefited from a large amount of public funds. Consequently the appointment of "Outside Directors" (eminent personalities or professional experts) became the practice and incidentally the activities of managements came under review. In particular, development financial institutions that were either large lenders or equity investors in companies took the opportunity to place their nominee/s on the board to protect their interests. (It may be noted that conflicts of interest were present even at that time. For example, in case of a group of companies having the same promoter/s, an accountant might be a director on the board of some companies as well as simultaneously being a statutory auditor of some other companies of the same group.[1])

During the last decade and a half or so, corporate governance issues have come to the forefront in India, partly as a fall out of the various stock market scandals, vanishing companies and the like and also because of the entry of more savvy investors, including Foreign Institutional Investors, Mutual Funds, Private Equity funds etc. This trend was also strengthened after the corporate scandals in US and elsewhere. In 1996 CII set up a task force under the chairmanship of Mr. Rahul Bajaj to suggest a corporate governance code. Thereafter in 1999, the Securities and Exchange Board of India (SEBI) appointed the K. M. Birla Committee on Corporate Governance to suggest measures to improve the standard of corporate governance in listed companies. Out of these deliberations the concept of appointment of independent directors on the boards of listed public companies was suggested with the expectation that it would improve corporate governance.

Definition of Corporate Governance: Protection of Investors

Whether recognized at that time or not, the financial innovation which was the creation of the concept of joint stock company, with a number of non-management shareholders who were given the protection of limited liability, was effectively founded upon the separation of ownership and management. The absentee owners would put up the funding, or part of it, and the actual operations of the firm would be entrusted to others (who might also be part owners) who would in turn share the profits with the owners. From that point onwards there was always a potential for a conflict of interest between the managers and the owners[2]. For the purpose of this discussion, corporate governance is that aspect of management which is concerned with ensuring that companies make and implement ethically sound decisions that are in the best interests of the shareholders and in accordance with the laws of the land. It, therefore, primarily deals with the exercise of fiduciary responsibility. This definition is different from some of those used elsewhere, especially those espousing the 'stakeholder' theory of governance, because, the other so called 'stakeholders' such as customers, employees, creditors etc, have recourse to legal options and mechanisms such as consumer courts, unions, labour commissioners and labour courts and legal provisions and these types of protection are generally not available to shareholders.

Definition of independent directors

The Indian definition of independent directors as originally given by the Securities and Exchange Board of India (SEBI) , (*vide* its circular dated February 21, 2000) was as follows: "the expression 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors."

Thereafter some amendments or clarifications were made by SEBI *vide* their circulars dated March 09, 2000, September 12, 2000, January 22, 2001, March 16, 2001, December 31, 2001. Most of these dealt with matters such as whether institutional nominees could be considered independent or not as so forth. However, the major amendment relating to the definition of independent directors was in the master circular dated October 29, 2004, where the definition was amended to mean "a non-executive director who 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; is not related to promoters or persons occupying management positions at the board level or at one level below the board; has not been an executive with the company in the immediately three preceding financial years; is not a partner or an executive or was not partner or an executive during the preceding three years, of the statutory audit firm or the internal audit firm that is associated with the company or the legal firm(s) and consulting firm(s) that have a material association with the company; is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares".

Thereafter some more clarifications and amendments to clause 49 were made *vide* circulars dated March 29, 2005, January 13, 2006, April 08, 2008. In the circular of April 08, 2008, it was also made necessary to disclose the relationships between directors in the annual report and other documents.

The Perceived Need For Independent Directors

While the need for independent directors has been discussed for some time, the demand arose because of information that emerged about the unethical, and more importantly fraudulent and illegal way in which a number of high profile companies were managed resulting in their collapse (Bajaj, 2005). It was felt that in addition to their professional expertise independent directors could provide some checks and balances (Thakur, 2005) protecting the shareholder's interests and in the process also the organization's own position, since governance failure ultimately threatened not merely the minority shareholders but the viability of the organization itself (D. K. P.

Rao, 2009). Similarly Maitra (2009) notes that independent directors are required because of the possibility of conflict in interest between the promoter shareholders and the other shareholders, with the promoters trying to maximize their gains at the cost of the others.

2. Usefulness And Effectiveness Of Independent Directors

The arguments about the efficacy of independent directors have centered round various issues a number of which are analyzed below. The second section is specifically concerned about the Indian scenario, and the section following thereafter considers more generic issues.

Role Expected Of Independent Directors

Maitra (2009) believes that independent directors should be alert and act to protect the interests of the minority shareholders and the welfare of the company in general. They should be able to get any information they require and should dissent to any decisions they are doubtful about. Vedpuriswar (2005) appears advocate a dual role partly as management and partly as a second line of auditors cum detectives who would independently collect data to cross check various activities. S.L. Rao (2009) falls somewhere in between and states that independent directors should carefully examine all proposals and if required call for a fresh evaluation. It would appear that while these views essentially are different points along a spectrum, expecting independent directors to play the dual role of management and auditor would appear to be a difficult balancing act, not to say impractical.

Indian Situation

As has been forcefully argued by Bajaj (2005), the Indian scenario is considerably different from that prevailing in the west particularly in the USA. In fact even among the western developed countries, there is little consensus much less unanimity about the type of corporate structure that is ideal. The German two tier structure for example has representatives of labour on the board which would be quite unimaginable in the UK or the USA. With specific reference to the US, most of the large listed corporations are managed by "professionals" with no connection to the original founders, promoters or public shareholders. The governance problems faced there are, in general, therefore quite different from the ones faced in India, where the promoters in general hold a significant shareholding in the company.

Bajaj (2005) and Thakur (2005) argue that in Indian firms since the promoters have large stakes in the companies managed by them their interest are congruent with those of the non promoter shareholders and that therefore, solutions which are proposed for the agency problem which is the root cause of the problem in the US are not pertinent here. However, Bajaj (2005) does accept that the public perception of Indian managements is that they enrich themselves at the benefit of their shareholders and concedes that this may be true in some cases. On the other hand Thakur (2005) takes an extremely strong stand terming the requirement of 50% independent directors as "almost expropriation". This stand is justified on the assumption that the promoters control significantly more than 50% of the shares.

However, expropriation would arise in practice only if it is also assumed that the independent directors would necessarily oppose the promoters or, in any other way, act contrary to a board packed with promoter nominees. This logically leads to the question of why independent directors would do so. If the decisions taken by the promoter are in good faith and in the best interests of the company (and this means the non promoter shareholders as well) why should the independent directors oppose the promoters? As a counter example, consider the case of the late Dhirubhai Ambani and Reliance Industries; without reference to anything else, his goodwill among his shareholders was such that he could have done almost anything, irrespective of the composition of his board. Clearly the problem with some promoters is that for what so ever reason they are unable to allay the doubts their fellow (non promoter) shareholders have about them; else why the clamour for independent directors? Perhaps what is not mentioned is that perhaps the other shareholders have good reason to be suspicious about promoters taking decisions that enrich themselves at the cost of the minority shareholders. For example, Subramanian (2009) indicts a number of companies for taking decisions which simply ignore the interests of minority shareholders. including: Crompton Greaves who invested Rs. 225 crores for a 41% stake in a group company, Avantha Power at approximately twice the value estimated by JP Morgan; Siemens who sold off its infotech subsidiary to its parent at apparently a lower price and had put through a similar deal in the past; Sterlite who wanted to swap better quality mining assets with a group company Malco in return for higher cost and poorer quality assets; and Larsen & Toubro who invested Rs. 650 crores for a 12% stake in Satyam, It may be noted that the short list here includes a whole spectrum of possible promoter and ownership patterns: one foreign MNC (Siemens), one reputed and so called professionally managed Indian company without any significant promoter interference or control (Larsen & Toubro) and two profitable Indian family business firms (Crompton Greaves and Sterlite). Clearly the malaise is not restricted to promoter managed companies.

Thakur (2005) also anticipated that managements would be reluctant to induct a large number of outsiders as independent directors. However, ultimately, managements could offer little resistance as SEBI introduced the change through the back door by requiring exchanges to modify the terms of the listing agreement, mandating that independent directors should comprise at least one third or half the board depending on whether the chairman was classified as executive or non executive, through the inclusion of a new clause (Clause 49) in the listing agreement. In addition clause 49 also specified the composition of the various board committees such as the Audit Committee,

More Generic Issues

In a more general (i.e. not necessarily India specific) context, various issues have been raised about governance and independent directors, which are briefly dealt with below.

I. What matters is the quality of independent directors and not merely the number of independent directors. Bajaj (2005) provides the example of S. L. Kirloskar and argues that the presence of one such person can be more than enough rather than simply having a large number of what he calls 'definitional independent directors'. This appears to be a valid concern, since mere stipulation of quantity cannot ensure quality. There appears to be little reason to assume that corporate governance is a linear function of the number of independent directors.

ii. The presence of independent directors should not become a paralyzing factor when managements need to take decisions (Bajaj, 2005). The whole-time directors and managers are the people who are engaged in running the business and they should be allowed to do their jobs. This also appears to a valid apprehension since from the point of view of governance inaction can be just as bad as action.

iii. The market exercises control over promoters (Bajaj, 2005). Talking about control from the market place is fine, but how is that control going to be exercised? Hostile takeovers have been unpopular with Indian corporates ever since Swaraj Paul tried to take over Escorts and DCM in the mid 1980s. It has only gotten more difficult to do so with the passage of the Substantial Acquisition of Shares and Takeovers Regulations by SEBI in 1997. Saying that promoters cannot be unfair to any shareholders and expect to go unpunished is a bit like the theory of *karma*, but *karma* depends on divine dispensation. Most people have somewhat less faith in the market, since all these results apply only in the 'long run' which is subject to Keynes' famous dictum. Furthermore, even if there were a competitive market for control i.e. to say if hostile takeovers were permitted without impediment, then poorly performing managements might be penalized. But the argument is not only about poorly performing managements, but about crooked managements, who may never the less perform well at points in time. In any case, in India hostile takeovers are practically non-existent. Therefore, relying on the marketplace to discipline promoters seems more than a little optimistic. Perhaps, companies whose companies lack credibility are discounted at a higher rate (have a lower P/E ratio), but it remains to be seen how important this factor is. However, this matter of valuation arises only if the management wants to raise money from the stock market or sell their stake.. Otherwise one might equally argue, like Warren Buffett, that lower valuations mean that you can buy shares cheaper and increase your stake at a lower cost.

iv. Bajaj (2005) notes that certain acts are illegal, and need to be dealt with legally rather than by independent directors. This would appear to be a very valid point: acts, which are illegal, must be dealt with swiftly, by the law, and the punishments must be exemplary and deterrent without allowing for any excuses such as 'first time offender', 'well intentioned' and the like. The question is: how is it possible to protect against such acts and on the other hand to detect such acts once they have taken place?

v. A number of authors (Bajaj, 2005; Maitra, 2009; D K Rao, 2009; S.L. Rao, 2009; and Thaakur, 2009)) observe that in case the promoters hold a controlling stake (in practice, even a large stake might be sufficient) then the independent directors are actually appointed by the promoters and therefore, the extent of their 'independence' would be constrained. Bajaj also notes that in addition, their remuneration is decided by the management and worse still as noted by Maitra, the total quantum of remuneration is linked to the company's performance. Thaakur (2009) on the other hands agrees that the first loyalty of independent directors is to the promoter who chose them, but believes that independent directors are not adequately compensated (in accordance with the time and effort required for them to fulfill their role)

vi. Independent directors may not be well versed with the business and it might be easy to mislead them about the operations and performance of the organization. There is a limit to what one can expect from them (Bajaj, 2005). A related point made by S.L. Rao (2009) is that independent directors often do not have any business expertise. Thakur (2005) adds that in such situations independent directors contribution may actually be detrimental, to the organization.

vii. Independent directors don't exercise their powers and perform the role expected of them. Satyam's board had five independent directors who were all renowned in their own fields, however it appears that none of them had any idea about the fraud (Maitra, 2009). (Or so they appear to claim.) Thaakur (2009) comments that independent directors do not exert themselves because they know fully well that in practice their opinion does not matter.

viii. Thaakur (2009) observes that there is no real compliance mechanism to ensure that managements pay attention to their independent directors. A similar point is also made by Maitra (2009).

ix. Thakur (2005) observes that there is a shortage of qualified individuals to serve as independent directors.

3. Possible Solutions

Suggestions to facilitate the functioning of independent directors (points (v) to (ix) above) are discussed in this section. The points discussed under (d) – (f) below include what may be considered the more controversial ideas or extreme measures.

(a) Attention should be focused on ensuring that non promoter shareholders are represented on the board (Thaakur, 2009; and Ghaisas, 2009). This suggestion is based on the case of promoters who do not hold a majority stake and yet are able to control the board. Thaakur recommends that in particular the large shareholders such as institutions and mutual funds should work together and seek that directors of their choice are nominated to the board. This is an interesting suggestion, but two points arise. The first is that at present, in India, there is no provision for pro rata appointment of directors or representation on the board. The laws and regulations will need to be amended to incorporate this. The second is that even at present government institutions (either lending or investment) do get to place their nominees on the board and these nominees are classified as independent directors by SEBI. However, in India, their ability to ensure governance appears to be minimal and remains to be conclusively determined. In the US on the other hand, institutions like California Public Employees' Retirement System (CalPERS) are able to make their voice heard and also provide guidance and actively lobby other shareholders to vote with them.

(b) Since independent directors must be competent in business management, new directors should go through a training programme with refresher courses at suitable intervals (S.L. Rao, 2009; Thaakur, 2009). Thaakur also suggests that an independent body should be set up for this purpose and to provide advice and guidance to independent directors who seek it. A related aspect is covered by Maitra (2009) who observes that one requirement is that at least some of the independent directors should have a good knowledge of the industry the company is operating in. This suggestion would appear to be a reasonable one as otherwise, the number of competent individuals is likely to be very small. However, establishing yet another body for independent directors might benefit from further thought, because in addition to company secretaries and accountants, independent directors would become just another statutory requirement with more potential for controversy due to overlapping functions and responsibilities.

(c) Independent directors should be allowed to publicize their dissent if the majority decision goes against them (Maitra, 2009). This is also an interesting suggestion, but several points arise. First, at present board minutes are not made public or even disclosed to the shareholders. Some legal mechanism or provision has to first be provided. Then there are procedural aspects: how to publicize the dissenting vote? What significance should this have? Should it merely be mentioned i.e. number of dissenting votes cast or should the subject matter be mentioned or explained in detail as also the position of the dissenting member? Finally, after all this, what is the next step? Does a dissent automatically mean that there is something wrong? In other words do independent directors have *de facto* veto power? After all it is quite possible that there can be honest disagreement. What about situations wherein the independent directors disagree among themselves? All these issues need to be thought through and clarified.

(d) SEBI can maintain a list of individuals who can potentially possibly act as independent directors from which companies can appoint independent directors (S.L. Rao, 2009). Alternatively SEBI or the government can be empowered to nominate some independent directors from a panel formed for this purpose (D. K. Rao 2009). Both these suggestions have a number of issues which need to be resolved. First, as D. K. Rao (2009) himself points out; the right of the shareholders (to appoint directors) is being completely taken away. Second, there is no guarantee that SEBI or government nominees will perform any better, as already discussed in the context of institutional nominee directors above. Third, in India and possibly elsewhere, where there is income, there is a source and where there is a source, lobbying will start! This will affect the composition of the panel as well as who gets nominated where, and furthermore, when the government becomes involved, it becomes even more difficult to ensure governance! Surely, on an average, the organization with the worst governance record, (by a very large margin), is the government ·? And, by involving that same organization with the poor governance record, how is it possible to improve governance, or punish delinquent individuals?

(e) Most independent directors are retired persons and the director's remuneration paid to independent directors is much higher than what they might have earned in the past. Therefore, they become reluctant to do anything such as dissenting with the management or even raising difficult queries that might jeopardize this source of income. S.L. Rao (2009) observes correctly that this problem will solve itself over time since salaries are much higher now, but recommends that independent directors should not be highly paid in the interim. Maitra (2009) also notes the possible problem about directors joining boards just to earn money and suggests that companies should instead appoint directors who are working and possess a stable income rather than a retiree who might be more swayed by the potential loss of income. While the point raised by these two authors does appear to be valid, their suggestions seem to be perverse. The question not answered by S. L. Rao (2009) is why anyone would want to become an independent director and risk imprisonment even for a misjudgment if they are not even going to be well paid? Likewise, Maitra (2009) appears to undercut his own position about the active role of independent directors. If the independent directors are employed full time elsewhere, where will they have the time to do justice to their role and discharge their duties as an independent director? There appears to be some disagreement about these points with Thaakur (2009) suggesting that retirees are particularly well qualified to act as independent directors with adequate and transparent compensation.

(f) In order to weed directors who do not contribute, S. L. Rao (2009) suggest the use of confidential peer appraisals by the directors and top level managers. This is an intriguing suggestion, but for one thing it is handing back power to the promoters and management to remove directors they find troublesome. Furthermore, while the idea of appraisal at these levels is on the face of it a good one, implementation is likely to become a contentious issue especially for independent directors.

With respect to many of the suggestions made above, what many of the authors appear to overlook is that SEBI has already provided wide ranging powers to the directors and in particular the audit committee *vide* its master circular of October 2004. Briefly, the powers given to the audit committee include the right "to investigate any activity within its terms of reference; to seek information from any employee [and] to obtain outside legal or other professional advice". The role of the audit committee includes 13 items (not counting sub-clauses separately), including review of "any internal investigations" and the list is not exhaustive because the 13 item is "Carrying out any function as is mentioned in the terms of reference of the Audit Committee." Another five items require to be mandatorily reviewed including analysis of finances and operations. Finally there are 15 items regarding which information is to be placed before the board of directors including the operating plans budgets quarterly results, the minutes of all the board committees and the non-compliance report [7]. Admittedly, the independent directors may have to depend on the information provided to them, but SEBI has provided considerable powers provided people are willing to exercise them.

4. Lack Of Clarity On Scope And Limitations Of Role And Liability

D. K. Rao (2009) notes that since independent directors do not constitute a majority, it is always possible that the final decision or conclusion may be other than what they might have chosen. Maitra (2009) (contrary to Vedpuriswar (2005) above) does not believe that the independent directors should act as policemen and notes that independent directors are not usually involved in the daily operations of the firm. S.L. Rao (2009) observes that independent directors are dependent on the information given to them. Therefore as long as they are not knowingly involved in any fraudulent activities they cannot be held liable. Majumdar (2009) relates the problems associated with over zealous prosecution of independent directors with the example of Nimesh Kampani. (chairman of JM Financial) who was a director of Nagarjuna Finance. Despite the fact that Kampani resigned in 1999 more than a year before Nagarjuna Finance defaulted in repaying its depositors, a case was filed against him (which was finally resolved after many months during which time he was a fugitive and forced to remain abroad). Both D. K. Rao (2009) and Maitra (2009) accept that independent directors are accountable for their actions or inactions. However, as Maitra notes, at the same time, they should not be held accountable for the actions of others.

Clearly, the role of the independent director needs to be clarified satisfactorily. Otherwise the first time any independent director is held accountable and penalized, all or at least most other independent directors will promptly run away and no others will come forward to act as independent directors[8].

One additional point relates to the position of the independent director with respect to the ethics of the other commercial or business practices of the firm. In part this question arises, because some of the other frameworks in which corporate governance is discussed such as the stakeholder theory lead to some confusion as to the extent of involvement of independent directors in ensuring that ethical decisions are taken. Casual empiricism would appear to indicate that public perception is that independent directors are involved in all major decisions including operational aspects and are expected to ensure that ethical decisions are taken.

As an illustration, consider a situation, where the issue is not of shareholder interests but of ethics in general. For example, in the initial years of the break up of the Soviet Union, a number of companies including Indian companies rushed to do business there. However, in many cases, it was not at all clear that those who were representing the other side (i.e. the Russians or Kazaks etc) were actually authorized to undertake those deals. The impression given was that everything that was movable was being looted and sold off by those nominally in charge locally, for their own benefit, since there was a complete break down in accountability. However, on the other hand there were great bargains to be had. It was almost certain that there would be no comebacks. More squeamish companies always had the option of operating through intermediaries (for a price). In case the question of whether to get involved in such a business deal had come to the board for discussion what should the position of the independent director have been? From a strictly commercial perspective, the deals made good sense, and if any company had inhibitions, there were any number of others willing to take its place.

To take another example, a contractor quotes a rate much lower than his competitors and is awarded the contract. One of the other bidders complains that it would be impossible to even recoup his costs at the price quoted and backs his claim with detailed evidence. On examination of the matter it is found that the successful bidder is also the contractor on a number of similar government projects. The suspicion arises that material is being diverted from the government project or is otherwise being procured by questionable means. Is it expected that such a matter be brought to the notice of the independent directors, and is it a matter in which the independent director is expected to get involved?

Such aspects need to be resolved to the satisfaction of all parties concerned in order to have a common understanding of the duties and responsibilities of the independent director and any legislation or regulations should be drafted and implemented accordingly.

5. Flaw In The Theory Of Independent Directors: Independent Directors Are Agents Too

However, in all the discussion above, one question is neither asked nor answered: what motivates the independent director to act on behalf of the shareholder (or minority shareholder)? Or put another way, the crux of the matter is: What is the basis for the belief that independent directors improve governance? (Ref. point (vii) under the "general Issues" of section 2 and last para. of section 3.) If it has proven difficult to ensure that managers act in the interests of the shareholders, will not the same problem arise in the case of independent directors? As mentioned earlier Bajaj (2005) and Maitra (2009) note respectively that their remuneration is decided by the management and that the total quantum of directors' remuneration is linked to the company's performance and therefore, it can be argued that it would be in the independent directors' interest if the reported profits are manipulate to appear higher than they should be. This point needs to be conclusively settled; otherwise the independent director might turn out to be like that other elusive creature the heffalump: a chimera kept alive only as an imaginary abstraction with the good intention and pious hope that competent persons would lend their expertise to keep rapacious managements in check. Unless a valid explanation is found, all the discussions and suggestions made earlier will fail.

Fundamentally, in a joint stock company as elaborated earlier, the managers were supposed to run the company in accordance with the wishes of the shareholders. Now, because, in some cases, the managers appear to have neglected their fiduciary responsibilities, it is being proposed that a new group of people called independent directors be appointed to protect the interests of the shareholders; but that is exactly what the managers were appointed to do! In other words, if there is an agency problem between managers and shareholders, the same problem is likely to occur with independent directors and shareholders. Therefore, the theoretical foundation for the belief that independent directors will necessarily improve governance appears to be weak.

Unfortunately, even empirically, there appears to be little evidence to support the beliefs about the beneficial effects of independent directors, or a higher proportion of independent directors (Niskanen, 2003; S.L. Rao, 2009; and Vedpuriswar, 2005). As noted by these authors, for example, the Enron board was a model board with 12 outside directors in a board of 14 directors. Likewise, Satyam had a board with a number of eminent personalities as independent directors. It also received the Golden Peacock award for good governance for 2008 as well as various other awards earlier. (Strangely enough, as Vedpuriswar notes, Enron too received a good governance award before its collapse!)

Since much of the corporate governance mechanism in India (and elsewhere) has revolved around the institution of the "independent director", this lack of evidence gives rise to serious doubts about the usefulness of governance measures. To start with, independent directors were essentially a structural solution to a performance problem. The decisive proof of good governance is that good decisions are made. ('Good' as defined under 'Definition of Corporate Governance' in Section 1.) By prescribing that independent directors be appointed, the essential underlying idea was to introduce a check on bad decisions. The problem is that even the best managers can and do make mistakes. The question that arises is that if a poor decision is in fact made, what then? All bad decisions are not necessarily made by individuals with *male fide* intentions trying to steal the silver that belongs to some one else. Individuals with good intentions can have lapses of judgment. Taking decisions in an uncertain environment is like driving in a car at high speed in reverse gear, through a changing landscape, with only the rear view mirror available for navigation [10]. Once events are passed, then they are visible clearly through the windows and windshield and passengers and it is easy to criticize the driver/s.

How then is one to distinguish between well intentioned individuals making a poor decision and scheming sinister insiders running the company for their own benefit? One question that immediately arises is: "Who gains from the decision?" If it can be shown that the individuals with fiduciary responsibility have gained at the expense of the shareholders then the case for bad governance becomes that much stronger or vice versa.

Having said all this, it is important to point out that just as some companies are acknowledged to have have good managements, independent (outside) directors can, and doubtless often do, play an important role by providing expertise or a different perspective as compared to blinkered managements. They may even help in improving governance. However, if the prime function is policing, then perhaps they are not the most suitable mechanism. In the Indian context, however, since the crux of the governance problems are not primarily due to agency problems, but rather due to the conflicts between promoters/ majority shareholders and the minority shareholders, perhaps some of the solutions mooted like pro-rata representation and disclosure of the dissenting notes may prove useful.

Ultimately, as noted by Bajaj (2005) and S L Rao (2009), what is required is better enforcement of the laws. As S. L. Rao (2009) rightly observes, in actuality, all these requirements of independent directors, committees, whistle blower policy, and the like are unable to check promoters / managers from acting exactly as they used to do before these rules and regulations were passed. The non-promoter directors and particularly the independent directors, auditors, media, and shareholders must be vigilant and expose wrong doings. The statutory auditors in particular are granted access to all information and should be the first line of defense in the war against bad governance. But thereafter, the law must act swiftly and sternly. It might even be necessary to increase the penalties in some cases so that they act as a deterrent as in the case of the US. The public should not let themselves be lulled into complacency just because independent directors are present on the board of a company.

6. Conclusion

The concept of independent directors as understood in India has various shortcomings. By implementing certain measures to ensure that independent directors are actually so and perhaps by making changes to the regulations to permit pro rata representation, greater involvement by institutions and large shareholders, it may be possible to place qualified independent directors on the boards of public limited companies. Similarly appropriate changes need to be implemented to allow the dissenting notes of independent directors to be made public The role of the independent director needs to be clarified and some thought needs to be given to their motivation. However, the agency problem will continue to exist in the case of independent directors as well, and there appears to be little evidence that independent directors are actually able to improve corporate governance. On the whole given the shareholding pattern and management style independent directors cannot be expected to make any significant additional contribution.

One limitation of the analysis was that the role of independent directors was examined primarily with respect to the agency problem framework. However, since the agency framework is a relatively more focused approach it is unlikely that approaches that do not satisfy its requirements will satisfy the greater requirements of other approaches such as the stake holder approach. In addition, further study is required of the role of other participants such as auditors, shareholders etc in ensuring corporate governance.

Acknowledgements

The author wishes to thank a retired senior executive who wishes to remain anonymous for the considerable help with the historical details and his penetrating insights into the intricacies of the functioning of the top management and the board.

Notes

1. In fact this continued to be case even after 2000 till the guidelines were revised in 2004 making this more difficult.

2. One of the seminal works in this area is Jensen, M.C., and W.H. Meckling (1976), Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics, 3, 305-360. Interestingly, this paper in turn begins with a quotation from Adam Smith.

3. All information about SEBI, definitions, etc., obtained from SEBI website www.sebi.gov.in

4. "The long run is a misleading guide to current affairs. In the long run we are all dead." (A Tract on Monetary Reform (1923) Ch. 3.) Keynes was [apparently] criticizing the belief that inflation would acceptably control itself without government intervention. Source: Wiki quote (Retrieved on 27/4/2010)

5. ...as long as you're a net buyer of stocks, which we are at Berkshire, we want them to be cheaper. I mean, if they reduce the price of hamburgers at McDonald's today I feel terrific. Now I don't go back and think, gee, I paid a little more yesterday. I think I'm going to be buying them cheaper today. Anything you're going to be buying in the future, you want to have get cheaper. (Retrieved on 27/4/2010 from http://www.cnbc.com/id/35804198/)

6. For example, PSUs and PSBs are reported as flouting the requirements (of SEBI and RBI) such as separation of Chairman and Managing Directors' positions. Another case in point concerns the so called oil marketing PSUs, who are forced to market their products at administered (read "loss making") prices in complete violation of the minority shareholders rights.

7. In actual practice, rather than a non-compliance report, the company secretary prepares a compliance report on all legal or statutory regulations.

8. The facts have overtaken the analysis – several reports of independent directors resigning *en masse* have appeared in the press since the first draft of this paper.

9. Lest this strike some as an exaggeration: A news item reports that,

"In October 2008, thieves stole a 199-year old church in Komarova, Russia, brick by brick, leaving only parts of the wall and foundation!" (Times of India, New Delhi, April 15, pg 20 Ripley's Believe it or Not)

10. Doubtless this owes something to Peter Drucker: "Trying to predict the future is like trying to drive down a country road at night with no lights while looking out of the back window".

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