THE INDEPENDENT DIRECTOR: HAS IT BEEN INDIANISED ENOUGH?

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This paper looks at the institution of the independent director as a corporate governance tool, and assesses its effectiveness in the Indian context. This analysis assumes significance in light of the fact that the independent director, i.e., a company director who has no ties with the company’s management, emerged in the US against a completely different backdrop, and to tackle a completely different problem than what afflicts Indian listed companies. The problem that the independent director was conceived to tackle in the US is the agency problem between the management and the shareholders resulting from a dispersed shareholding pattern. However, the corporate setting in India is marked by the presence of a controlling shareholder, and hence the major corporate governance problem is the conflict between the majority shareholders (who often control the management) and the minority shareholders. This paper finds that while the institution might not have been conceived with this problem in mind, it can nonetheless be adapted sufficiently. The purpose of this paper is to examine whether this adaptation has taken place, and if not what further steps are required at the regulatory or legislative level. In this context, I have made a number of suggestions which I hope will make the independent director a more effective tool.

I. INTRODUCTION

“Citizens never support a weak company and birds do not build nests on a tree that does not bear fruits.”

– Salman Khurshid,1 quoting Kautilya’s Arthashastra

A general lack of accountability and the consequent failure of institutional structures is perhaps the greatest ill affecting Indian public life. This is a trend with few exceptions, and India Inc. is certainly not one of them. Over the last few decades, a fair bit of work has been done in both policy and

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1 Indian Minister of State for Corporate Affairs, Foreword to the Corporate Governance Voluntary Guidelines 2009.
regulatory circles to deal with this problem of trust deficit afflicting Indian corporations. Unsurprisingly, as is usual for Indian policymakers when faced with a tricky situation, they have looked at the West (particularly the UK and the US) for inspiration. At least one of the solutions that has been recommended and subsequently implemented appears to have been transplanted almost wholesale from existing Anglo-Saxon jurisprudence.\(^2\) The independent director is technically part of the board of directors but is divorced from the internal workings of the management, and is expected to monitor the board with a sense of detachment that the executive directors would not have.

From the Desirable Corporate Governance Code in 1998\(^3\) to Chapter 11 of the Companies Act, 2013, there has been a consistent and nearly uncritical endorsement of the independent director - a concept conceived in the US in the mid-20\(^{th}\) Century, and popularised further by UK in the 1990s.\(^4\) In this paper, I will dwell upon the office of the independent director in the Indian regulatory framework, and assess its workability particularly in view of the wide variances in the corporate cultures between India on the one hand, and the Anglo-Saxon core of the US and the UK on the other. Unlike American and British companies which are characterised by a widely dispersed shareholding pattern, most large Indian companies have concentrated shareholding structures with a powerful controlling shareholder.\(^5\) This, in my opinion is a major differentiating factor, and can almost render the concept a non-starter. In light of that, the efficacy or otherwise of the institution will be examined at two levels to assess whether the institution has the core fundamentals required to address the corporate governance issues in the Indian context – (1) Can a company director be ‘truly independent’?; and (2) Can an independent director be a solution to the majority-minority divide in Indian share registers? Based on the

\(^2\) It has been the stated intention of Indian corporate governance committee members that Indian corporate governance norms should be homegrown, although I doubt it has indeed been the case especially as far as the provisions relating to independent directors are concerned. See generally, CII Report, infra note 3, 1 (‘…one cannot design a code of corporate governance for Indian companies by mechanically importing one form or another’). See also, Kumar Mangalam Birla Committee Report, infra note 14, ¶ 2.6 (‘... to prepare a Code to suit the Indian corporate environment, as corporate governance frameworks are not exportable’).

\(^3\) Published by the Confederation of Indian Industry (CII) in 1998 following recommendations from a National Task Force under the Chairmanship of Mr. Rahul Bajaj, available at http://www.nfcgindia.org/desirable_corporate_governance_cii.pdf (Last visited on 2 August 2013).

\(^4\) The CII Report, as well as the SEBI Committee Report on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla, 1999 have acknowledged inspiration from previous policies implemented in the UK and the US. Also as will be discussed later in this paper, India has adopted corporate governance practices that are unmistakably based on either UK or US precedents. Also see Varottil, infra, note 16, 282 (The Cadbury Committee Report has led the development of corporate governance norms in various countries such as Canada, Hong Kong, South Africa, Australia, France, Japan, Malaysia, and India, just to name a few).

\(^5\) Shaun Matthew, Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities, 3 COLUM. BUS. L. REV. 800, 833 (2007) (“...the average BSE 100 company has a promoter who owns over 48% of the company). See, Annexure to this paper showing the recent shareholding patterns of BSE SENSEX 30 companies (Only five out of the thirty companies on the BSE SENSEX 30 have promoter shareholding of less than 25%).
findings to these questions, I will scout for solutions to this problem and in that pursuit examine institutions in other comparable jurisdictions.6

This paper will track the development of the idea of independent directors in general, and in India in particular. Chapter II will explore the motivations behind the origin and development of the institution in the US and the UK, and explore how it has been adapted for India. Chapter III will examine the theory underlying the institution, and discuss how the definition of ‘independence’ has evolved over time and what are the functions that the independent directors are expected to perform. It will also examine the Indian regulatory and legislative landscape including a detailed analysis of Clause 49 of the Listing Agreement and the new Chapter 11 of the Companies Act, 2013. Chapter IV will look into the inherent problems in the institution including the processes related to the nomination, election and removal of independent directors. It will also examine whether psychological factors can affect the performance of the directors and suggest solutions based on these findings. Chapter V will evaluate the performance of the independent directors against the stated objectives particularly in light of the legal and cultural peculiarities of the Indian corporate scene. In that chapter, I will also explore potential alternatives and suggest ways in which the institution can be made more effective.

II. WHY INDEPENDENT DIRECTORS?

In wake of the mega scandals that have rocked the corporate world lately, there has been much soul searching in policy circles around the world, and a level of consensus has been reached that large companies must be made subject to increased non-management supervision. However, there has been less agreement on the way in which this supervision should be carried out in practice.7 Amongst the many institutions that have been mooted, the idea of having an independent director has come to emerge as the forerunner. Perhaps the prime attraction of this institution is that, at least at a theoretical plane, it has the illusion of infallibility – having an independent director who sits in the same room as the senior managers when corporate decisions are being made, but is untouched by management dynamics, appears more likely than any other

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6 Most large Indian companies are characterised by the presence of a large controlling shareholder with the rest of the shares being dispersed amongst a wide body of small shareholders. The controlling shareholder is either a business family or the state. This shareholding pattern is seen in many other jurisdictions including most countries in Continental Europe and the People’s Republic of China (to name a few examples).

7 For example in most common law countries including the US, UK and India, the institution of the independent director has been accepted; whilst in civil law countries like Germany and Japan, the law prescribes a supervisory board with a mandate to monitor the management in the interest of its shareholders. China follows a hybrid model that includes both a supervisory board as well as an independent director.
institution to ensure accountability and to weed out board room corruption.\(^8\)

Prodded on by this theoretical cogency, many countries around the world have reacted warmly to the concept.\(^9\) It must however be admitted that it is by no means the only model of outsider supervision of the board that has been mooted or indeed practised. For instance, Germany has a two-tiered board with the task of supervising the management being vested with a separate supervisory board.\(^10\) Similarly in Japan, the idea of the outside director is often confused with the independent director whilst in reality there is no formal requirement for independence at all.\(^11\) China follows a curious supervisory structure characterised by the co-existence of both the German style supervisory board and the Anglo-Saxon independent director.\(^12\)

As for India, it is the independent director that has been almost unquestioningly accepted as the right model for outside supervision.\(^13\) Given its common law based legal system and a historical affinity to Anglo-Saxon style institutions, the choice is perhaps not surprising. The concept which was first introduced in the 1998 CII Report was enthusiastically endorsed by the Kumar Mangalam Birla Committee Report which asserted that the independent directors have "a key role in the entire mosaic of corporate governance" in India.\(^14\)

This faith in the person of the independent director has been reflected in vari-

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\(^9\) Jay Dahya & John J. McConnell, Board Composition, Corporate Performance, and the Cadbury Committee Recommendation, 2005, available at http://ssrn.com/abstract=687429 (Last visited on 2 August 2013) (Dahya & McConnell describes how during the 1990s, companies in several countries experienced the 'outside director euphoria' with at least twenty-six countries prescribing some form of outside representation in their respective corporate governance codes. It was believed that boards with more outside directors will lead to better board decisions and consequently better corporate performance).

\(^10\) German Corporate Governance Code, ¶ 5.1 says that the task of the Supervisory Board is to advise and supervise the Management Board in the management of the enterprise, and to be involved in decisions that are of fundamental importance to the enterprise. Whilst separate from the Management Board, ¶ 3 says that the Supervisory Board is expected to cooperate with the Management Board for the benefit of the enterprise. Also, ¶ 5.4 stipulates that the Supervisory Board should have an adequate number of independent members. An English translation of the German Corporate Governance Code is available at http://www.corporate-governance-code.de/eng/kodex/5.html (Last visited on 28 July 2013).

\(^11\) See, Clarke, infra note 18, 4. The term 'outside director' which is part of the Japanese regulation, is translated from the Japanese expression shagai torishimaryaku, appearing in Shōhō [Commercial Code], Japan, Art. 188(2) (7.2) (2002). Shagai torishimaryaku in Japanese literally translates to 'director from outside the company'.

\(^12\) See generally, S.H. Goo & Fidy Xiangxing Hong, The Curious Model of Internal Monitoring Mechanisms of Listed Corporations in China: The Sinonisation Process, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (2012) 469, 471 (Goo & Hong however assert that both these institutions are going through a process of Sinonisation in order to fit into the local business).

\(^13\) CII Report, supra note 3, 2 (The CII Report had rejected the German model of two-tier boards as part of Recommendation 1 without citing any particular reason).

ous committee reports and regulations and has eventually made its way into the statutory domain in the form of Chapter 11 of the Companies Act, 2013.\textsuperscript{15} The reception to the idea of the independent director has been so enthusiastic and consistent that it has come to be seen as the centre-piece of Indian corporate governance.

However, more recently and especially in light of the abysmal governance records of some large Indian companies, academics have started debunking the institution and are seemingly coming to the conclusion that the concept of the independent director might have been so neatly customised to the Anglo-American context that it may not work in other corporate systems.\textsuperscript{16} The concept was developed in the US where the primary corporate governance concern is the agency problem existing between on one hand, the shareholders who in theory own the company; and on the other, the class of professional managers. The agency problem arises because although the managers run the operations nominally for the benefit of the shareholders, they in fact often have separate agendas of their own.\textsuperscript{17} The share registers of most public companies in the UK and the US are characterised by the presence of large institutional investors who own sizeable holdings in the company, but not enough to be able to control its day-to-day operations. As these investors cumulatively hold a majority of the company’s share capital amongst themselves, the companies do not have a controlling shareholder. Also as the institutional investors view the investee company shares primarily as financial investments, there are fewer incentives for the shareholders to take part in the management. Given this skewed power dynamics, these companies are essentially run at the level of board meetings with the general meetings serving merely as a rubber stamp on key issues. If the board meetings are left to be driven by the management, the shareholders will not have much of a say in the running of the company at all. As can be expected, the managers of such companies come to accumulate significant clout and authority, and often pursue their own agendas which are not necessarily aligned with those of the investors. It was in the backdrop of this agency problem that the idea of having non-management directors germinated, with the expectation that these directors who are not beholden to the management will check managerial excesses and protect the interests of the shareholders. This idea has gone through various phases of evolution with consequent changes in

\textsuperscript{15} Companies Act, 2013, § 149 states that every listed public company shall have at least one-third of its board as independent directors. Further, it has been laid down that the central government may prescribe that other public companies should also have a certain percentage of its directors as independent directors. The Companies Act, 2013 also lays down a detailed list of criteria to determine independence, and also a code of conduct that independent directors are expected to follow.\textsuperscript{16} Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, (2010) 6 HASTINGS BUS. L.J. 281, 294. Also see, Urtiaga & Saez, supra note 8, 4-5.\textsuperscript{17} Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, 61 GEO. WASH. L. REV. 1034. (1993). Also see Id.,Urtiaga & Saez, 4.
However at its heart, the independent director by whatever name called, remains an institution designed to protect the interests of a dispersed body of investors from the excesses of a self-serving management. Whether or not this mission is being successfully accomplished is another question, and this paper will address that issue in some detail later.

In contrast to the American and British companies, the shareholding patterns of Indian companies are fundamentally different. Indian companies have traditionally been and still are, largely dominated by family promoters or controlling shareholders. In that regard, most Indian companies share similarities with companies in Continental Europe and also in other emerging markets. Several of the large Indian listed companies had their origins in modest family owned private companies or even sole proprietorships. As their operations grew, these enterprises felt the need to tap more capital and outside expertise; this road eventually leading to their shares being offered to the general public and institutional investors. However the promoter families have mostly retained a substantial shareholding, and often rather zealously (and even publicly) consider the listed company as an extension of the family heirloom. Given their large stakes, these controlling shareholders can easily control the board and the management; indeed several Indian listed companies

18 Donald C. Clarke, Setting the Record Straight: Three Concepts of the Independent Director, 4 (The George Washington University Law School Public Law and Legal Theory, Working Paper No. 199) (Clarke cites different terms being ‘non-interested’, ‘independent’, ‘outside’, ‘non-executive’, ‘non-employee’ and ‘disinterested’ which though literally connote different qualities, have been commonly used as if referring to the same thing. Please note that all these expressions originated in either the US or the UK; the only exception being the term ‘outside director’ literally translated from the Japanese expression shagai torishimariyaku, appearing in Shōhō [Commercial Code], Japan, Art. 188(2)(7.2) (2002). Shagai torishimariyaku in Japanese literally translates to ‘director from outside the company’).

19 Paul L Davies, The Board of Directors: Composition, Structure, Duties and Powers, Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends, December 7–8 2000, 3 (The expression ‘controlling shareholder’ is used in the same sense as Davies: “the ‘non-controlling’ shareholders may collectively hold more voting shares than the ‘controlling’ shareholders. However, if the non-controlling shares are widely dispersed, effective control of the company will lie in the hands of the block-holder, even if that block consists of less than 50% of the voting shares. In this paper the terms ‘non-controlling’ and ‘minority’ shareholders are used interchangeably, with some preference for the latter term...”). See, Annexure for a detailed shareholding pattern of some of India’s largest listed companies.

20 Urtiaga & Saez, supra note 8, 4-5.

21 For example, Reliance Industries Limited had its origins in a small textile company prior to its listing in 1977. Subsequently, the Reliance Group has grown to become one of India’s largest private sector enterprises with annual revenues in excess of US$ 66 billion. Whilst this story might be slightly exceptional, it is by no means the only story of a small privately held company eventually becoming a large public listed company. See, Reliance Industries Limited, Major Milestones, available at http://www.ril.com/html/aboutus/major_milestones.html (Last visited on 28 July 2013).

22 See, Annexure for detailed shareholding pattern of BSE SENSEX 30 companies (For example, as of June 30, 2013, the promoters hold 46.97% of Reliance Industries Limited. For Wipro Limited, the promoters hold 74.98% as of June 30, 2013, whilst for Bharti Airtel Limited, the figure is 65.23%).
have had a history of only having family representatives in senior managerial positions. Apart from family controlled companies, several Indian listed companies have the state as the major shareholder which poses a set of problems that English and American companies do not often have to deal with. Hence, it is evident that the prime corporate governance concern in India is not manager versus shareholder agency problem, but the protection of the minority shareholders from the excesses of the majority. In light of this, it is worth asking the question as to whether the institution of the independent director can serve its intended purpose in the Indian context at all, given the many local variables the original model would have never needed to contend with. Although there are some Indian companies which have diffused shareholding patterns, most large companies have a controlling shareholder. Any corporate governance regime would need to build in the flexibility to accommodate such variations. However for the purpose of this paper, I will work on the presumption that most Indian companies have a large controlling shareholder, although I will bear in mind the need for flexibility when suggesting remedies.

III. CONCEPTUALISING INDEPENDENT DIRECTORS

Although the concept of independent director has entered popular business lexicon relatively recently, early variants of this concept have been part of corporate jurisprudence for at least sixty years in one form or another. The genesis of the concept lay in the understanding that the agency problems arising in diffused corporate systems can be best resolved by separating the function of ratification and monitoring of decisions by the board, from the

23 See, Annexure (For example, Mr. Mukesh Ambani (Reliance Industries Limited); Mr. Kumar Mangalam Birla (Aditya Birla Group); Mr. Naveen Jindal (Jindal Steel and Power Limited); Mr. Anand Mahindra (Mahindra & Mahindra) etc. are all representatives of the promoter family and also simultaneously occupy senior executive positions. However, some chairman of promoter controlled public companies are making statements that the next generation of senior management will not be drawn from the promoters’ family). See, My Son Will Never Become CEO of Wipro, Azim Premji Says, TIMES OF INDIA January 23, 2013, available at http://articles.timesofindia.indiatimes.com/2013-01-23/strategy/36504457_1_rishad-azim-premji-ceo-tk-kurien (Last visited on 28 July 2013).

24 In case of Coal India Limited, the state owns 90% (as of March 31, 2013). Similarly as on March 31, 2013, the state owned 69.23% of Oil and Natural Gas Corporation Limited. The trend is similar for most listed public sector companies. (See, Annexure for detailed breakdown).

25 Varottil, supra note 16, 290 (India suffers predominantly from the majority-minority problem, and not the manager-shareholder agency problem).

26 Jeffrey 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, 1477 (Based on research on American companies, Gordon asserts that the term ‘independent director’ entered the corporate governance lexicon in the 1970s. Prior to that, the board was divided into inside (management) and outside (non-management) directors. During the 1990s which were dominated by hostile bids, the concept of independent director got a further boost. More recently, mega corporate scandals such as Enron, WorldCom etc. (in the West), and Satyam (in India) have led to increased debate aimed at strengthening the position of independent directors).
initiation and implementation of these decisions. Given this general presumption, one of the major corporate governance problems that academics have had to think about is the lack of clarity on the real ambit of the board’s functions and the principle of its separation from the management.

Till the middle of the 20th century, corporate boards around the world typically consisted of the firm’s senior management, some non-executive directors who were usually well connected to the management and some directors who were deemed formally independent even though they were mostly selected by the members of the senior management through personal connections. However specially as the monitoring function of the board came to assume more importance, there was increasing consensus that directors who were also responsible for the management of the company would be unsuited for the monitoring role. Professors Leech and Mundheim in a paper written in 1973, were amongst the first to suggest that the board should be primarily composed of independent directors whose role would be to monitor the management in the interests of the shareholders. However, this model was not universally accepted then, and was subject to severe criticism by academics who viewed it as an incursion on the fundamental principle of free enterprise. However over the course of the succeeding decades, the eligibility criteria for independent directors have become more clearly defined and are nearly always circumscribed by strict legal tests. The idea of an independent director as we understand it today has come into existence as part of the US corporate governance reforms of the 1970s. One major problem that has lingered since the inception and has

27 Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, JOURNAL OF LAW AND ECONOMICS, Vol. 26, No. 2 (Corporations and Private Property: A Conference Sponsored by the Hoover Institution, June, 1983), 322 (Fama & Jensen refer to this separation as the separation between decision control and decision management).

28 Davies, supra note 19, 6 (Davies talks about the ambiguous position of the board in large companies. His understanding is that in the nineteenth century, the board was often conceptualised as the body which supervises the management on behalf of the shareholders. If, however, the accountability of the board to the shareholders is weak, the board will be controlled by the management, and will fail to serve the function it was meant to. In that scenario, the board would become an expression of unaccountability of the management rather than an instrument for the control of management by shareholders).

29 Statement of the Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083, 2092, 1977-1978 (This trend was noticed in India as well). See, Kumar Mangalam Birla Committee Report, supra note 14, ¶6.3 (“Till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent”).


31 Id., but see Committee on Corporate Law Departments, Report of the Committee on Corporate Law Departments on Corporate Director’s Guidebook, 32 Bus. Law. 1841, 1842 (1977).

32 Gordon, supra note 26, 1468.

never really been resolved is the issue as to how one decides that a director is truly independent, considering that ‘independence’ is essentially a qualitative attribute incapable of precise legal definition.\textsuperscript{34} Whilst several definitions and parameters have been attempted, the ground reality remains the same. Quite often, independent directors are nominated by powerful figures in the company (usually members of the senior management or a large shareholder), and consequently they remain loyal to their backers. This misplaced loyalty, it has been alleged, has led them to fail in their all-important monitoring role.\textsuperscript{35}

The definitional problem acquires even more significance in countries like India where apart from formal independence from the management, independence must also be judged on the basis of the nominee’s independence from the controlling shareholders. An ideal definition of independence should also consider social factors although none of the definitions currently in vogue make any reference to them.

\textbf{A. FUNCTIONS OF INDEPENDENT DIRECTORS}

Perhaps even more pressing than the definitional issue is the fact that there seems to be a lack of clarity on the role that the independent director is called upon to perform – is his mandate the protection of minority rights or is he supposed to ensure that the management acts in compliance with the relevant legal and ethical standards?\textsuperscript{36} This problem has been articulated with remarkable brevity by Jeffrey N. Gordon when he extorts, “‘Independent directors’ – that is the answer, but what is the question?”\textsuperscript{37}

In order to understand what is expected of independent directors, one must first understand what is expected of directors generally. The company legislations of most jurisdictions do not give a precise list of functions that the directors are expected to play. However as a matter of fact, it is generally understood that amongst the commonly accepted roles of the board are to select, advise, monitor and discipline the management, apart from establishing the

\textsuperscript{35} Randall Morck, \textit{Behavioral Finance in Corporate Governance- Independent Directors and Non-Executive Chairs}, 3 (Harvard Institute of Economic Research Discussion Paper Number 2037, May 2004) (“Corporate officers and directors, who should have known better, placed loyalty to a dynamic Chief Executive Officer above duty to shareholders and obedience to the law”).
\textsuperscript{36} Urtiaga & Saez, \textit{supra} note 8, 5.
\textsuperscript{37} Gordon, \textit{supra} note 26, 1468.
objectives, strategies and policies of the company.\textsuperscript{38} Thus, the duties are both strategic as well as operational, and include sweeping monitoring and disciplining functions.\textsuperscript{39} The management of the company is expected to be conducted at the superintendence, control and direction of the board of directors although the directors are seldom expected to get involved in the day-to-day management of the company.\textsuperscript{40} In light of that, it may not be an overstatement to say that the director is the living face of the inanimate legal person that is the incorporated company.\textsuperscript{41} Given this important role that the board plays, it is no-brainer that all the stakeholders of the company justifiably have a keen interest in the composition and functioning of the board. Whilst a modern corporation has several classes of stakeholders including employees, creditors, consumers, the environment, and even its competitors, I believe that a company’s stockholders have a more immediate and better defined interest in the company’s functioning.\textsuperscript{42} The reasons are not hard to find; unlike other constituencies, stockholders have sunk financial investments and yet have little protection outside the company’s own internal processes unless in exceptional circumstances.\textsuperscript{43}

\textsuperscript{38} Leech & Mundheim, \textit{supra} note 30, 1800. \textit{Also see}, Statement of the Business Roundtable, \textit{supra} note 29, 2097-2103.


\textsuperscript{41} The fact that the directors are the human manifestation of the company is evidenced by the fact that personal liability for offences by the company is mostly attached to the directors. \textit{See}, \textit{infra} note 52 (Dealing with the concept of ‘officer who is in default’ under §5 of the Companies Act, 1956).

\textsuperscript{42} \textit{See generally}, Victor Brudney, \textit{The Independent Director – Heavenly City or Potemkin Village?}, 95 \textit{Harv. L. Rev.} 598, 599 – 606, 643 (1982) (Brudney says that the role of the independent directors is to align the long term interests of the stockholders with those of the other constituencies. However, he admits that the primary duty of the independent directors is towards the stockholders. He expresses this sentiment, “…that cakes and ale are to be shared with strangers only after the stockholders are well fed on beef and beer”). \textit{Also see}, Corporate Director’s Guidebook 1976, \textit{supra} note 40, 19- 20 (“The fundamental responsibility of the individual corporate director is to represent the interests of the shareholders as a group as the owners of the enterprise… [T]he law does not hold the business corporation or the individual corporate director directly responsible to other constituencies, such as employees, customers or the community, except to the extent expressly provided by public law”).

\textsuperscript{43} Clarke, \textit{supra} note 18, 10 (The other stakeholders have legal protections outside the company’s mechanism. For example, the interests of the work force are protected by labour laws. Likewise, there are insolvency laws, consumer protection laws, environmental protection laws etc. to protect the interests of the other stakeholders. Except for a petition against oppression and mismanagement, there are not many legal remedies available to the minority shareholders. Even in case of winding up of the company, the shareholders rank at the bottom of the list of creditors to be paid out of the company’s liquidated assets).
The concern that a shareholder has regarding his rights in the company also depends on the shareholding structure of the company in general. For example, a small shareholder of a company which also has a large controlling shareholder is more likely to be overrun by the controlling shareholder, than a shareholder of a company where the difference in the size of individual shareholdings is smaller. American and British companies have traditionally been characterised by a dispersed shareholding pattern with large institutional holdings, where no one shareholder controls enough of the company to be able to exploit another. Further, these institutional shareholders tend to have interests in a wide portfolio of companies as part of their investment strategies, and would usually not have either the capacity or the inclination to monitor the individual companies on a day-to-day basis. This ‘separation of ownership and control’ leads to a concentration of power in the hands of the professional managers who run the company. Given these dynamics, the shareholders are left at the mercy of the managers who (absent any institutional constraints) are able to run the company at their own will. As discussed above, it was this tension between the shareholders and the management that had led to the conception of the independent directors, whose primary role is to monitor the board, which will in turn monitor the management. This was designed to be a counter to the idea of having boards dominated by the management in which case the shareholders will virtually not be left with any protection at all.

However, even in the US and of course also in other jurisdictions, there is still considerable disagreement about the efficacy of having independent directors as a means to effectively monitor the executive. Indeed, there is also some doubt as to what exactly is the principal function of the independent directors in the first place. One of the most frequently articulated objectives

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44 Varottili, supra note 16, 284.
45 Bainbridge, supra note 17, 1055 (Shareholders are rationally apathetic. Rational shareholders will expend the effort to make an informed decision only if the expected benefits are greater than the costs. It is often not the case as most shareholders’ holdings are too small to have significant effect on the vote’s outcome).
46 Varottili, supra note 16, 291 (Citing Adolfo A. Bearle & Gardiner C. Means, The Modern Corporation and Private Property (1940)).
47 Bainbridge, supra note 17. Also see, Urtiaga & Saez, supra note 8, 8.
48 Varottili, supra note 16, 294. Also see, Report of the Committee on Financial Aspects of Corporate Governance, ¶¶ 4.5 and 4.6 (The Cadbury Committee Report states that the non-executive directors have two important functions, viz. to review the performance of the executive, and to take lead on issues when conflicts arise, e.g., takeover, director appointments, remuneration etc).
49 Clarke, supra note 18, 2. Cf. New York Stock Exchange, Final NYSE Corporate Governance Rules, 4 (The NYSE commentary on the desirability of having a majority of independent directors in company boards arises from the stated presumption that it will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest). Also see, Vikramaditya Khanna & Shaun J. Mathew, The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence, NAT’L L. SCH. OF INDIA REV. 22, 39 (2010) (Several interviewees contacted by Khanna & Mathew reported that imposing substantial monitoring obligations on independent directors would be contrary to the realities of modern board service).
is that they can ensure the company’s compliance with external regulation. However, the basis behind viewing the independent directors as competent enforcers of external regulation is clearly flawed. Independent directors are not any more likely than auditors to be able to investigate problems within companies in order to report legal non-compliances. Also if this were to be the reason behind having independent directors on boards, the prescribed qualities for selection would have to be more detailed, and should require qualities more than mere formal independence. Actively looking out for financial irregularities and legal non-compliances would call for a skill-set akin to that of auditors, which is not the requirement for appointment as independent directors. Even if one were to assume that the independent directors had the technical skills required to effectively monitor the senior management, it is difficult to comprehend the motivation they would have for carrying out that role. Monitoring the executive would put considerable pressure on time, and as most independent directors are likely to be busy executives or professionals elsewhere, it is unlikely that they will be able to devote sufficient time and resources to their monitoring function. In any event, the corporate laws of many jurisdictions including India impose positive obligations on directors to ensure that the company is compliant with legal and accounting policies, and there are individual sanctions on the directors for the company’s failure to comply. So, there are enough disincentives for the directors to not breach the law or to procure such breaches on part of the company. In any event, the independent directors, who usually function based on a lower level of information than the executive, would not be able to actively prevent such breaches.

Another assumption used to justify the presence of independent directors is that they are more likely to effectively monitor related party transactions which although not barred by law, may nonetheless erode shareholder

50 Id., Clarke, 5. Also see, Leech & Mundheim, supra note 30 (Leech & Mundheim say that the SEC has often relied on outside directors to promote its own regulatory objectives).
51 Stephen M. Bainbridge, A Critique of the NYSE’s Director Independence Listing Standards (University of California, Los Angeles School of Law Research Paper Series, Paper No. 02-15). C.f., Fama & Jensen, supra note 27, 315 (Fama & Jensen hypothesise that outside directors, particularly if they are trying to build a reputation as experts in their field, have the incentives to monitor the board effectively). Also see, Corporate Director’s Guidebook 1976, supra note 40, 33 (Although by virtue of being divorced from the management, independent directors are expected to spend less time on company matters than management directors, they should nonetheless spend sufficient time in order to be able to perform their job well).
52 Under Companies Act, 1956, §5, all executive and shadow directors of the company come within the definition of “officer who is in default” for purposes of liability under the Companies Act, 1956. Whilst even independent directors can technically come within the ambit of the expression, they are unlikely to be implicated in light of Master Circular No. 1/2011 dated July 29, 2011 of the Ministry of Corporate Affairs. The circular specifies that the Registrar of Companies should take extra care before proceeding against non-executive directors particularly for breaches that happened without that director’s knowledge. Apart from that, there are positive obligations on the company to ensure that the company is compliant with the legal and accounting requirements. See, e.g., Companies Act,1956, §217(2AA). There is a similar provision under English law as well, see UK Companies Act, 2006, §393.
value if conducted without following proper valuation practices.\textsuperscript{53} In order to be effective, the independent directors would be required to challenge the commercial merits of the transaction from a detached standpoint. An optimum result of this adversarial stand-off would be to have a transaction as though it was conducted on arms-length basis.\textsuperscript{54} I believe that this is indeed a role where the independent directors may fare better than the executives, although there is a valid criticism that monitoring related party transactions would require assessment of independence on a case-by-case basis (which is the case in most jurisdictions) rather than in an abstract sense of the term.\textsuperscript{55} However admittedly, having a majority of independent directors on the board is likely to lead to more effective monitoring of related party transactions as the executive directors may become wary of proposing transactions that may potentially be blocked by the independent directors. Presumably, the independent directors by virtue of their economic detachment and social distance from the executive are less likely to share the camaraderie that would put them under peer pressure to approve such transactions. However I concede that this argument assumes that the independent directors are socially distant from the executive directors, which is often not the case.\textsuperscript{56} Morck even argues that independent directors often feel a sense of obligation towards the executive directors who have appointed them, and seek to repay them with loyalty often at the expense of the duties they are expected to perform.\textsuperscript{57} Hence, the independent directors are likely to fare better in their role as monitors of related party transactions only if there are subjective social criteria prescribed for their appointment, which is not the case.\textsuperscript{58}

Another expectation from the independent directors is that they can bring onboard their specialist knowledge and business connections and thus make the board more efficient.\textsuperscript{59} However as Clarke argues, this advisory role in itself is not something that justifies appointing independent directors as the company can always hire external consultants when it requires such

\textsuperscript{53} Principle IV.D.6, Organisation for Economic Co-operation and Development, OECD Principles of Corporate Governance (2004): One of the functions of the board of directors is to monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

\textsuperscript{54} Brudney, \textit{supra} note 42, 610.

\textsuperscript{55} Clarke, \textit{supra} note 18, 5-6.

\textsuperscript{56} See, Byoung-Hyoung Hwang & Seoyoung Kim, \textit{It Pays to Have Friends}, 93 \textit{J. Fin. Econ.} (2009) 138 (Hwang & Kim assess the impact of close social relationships on the performance of independent directors, and conclude that directors who are socially related to the CEO are likely to be less effective as monitors). \textit{Also see}, Brudney, \textit{supra} note 42, 612. \textit{Also see}, Urtiaga & Saez, \textit{supra} note 8.

\textsuperscript{57} Morck, \textit{supra} note 35, 18.

\textsuperscript{58} Brudney, \textit{supra} note 42, 613. \textit{Also see}, Julian Velasco, \textit{Structural Bias and the Need for Substantive Review}, 82 \textit{WASH. U. L.Q.} 821, 859 (2004) (In the context of the US courts’ reluctance to take into account social relationships when deciding on cases involving the business judgement rule, Velasco says, “… the influence of friendship should not be underestimated. To pretend that financial interests are inherently stronger than the bonds of friendship is both substantively indefensible and morally insulting”).

\textsuperscript{59} Statement of the Business Roundtable, \textit{supra} note 29, 2107.
expertise.\textsuperscript{60} Also, if that were to be the main function of independent directors, it would not have required regulatory/statutory prescriptions because the quality of business advice a company receives is not an area that regulators are expected to be concerned with. Further, the jurisprudence surrounding the composition of modern boards indicates that there is a distinct change in the profile of board composition, and boards are now expected to give primacy to their monitoring role over their advising role.\textsuperscript{61} I believe that the key role of the independent directors should indeed be to monitor the board from within although in light of the findings of Khanna and Mathew discussed above, I understand that this proposal may not be particularly popular with many Indian independent directors.\textsuperscript{62}

B. THE DEFINITIONAL ISSUE

For an institution that derives its title from an abstract attribute – ‘independence’, there seems to be surprising lack of clarity on the importance of the attribute attached to the word. In this part, I will look at the various ways of defining independence in some key jurisdictions. The first part of this sub-chapter will concentrate on the US as it is the place of origin of the institution.

1. The American understanding of independence

As the practice of having independent directors in corporate boards originated in the US, the institution was always designed to be an assault on the manager-shareholder agency problem discussed earlier. It was felt that the only (or at least the primary) role of the independent directors was to protect the shareholders from the excesses of the management.\textsuperscript{63} Hence since the early days, the ‘independence’ requirement has always centred on independence from the management. Academics and policymakers have historically argued for boards composed of a majority of outside directors who are independent of the management; indeed the term used in the early years was ‘non-management’ rather than ‘independent’.\textsuperscript{64}

\begin{footnotes}
\item[60] Clarke, \textit{supra} note 18, 6.
\item[61] Gordon, \textit{supra} note 26, 1469.
\item[62] Khanna & Mathew, \textit{supra} note 49.
\item[63] Clarke, \textit{supra} note 18, 10.
\item[64] See generally, Leech & Mundheim, \textit{supra} note 30. Also see, Lynne L. Dallas, \textit{Developments in U.S. Boards of Directors and the Multiple Roles of Corporate Boards}, 18 (University of San Diego School of Law Public Law and Legal Theory Research Paper No. 48 and Law and Economics Research Paper No. 1) (Citing MELVIN ARON EISENBERG, \textit{THE STRUCTURE OF THE CORPORATION} 139-85 (1976)). Also see, Marshall L. Small, \textit{The 1970s: The Committee on Corporate Laws Joins the Corporate Governance Debate}, 74 \textit{Law \& Contemp. Probs.} 129, 132-134 (Winter 2011) (Small discusses the work of the Subcommittee on Functions and Responsibilities of Directors constituted by the American Bar Association which recommended that non-management directors constitute a majority of the full board of directors, and were to have a primary role in selecting the CEO and other key officers, apart from having responsibilities in relation to compensation of key management, oversight of the company.
\end{footnotes}
Initially the test focused narrowly on the director’s employment status, and anyone who was not currently in employment with the firm was deemed to have passed the test to be considered non-management. However, over time, this test has been tightened further and other factors have been gradually added to the list. In 1976, the Corporate Director’s Guidebook published by the American Bar Association (‘ABA’) laid down a stricter criterion when deciding between management and non-management directors, implying that even a person who was formerly employed by the firm would be deemed to be a management director. Even within the class of non-management directors, personal or economic ties were seen as relevant, and a director who regularly supplied important services in his professional capacity would be considered to be an affiliated non-management director. This would mean that the company’s bankers, lawyers etc. would be regarded as affiliated non-management directors. The following year, a revised edition of the Corporate Director’s Guidebook was published which clarified that the decision on whether a person is a ‘non-affiliated, non-management director’ was based on the subjective judgment of the board which should be based on the absence of any relationship that could interfere with the director’s independent judgment.

To the same end, there has been a growing consensus amongst policymakers in the US for requiring audit committees to be composed exclusively of independent directors, a trend which was soon replicated around the world. Defining the ambit of independence for this purpose has also led to further work on the definition. In 1983, the New York Stock Exchange (“NYSE”) Audit Committee Listing Standards Committee clarified that an individual with “customary commercial, industrial, banking, or underwriting audit system, and nomination of directors etc. Although these recommendations were initially met with hostile criticism from the corporate sector, they were mostly approved by the Statement of the Business Roundtable). Also see, New York Stock Exchange, supra note 49.

Gordon, supra note 26, 1478 (Citing N.Y. Stock Exch., The Corporate Director and the Investing Public 7, 19-20 (1962)).

Corporate Director’s Guidebook 1976, supra note 40, 31.

Id., 32.


IM-5605-4 of the NASDAQ Equity Rules state that companies listed at NASDAQ have a minimum of three members and be comprised only of independent directors, available at http://nasdaq.othwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_3&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F (Last visited on 30 July 2013). Also see, NYSE’s Listed Company (Audit Committee Additional Requirements), § 303A.07, which require all audit committee members to be independent. The same position is replicated under Sarbanes-Oxley Act of 2002, § 301. The position is similar in the UK. See, UK Corporate Governance Code, ¶C.3.1, which state that audit committees should comprise exclusively of independent directors. But see, Clause 49 of the Indian Listing Agreement which does not require audit committees to be exclusively independent although there is a requirement that two-thirds of its membership should be independent. The composition is proposed to be tightened under Companies Act, 2013, § 177(2), which requires that a majority of the members of the audit committees should be independent.
relationships with the company” was eligible to serve on audit committees unless the board formed the opinion that such relationships “would interfere with the exercise of independent judgment as a committee member”.

Although this hinted at relaxing the requirements for independence, subsequent developments proved otherwise. In 1999, the Blue Ribbon Committee on Audit Committee Effectiveness (‘BRC’) set out much stricter criteria for determining independence and recommended the barring of individuals who were linked to a firm which has had significant business relations with the company during the preceding five years.

These BRC recommendations were largely accepted by the NYSE Corporate Accountability and Listing Standards Committee in 2002 when setting out its criteria for determining ‘independence’ of directors. Apart from the criteria prescribed by the BRC, the NYSE also required that the board of directors must affirmatively and publicly determine that the proposed independent director had no material relationship with the listed company.

The final NYSE Corporate Governance Rules approved by the Security and Exchange Commission (‘SEC’) on November 4, 2003, added more specifications to the BRC recommendations. It lay down that no director should be considered as ‘independent’ unless the board had affirmatively determined that the director had no material relationship with the company either directly or through an organisation that had a relationship with the company. This determination of materiality is however required to be done on a subjective basis by the board, having regard both from the company’s standpoint as well as from the standpoint of the director, and also from the standpoint of the other organisation to which the proposed independent director was related.

The subjective parameters that are considered include whether the director in question receives or has received compensation from the company or its affiliated companies. The approved NYSE independence test remains current, and is part of § 303A.02 of the NYSE’s Listed Company Manual. It requires that no person may be considered for appointment as independent director if he has been an employee of the company within the previous three years, or any member of his immediate family has been an executive within the same period. There

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73 NYSE, Final NYSE Corporate Governance Rules, 4.

is also a restriction on a person who either himself or whose immediate family members have been associated with the company’s audit process. Further, employees of companies which are significant suppliers of goods or services to the listed companies are barred for a period of three years after the end of such employment. § 303A.02(b)(iv) further says that a person cannot be considered independent if he or an immediate family member is, or has within the last three years, been employed as an executive officer of another company where any of the listed company’s present executive officers serves or has served on the compensation committee. This requirement suggests that the NYSE is willing to consider informal connections amongst directors as well when deciding on the independence requirement. However, none of the definitions expressly suggest that the definition would consider social relations when deciding on the independence requirement. I believe that for a definition to be complete, consideration of social factors is essential. This will be addressed in a later section when discussing the definition of independence for India.

2. The definition of independence in the United Kingdom

Similarly, on the other side of the Atlantic, the emphasis of corporate governance policies has been on protecting the interests of the shareholders from the management, and hence there has been an emphasis on having boards with a majority of non-executive directors.\textsuperscript{75} However, in interesting contrast to its North American cousins, the UK regulators and policymakers do not set mandatory requirements, but rely on companies to voluntarily follow the principles.\textsuperscript{76} The tone was set by the Cadbury Committee Report of 1992, which called for listed company boards to have a judicious mix of executive and non-executive elements.\textsuperscript{77} The class of non-executive directors whose prime contribution to the board was expected to be ‘independence of judgment’ was required to include within their ranks, a majority of independent directors.\textsuperscript{78} However, the criteria by which independence would be judged were left at the discretion of the board. The only and rather broad prescription was that the independent directors should be independent of the management and they should have no business or other relationships that could materially interfere with the exercise of independent judgment.\textsuperscript{79} Following the American lead, the Cadbury Committee also recommended that the audit committee should be comprised

\textsuperscript{75} Preface, Financial Reporting Council, The Corporate Governance Code (September 2012), ¶7.
\textsuperscript{76} Id., 4 (The London Stock Exchange requires that any listed company that does not comply with the UK Corporate Governance Code issue a statement indicating that the company is not in compliance and explaining the reasons for such non-compliance. The Financial Reporting Council states that the ‘comply or explain’ approach is the trademark of corporate governance in the UK. It has been in operation since the commencement of the Code and is the foundation of the Code’s flexibility. Also, the UK Corporate Governance Code only applies to FTSE 350 companies, i.e., the 350 largest listed companies in the UK classified by market capitalisation).
\textsuperscript{77} Cadbury Committee Report, supra note 48, ¶ 4.1.
\textsuperscript{78} Id. ¶ 4.12.
\textsuperscript{79} Id.
entirely of non-executive directors with a majority of independent directors.\textsuperscript{80} This Report was followed in 1996 by the Greenbury Committee Report on Directors’ Remuneration, which recommended that all listed companies should have a remuneration committee, composed exclusively of non-executive directors. The term ‘non-executive director’ appeared to have been used as an interchangeable expression for ‘independent director’. Again, the definition is extremely broad with the only requirement that the members should have no personal financial interest except as shareholders; no conflicts of interests arising from cross-directorships, and no involvement in the day-to-day running of the company.\textsuperscript{81}

Following recommendations by the Hempel Committee Report, the recommendations of the Cadbury Committee Report and the Greenbury Committee Report were consolidated into a single Combined Code on Corporate Governance (‘Combined Code’) published by the Financial Reporting Council in 2003. The Combined Code recommended that all FTSE 350 boards should have a majority of independent non-executive directors.\textsuperscript{82} In addition to the exclusively non-executive audit\textsuperscript{83} and remuneration committees,\textsuperscript{84} the Combined Code also required a nomination committee with a majority of its members being drawn from non-executive independent directors.\textsuperscript{85} The Combined Code also for the first time laid down a detailed set of criteria that the board is expected to take into account when deciding on a particular director’s independence. Factors leading to presumptions against a director’s independence are the following:\textsuperscript{86}

(i) Being an employee of the company or group within the past five years;

(ii) Has, or has had a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company within the past three years;

(iii) Has received or receives additional remuneration from the company apart from a director’s fee; participates in the company’s

\textsuperscript{80} Id., ¶ 4.35.
\textsuperscript{81} Report of the Study Group chaired by Sir Richard Greenbury on Directors’ Remuneration Committee, ¶¶ 4.8 and 4.9.
\textsuperscript{82} Financial Reporting Council, The Combined Code on Corporate Governance (July 2003), ¶ A3.2(The Combined Code recommends a minimum of two independent non-executive directors for listed companies below the FTSE 350).
\textsuperscript{83} Id., ¶ C3.1.
\textsuperscript{84} Id., ¶ B2.1.
\textsuperscript{85} Id., ¶ A4.1.
\textsuperscript{86} Id., ¶ A3.1.
share option or a performance-related pay scheme; or is a member of the company’s pension scheme;

(iv) Has close family ties with any of the company’s advisers, directors or senior employees;

(v) Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

(vi) Represents a significant shareholder; or

(vii) Has served on the board for more than nine years from the date of his first election.

Although the Combined Code has been replaced from 2012 by the UK Corporate Governance Code, the above list of criteria has remained untouched, which now appears to be the settled position in the UK.\(^87\) I believe that the prohibition in the UK codes against a person representing a significant shareholder is useful and has perhaps been the inspiration behind the prohibition against the ‘promoter’ in the Indian codes. However as in the US, no restrictions based on social relationships have been prescribed.

3. Customising the definition for India

Not unlike the UK and the US, Indian policymakers have also had to make several attempts at setting out the connotations attached to the term ‘independence’. Although the CII Report did recognise the importance of having independent non-executive directors, it did not define the term.\(^88\) The first real attempt at a definition was made by the Kumar Mangalam Birla Committee, which defined independent directors as “directors who apart from receiving directors’ remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries which in the judgement of the board may affect their independence of judgement”.\(^89\) It is evident that the definition takes into account only pecuniary considerations, which is an extremely narrow test. Although the Kumar Mangalam Birla Committee Report also lays down a subjective element of the test insofar as it is for the board to determine whether there is a relationship that is detrimental to independence, the ambit of this discretion was very narrow. It is arguable that if this test were to be made part of the regulatory framework, the board would not have been allowed to look at factors other than

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\(^87\) Financial Reporting Council, \textit{supra} note 75, ¶ B1.1 (¶ B1.2 of the UK Corporate Governance Code has also retained the requirement of having boards with majority of independent non-executive directors for FTSE 350 companies).


\(^89\) Kumar Mangalam Birla Committee Report, \textit{supra} note 14, ¶6.5.
those of a pecuniary nature. In an Indian context, this is especially restrictive in view of the significance of familial and social relations in the business world.\(^\text{90}\)

Although it failed to address this problem adequately in the definition; to its credit the committee had recognised early the importance of the controlling shareholder/promoter problem in Indian corporations, and had done well to include that in the list of prohibited relations.

These committee recommendations soon became part of the regulatory framework through their inclusion in clause 49 of the Listing Agreement which deals with corporate governance issues of listed companies. Clause 49 built upon the definition suggested by the Kumar Mangalam Birla Committee Report by excluding from the list of eligible persons, other individuals who were related to the promoter and members of the senior management by familial ties.\(^\text{91}\) It also excluded several other individuals who had commercial interests in the company which may lead to a presumption of loss of independence.\(^\text{92}\) Individuals so excluded include those who own two percent or more of voting shares, or who have held an executive position in the company during the preceding three financial years. It also excludes individuals who during the preceding three years, have been a partner of its audit firm, or law firm or consulting firm which have had material business with the company.\(^\text{93}\) It also excludes material suppliers, service providers, lessor/lessee and customers from being considered independent.\(^\text{94}\) However, it had still failed to capture certain social relations that are likely to taint the directors’ independence. For example, even if the director does not have any direct business relationship with the company, it is possible that some of his relatives may have such ties which are likely to influence the way he votes in board meetings thus compromising his independence.

This issue appears to have been dealt with in § 149 of the new Companies Act, 2013. I consider this to be a major step in corporate governance jurisprudence generally as it attempts to bring the concept of the independent director into the legislative domain. This Act prescribes that every public listed company must have at least at least one-third of its board as independent

\(^{90}\) See supra text accompanying note 23. Also see, Mr. Nawshir Mirza, Independent Director, Presentation on the Role of the Board in Related Party Transactions, available at http://www.nfcgindia.org/se_1.pdf (Last visited on August 4, 2013) (“...I could indirectly be influenced by this emotional connection, as it were, between me and my business partner and indeed between me and my wife, my brother-in-law and all the other vast army of relatives that all of us, Indians always have”).

\(^{91}\) C.f., Kumar Mangalam Birla Committee Report, supra note 14, ¶6.5 (The Kumar Mangalam Birla Committee Report does not specifically state that persons related to the promoters or the members of the senior management will be considered tainted. By including that in the list of exclusions, clause 49 of the Listing Agreement marks a major improvement over the Kumar Mangalam Birla Committee Report recommendations).

\(^{92}\) Clause 49(A)(iii)(f), Listing Agreement.

\(^{93}\) Id., Clause 49(A)(iii)(d).

\(^{94}\) Id., Clause 49(I)(A)(iii); C.f. infra note 95(Companies Act, 2013, § 149).
directors, and is hence more lenient than the test requirement under the Listing Agreement which requires two-thirds of the board to be independent if the Chairman is an executive director. There is still some ambiguity arising from these conflicting requirements although I understand that either the Act or the Listing Agreement will be amended shortly to deal with this ambiguity. On the definition of ‘independence’, it contains a fairly exhaustive list of exclusions. Apart from plugging some holes left open in the Listing Agreement, it lays down an overarching subjective requirement of integrity, expertise and experience. Another major proposed improvement is that the test of independence has also been held to require the consideration of the associations that the relatives of the proposed independent director has with the listed company. An individual will not be considered independent if any of his relatives has had pecuniary relations or transactions with the company or with entities or individuals associated or affiliated with the company (subject to a de minimis threshold) within the two preceding financial years. Also, an individual will be barred if any of his relatives holds or has held a key managerial position, or is or has been an employee of the listed company during the preceding three years. The prohibition also applies if the proposed independent director holds (together with his relatives) two percent or more of the total votes in the listed company. Also, a person will not be considered independent if he or any of his relatives is or has been an employee, proprietor or partner of a firm of auditors, company secretaries or cost auditors of the listed company within the three preceding years. There is a similar restriction on employees, proprietors or partners of law firms or consultancy firms which have material business relationships with the listed company. By considering other relatives as part of the independence test, the Act does make a serious effort in customising the test for the Indian context, and appears to be fairly exhaustive.

However, there is a more fundamental problem that the institution suffers from, and it is more than just a theoretical problem. Is it enough for the definition of independence to merely consider objective factors or should there be a subjective element to the test as well? It is this problem that will form the crux of the succeeding chapter, and also in fact the focal point of this paper.

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95 Companies Act, 2013, § 149(6)(a).
96 Id., §149(6)(d).
97 Id.
98 Id., §149(6)(e).
99 See, Companies Act, 2013, § 149(6)(d)-(e) (Being an employee, proprietor or partner of a law or consultancy firm will be considered to be a tainting factor if such firm derives ten percent or more of the gross turnover from business with the listed company).
IV. HOW ‘INDEPENDENT’ ARE INDEPENDENT DIRECTORS?

Having considered the theoretical basis behind the institution, I have come to the conclusion that it may technically be possible to come up with an objectively satisfactory definition of ‘independence’ which is suited to each specific jurisdiction. However, business is carried on at real-time and objective perfection would serve no real purpose if an institution cannot tackle the real issues that businesses face on the ground. This begs two questions:

(a) Can a company director ever be ‘truly independent’?

(b) Can the independent director be the solution at all?

This chapter will seek answers to these two questions.

A. NOMINATION AND ELECTION PROCESS

In this part, I will critique the nomination and election process of independent directors and examine how this can impact the likelihood or otherwise of the independent director being an effective corporate governance tool. I will focus on aspects of the nomination and election process, which make the independent director less efficacious than it may appear at first sight. As a general rule, the elections of directors take place at every Annual General Meeting (‘AGM’), and are voted for by the body of shareholders. In case of most large companies, the list of incoming directors for the forthcoming year is nearly always accurately ascertainable in advance. In case of companies with dispersed shareholdings, the list of incoming directors for the forthcoming year is nearly always accurately ascertainable in advance. Usually, the names are proposed by the existing board and are included as part of the AGM agenda. The vote is then a matter of mere formality, and not much debate takes place especially as regards the independent directors. Subject to certain exceptions, the nominees proposed by the powers that be, are usually elected. In case of companies with dispersed shareholdings, this means that the independent directors are usually nominated by the senior managers, and in case of companies with a concentrated shareholding pattern, they usually represent the controlling shareholders. In either case, these nominees proposed by the management or by the controlling shareholder (as the case may be) are likely to get elected without much opposition.

In case of companies with dispersed shareholdings, the different groups of investors are usually not united enough to be able to jointly evaluate

100 See for example, Companies Act, 1956, §255.
101 This general statement does not always hold true in jurisdictions with companies having more dispersed shareholdings, where there have been reports of shareholders joining forces to vote down directors. This has led to the coinage of the expression ‘shareholder spring’.
102 Bainbridge, supra note 17, 1060.
individual candidates and to reject persons backed by the management unless there are some really compelling reasons. Because of the dispersed nature of the shareholdings and disunity amongst the various groups of shareholders, the members of the senior management can easily co-opt the shareholders and stage-manage the election process. This applies equally to non-executive directors as it does to the executives. The Higgs Review of the Role and Effectiveness of Non-Executive Directors (‘Higgs Review’) found that almost half of the non-executive directors in the UK were recruited through personal contacts or friendships, and that only four percent had a formal interview, and only one percent had got the job through open public advertisement.\textsuperscript{103} The statistics are even worse for India with about 90% being recruited through the CEO/Chairman’s personal connections.\textsuperscript{104} Needless to say, these directors are more likely to be beholden to the senior management; rather than safeguarding and furthering the interests of the shareholders as they are supposed to. In fact, they often end up being closer to the management both economically and socially.\textsuperscript{105} Hence, whilst there may be formal independence from the management, there is no independence in the substantive sense of the term.

This statement is equally true for companies with concentrated shareholding patterns, albeit \textit{vis-à-vis} a different constituency. In these companies, the numbers are unlikely to work out in favour of a person nominated by the minority shareholders unless he also has the support of the majority.\textsuperscript{106} Quite often, the interests of the majority and minority shareholders can be so diametrically different that it may not be possible for the same director to represent both constituencies simultaneously. Also the controlling shareholder by virtue of the sheer size of its holdings will be able to exercise control over the management anyway, and does not need the protection of the independent director.\textsuperscript{107} However, because of the skewed equations surrounding the nomination and election process, any candidate is bound to need the blessings of the controlling shareholder in order to enter office, then to stay on and to get

\textsuperscript{103} Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors, January 2003, ¶ 10.5. Also see, Eisenberg, supra note 40, 382 (Many of the outside directors are tied to the CEO by social or professional ties, and one of the likely considerations in the selection process is “...whether the candidate can be counted on not to rock the boat”).

\textsuperscript{104} Varottil, supra note 16, 323 (Quoting AT Kearney, AZB & Partners and Hunt Partners, India Board Report – 2007: Findings, Action Plans and Innovative Strategies (2007)).

\textsuperscript{105} It is a rather strange paradox because technically, the management serves the company at the pleasure of the directors, although it does not play out quite as well in practice. In the absence of a truly independent nomination committee, the management plays an important role in the nomination of potential directors.

\textsuperscript{106} Most companies follow the ‘first past the post’ method of election in general meetings. Under that system, it is but obvious that the candidates having the support of the large shareholders are most likely to get elected. This leads to a circuitous chain resulting in the creation of self-perpetuating boards, which is essentially a representative body of the controlling shareholder. This can potentially lead to the controlling shareholders enjoying virtually untrammeled powers in the company.

\textsuperscript{107} Particularly in the Indian context, a person who is related to a major shareholder is not eligible to be considered for independent directorship.
re-elected. So even if companies have independent and committed nomination committees, the nominees are unlikely to get elected unless they are also supported by the majority. This defeats the integrity of the entire process. The only way this issue can be resolved is by radically altering the election process. One of the ways this can be done is by mandatorily introducing the system of proportional representation in board elections which will ensure that the nominees of the minority shareholders will have a realistic chance of getting elected even without the support of the majority.\footnote{Companies Act, 1956, §265 already allows a company to adopt in its articles, a provision that the election of its directors will be conducted by the method of proportional representation. A similar provision is also contained in Companies Act, 2013, §163. However, I have noted that very few companies have actually adopted this practice in their articles.} The other alternative is to make the election of independent directors a process exclusive to the non-controlling shareholders. Both these suggestions will be expanded upon later in this paper.

Given this problem of lack of substantive independence, it is unlikely that the independent directors would be able to perform the function they are expected to - which is to monitor the board and the management in the interests of the constituencies that have less formal protections. As we have seen, in practice, the independent directors are bound to rely on the management (or the controlling shareholder) for their appointments leading to both monetary and professional benefits.\footnote{Leech & Mundheim, supra note 30, 1830 (Leech & Mundheim caution against paying very high fees to independent directors. Their understanding is that if an independent director is materially dependent on the compensation derived from the company, his independence is likely to be compromised. This means that the compensation for independent directors must strike the subtle balance between not being too low so as not to be able to attract the right talent and not to be too high as would compromise the director’s independence. Also see, Varottil, supra note 16, 327 (Varottil concludes on the basis of interviews that increased compensation is unlikely to affect a director’s independence particularly if he is a director on multiple boards).} Many independent directors are from professional backgrounds and would not be averse to using their board connections to boost their careers. Other common recruiting grounds for independent directors are universities and other institutions of higher education and research. These professionals and academicians, despite their statures in their respective fields may not necessarily have the commercial knowledge to be able to effectively oversee the workings of listed company boards.\footnote{S.H. Goo & Fidy Xiangxing Hong, supra note 12, 497. Also see, Varottil, supra note 16, 327. C.f., Brudney, supra note 42, 643 (Independent directors who are from non-traditional backgrounds may give to its management, a different and holistic perspective of its business).} Also the fact that their remuneration as independent directors often constitutes a substantial proportion of their income is likely to affect their independence. The other category of independent directors are the ones who are themselves executive directors of other companies and are likely to have sympathies with the executive directors both at a social as well as philosophical level.\footnote{Bainbridge, supra note 17, 1059. Also see, Velasco, supra note 58, 824 (Velasco uses the term ‘structural bias’ to mean the prejudice that directors tend to have in favor of each other and also the management. By referring to US judgements, he says that the structural bias can arise...} Neither of these categories is
equipped with the set of skills that would be considered ideal for individuals who are expected to monitor a powerful body of individuals on behalf of an often cornered and vulnerable minority.

B. PSYCHOLOGICAL ANALYSIS

Apart from the problems associated with the nomination and election process that may lead the independent directors to be somewhat ineffectual monitors of corporate boards, I believe that there are also certain psychological factors at play. Quite often, the persuasive personality of the CEO or the representative of the controlling shareholder prevails over an otherwise independent and competent board, resulting in its failure to prevent seemingly obvious corporate frauds.  

In 2004, Randall Morck authored a paper in which he compared the loyalty indices of corporate directors with the subjects of the Milgram experiment. The Milgram experiment is a psychology experiment which assessed the ability of human participants to resist a legitimate authority figure who had instructed them to perform certain actions that conflicted with their own ethical standards. Based on the results of the experiment which concluded that

as a result of ‘common cultural bond’ and ‘natural empathy and collegiality’, the ‘economic or psychological dependency…’, and the ‘process of director selection and socialization, which incumbent management dominates’. Velasco believes that structural bias can often lead directors to protect the interests of each other and the management rather than to act in the interests of shareholders).

For example, at the time of the fraud in 2008-09, the board of directors of Satyam Computer Services Limited comprised of a majority of independent directors, who were all extremely highly regarded in their respective fields. The company was fully compliant with the requirements prescribed by Clause 49, Listing Agreement and the Sarbanes-Oxley Act, 2002 in relation to its NYSE listing. There are reports that the independent directors were suspicious about some of the transactions, and had even objected. However, the objections were not strong enough, and eventually the objectionable transactions were cleared unanimously. See Varottil, supra note 16, 323-340 for a discussion on the role of the independent directors during the Satyam fraud. C.f., Id., Velasco, 860 - 863 (‘…even disinterested directors will tend to favor other directors because of psychological forces such as ingroup bias.’) (Velasco does not address the issue of the psychological factors arising from the CEO’s dominant position; rather his understanding is that the directors tend to support each other because of the psychological factors arising from cultural and social closeness).

See generally, Morck, supra, note 35(The Milgram experiment on obedience to authority figures is a series of psychology experiments conducted by Stanley Milgram, then an Assistant Professor of Psychology at Yale University, which assessed the willingness of human participants to obey a legitimate authority figure who had instructed them to perform certain actions which conflicted with their own ethical standards. The purpose of the experiments was to see how far a subject would proceed before refusing to comply with the experimenter’s instructions. The experiment involved three characters – two actors (one playing the character of a ‘psychology professor/experimenter’ and another playing the role of the ‘learner’); and the real subject of the experiment who was asked to play the role of a ‘teacher’. As part of the experiment, the ‘teacher’ was made to believe that the ‘learner’ was the real subject of an experiment on the effect of punishment on learning and memory. The ‘experimenter’ then asked the ‘teacher’ to ask a question to the ‘learner’, and administer an electric shock every time

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most people are willing to trade their inner morals to demonstrate loyalty to people whom they perceive as commanding legitimate authority, Morck concluded that the power equations between the CEO and the directors were so lopsided that the directors are unlikely to object to a wrongdoing even if they were aware that the actions they were asked to sanction were not right and were perhaps even illegal. Drawing parallels with the subjects of the Milgram experiment, Morck asserts that the directors are often persuaded and even intimidated by the presence of the senior management, and this affects their sense of judgment. This argument holds equally true for the independent directors vis-à-vis the controlling shareholder in the Indian context.

The results of the Milgram experiment can be used to justify the institution of independent directors who are at least in theory not as beholden to the company’s management as the other directors. However, the reality may be quite different. As stated earlier, most independent directors are in fact dependent on the management (or the controlling shareholder) for their tenures: this imbibes a sense of loyalty that would not let them question the decisions of their backers. As many independent directors are professionals, there is a good likelihood that they might seek to leverage on their board connections to further their professional interests elsewhere. Hence, they may be wary of developing the reputation of being troublemakers. This submissive mentality will lead to a largely rubber stamping role, thus frustrating the larger objective the institution is designed for. Comparing the loyalty indices of directors with the subjects of the Milgram experiment creates a rather gloomy picture indeed.

However certain strands of the Milgram experiment can indeed be used to bolster the authority and efficacy of the institution of independent directors. One of the findings of the experiment was that individuals tend to be more subservient towards authority figures if they were within each other’s physical presence. This according to Morck, justifies the commonly accepted requirement that audit committees should be exclusively composed of independent

the ‘learner’ gave an incorrect answer. The subjects were also made aware that the voltage of electric shocks they would administer might be lethal, but were asked to do so as part of the experiment. The study showed that a vast majority of the subjects complied with the instructions despite the knowledge that what they were doing was morally wrong). See generally, STANLEY MILGRAM, OBEDIENCE TO AUTHORITY, 1974.

114 See, Id., Morck (One of the findings of Milgram’s experiment is that if there are more than one legitimate authority figures, the subject’s loyalty is undermined and they revive their internal moral reasoning. This can also be used as a justification for having lead independent directors and non-executive chairs as mandated by the UK Corporate Governance Code (alternative authority figures) to offer alternatives to the other directors).

115 Id., Morck, 20. C.f, Davies, supra note 19 (Some independent directors believe that being competent monitors on behalf of the shareholders will help them develop good reputations, which will have positive effect on their careers).

116 Bainbridge, supra note 17, 1061.

117 MILGRAM, supra note 113, 64.
directors, although this is not yet the requirement in India.\textsuperscript{118} I agree with this logic, and believe that the model can be extended further. However I do not go as far as suggesting that company boards should be exclusively composed of independent directors, as this would deny them of valuable inside knowledge.\textsuperscript{119} Another argument against having an entirely non-executive board is the crucial role that independent directors can play in management succession. For these reasons, it is important that the independent directors should have the chance to have regular interactions with the executives.\textsuperscript{120}

In light of this, there is definitely a case for a provision which requires that all board resolutions should be passed at two stages – a vote by the executive directors and a separate vote by the independent directors in a separate meeting. In deference to the time tested principle of majority rule in general, I however believe that the votes of these separate meetings should be added together to decide on the final outcome of the meeting. In order for this to be effective, whilst the executive sessions should be held in the presence of the independent directors, the reverse should not be permitted.\textsuperscript{121} The Companies Act, 2013 already contains a provision that mandates exclusive sessions for independent directors at least once a year.\textsuperscript{122} Whilst this may be the first step towards requiring an exclusive session of the independent directors as part of every board meeting, I believe this is a rather feeble first step. The provision as it reads now is unlikely to serve any real purpose as the annual sessions would be reduced to nothing more than a ceremonial event in the company’s calendar. Even if the independent directors were to take these annual sessions seriously, they would be so far removed from the actual event requiring consideration that these would not have much effect, if any at all.\textsuperscript{123} If on the other hand, each board resolution is preceded by a separate meeting, it is more likely that the

\textsuperscript{118} Supra note 69 for discussion on audit committee independence requirements in the UK, the US and India.

\textsuperscript{119} Bainbridge, supra note 17, 1056 (Management directors, by virtue of having spent a considerable period of time with the company, usually have a better understanding of the firm’s internal workings and culture, and are more likely to be able to visualise a board decision in the broad perspective).

\textsuperscript{120} Corporate Director’s Guidebook 1976, supra note 40, 35.

\textsuperscript{121} Whilst I understand that this suggestion may be considered slightly radical, there has been a general understanding that having exclusive sessions of independent directors are more likely to make them effective as monitors, and would also give them a better chance to exchange evaluations. See generally, Leech & Mundheim, supra note 30, 1826.

\textsuperscript{122} Companies Act, 2013, Schedule IV, ¶ VII. Also see, Dallas, supra note 64, 2 (Dallas asserts that boards are increasingly following the practice of having independent directors to meet in separate sessions).

\textsuperscript{123} See generally, NYSE’s Listed Company Manual (Executive Sessions), §303A.03 (as amended on November 25, 2009), available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.aspx?selectednode=chp_1_4_3&manual=%2Fsections%2Fsections%2Fsections%2F (Last visited on 3 August 2013) (The NYSE mandates regular sessions of non-management directors without the presence of the executive directors. However, the manual does not prescribe the number or frequency of these sessions. Also, these sessions are not exclusively for the independent directors who are required to have an exclusive session once every year).
independent directors will take their responsibilities as monitors of the board more seriously.

In case of transactions which require more independent director input, the board decision may even be made subject to ratification by the independent directors. While it is difficult to lay down an exhaustive list of such items, I believe that they should be defined by a mix of qualitative and quantitative parameters generally, and should include all related party transactions in particular. This is a practice that is already followed in Italy where a related party transaction can only be executed if it receives a favourable vote from the committee of independent directors. This practice may be considered for other jurisdictions with concentrated shareholding patterns like India.  

Another finding from Milgram’s experiments is that rational individuals are less likely to be induced by malevolent commands if the individual is in close proximity to the person likely to be affected by the command. This finding can also be used to design corporate governance policies to ensure that independent directors have closer and more regular interaction with the shareholder community they represent. Usually in case of large companies, the directors are in far closer proximity to the management (and the controlling shareholder) than to the small shareholders whom they encounter only once a year in the Annual General Meeting. I understand that it may not be practicable to overturn years of corporate law practice and have more than one statutory general meeting in a year. However what may be practicable is to have more regular sessions where the small shareholders can interact exclusively with the independent directors. I understand that implementing such a requirement would result in additional administrative costs, and would require independent directors to spend more time on the job than they are currently required to do. However, this will ensure that the independent directors remain connected to the constituency whose interests they are mandated to safeguard.

Whilst I anticipate significant criticism if the above suggestions are ever incorporated into the law, I believe that absent such safeguards, the ability of the independent directors to perform any meaningful role is severely prejudiced.

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124 Commissione Nazionale per le Società e la Borsa (CONSOB), Regulations Containing Provisions Relating to Transactions with Related Parties (adopted vide Resolution no. 17221 of March 12, 2010, later amended by Resolution no. 17389 of June 23, 2010): Boards of listed companies are allowed to carry out a related party transaction exceeding a certain value only if a committee comprised entirely of independent directors gives a favourable report. Absent such a favourable report, the related party transaction must be put to vote in a general meeting. Also see, Italian Corporate Governance Code, Art.7.

125 Morck, supra note 35,11.
V. INDEPENDENT DIRECTORS IN INDIA: THE WRONG MEDICINE?

Despite its many flaws, and equivocal findings on the impact that independent directors have on board performance and the quality of monitoring, it has established itself as an unquestioned feature in the corporate governance framework of several jurisdictions including India.126 The experiences in other jurisdictions like the US and the UK were clearly guiding factors when choosing it for implementation in India. As observed earlier, the institution was created in the US as a solution to a very specific problem, i.e., the agency problem between the management and the shareholders. However in India, the prime corporate governance problem is not the manager-shareholder agency problem but the majority-minority problem. This is not an issue the original idea was designed to tackle, although this fact has been largely overlooked by Indian policymakers. From historical experience, it is evident that the institution of the independent director has not managed to check the excesses of controlling shareholder even if the promoter does not hold a significant stake. By way of illustration, in the Satyam case, the Raju family owned only about 5% of the company’s shares but was still able to keep a seemingly independent (and well qualified) board in the dark about one of the greatest frauds in Indian corporate history.127

From the discussion so far, it appears that the reason for the lack of success of independent directors in India is not an issue of mere individual failings but inherent problems in the institution itself. The Indian independent director is conceptually so close to its Anglo-Saxon ancestors that it is bound to struggle in a different ecosystem where the rules of engagement are fundamentally different. I believe that these issues may be resolved if the institution is adequately customised to tackle the majority-minority problem. This chapter shall look at ways in which this customisation may be brought about.

A. CHANGING THE ELECTION SYSTEM

One of the reasons why the office of the independent director is unlikely to be able to tackle the majority-minority problem that persists in

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126 Id. Urtiaga & Saez, supra note 8, 6 (Urtiaga & Saez assert that academic literature has failed to show a direct link between independent directors and firm performance). C.f. Dahya & McConnell, supra note 9, 3, 21 (Dahya & McConnell find that compliance with the Cadbury recommendations was followed by a statistically and economically significant improvement in operating performance. Such compliance also showed better stock prices).

Indian corporate boards is the method of election for company boards. § 263 of the Companies Act, 1956 states that each individual candidate must be voted on individually. Apart from that, the form of voting practiced by most Indian companies is the ‘first past the post’ system, which results in the election being won by the candidate who gets more votes than anyone else. Evidently this system which is also known as simple majority voting, disproportionately favours the majority shareholders as they can vote for every board vacancy and can vote down anyone whom they do not want to be included in the board. As a result, the votes of the minority shareholders virtually count for nothing. Hence, the board of an Indian public company including its independent directors can be utterly controlled by the controlling shareholder.

Perhaps even more worryingly, the process of removal of directors is equally dominated by the controlling shareholder. There is merely a requirement for a simple majority of votes, and there is no requirement to prove a case against the director sought to be removed. Although this mechanism is rarely used in practice, its mere existence sends a rather stark signal that the system does not encourage dissent. In any event, any director who is not favoured by the controlling shareholder cannot expect to be considered for renewal of term as the same process as is applicable for appointment also applies for renewal. Given this framework, it is perhaps unsurprising that the institution of independent directors has not been very effective in India. In light of this, the SEBI Consultative Paper on Review of Corporate Governance Norms in India (‘SEBI Consultative Paper’) suggests introducing certain changes including changes to the election method.

1. Case for Cumulative Voting

One potential remedy would be to introduce proportional representation as the mandatory system for election of directors. Unlike the simple majority voting system in which the shareholders can vote the number of shares he owns for each candidate standing for election; under cumulative voting, each shareholder gets a block of votes equal to the number of shares he owns multiplied by the number of directors to be elected. The shareholder can then either

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128 Companies Act, 1956, §263(1): At a general meeting of a public company or of a private company which is a subsidiary of a public company, a motion shall not be made for the appointment of two or more persons as directors of the company by a single resolution, unless a resolution that it shall be so made has first been agreed to by the meeting without any vote being given against it.

129 Varottil, supra note 16, 315.

130 Companies Act, 1956, §284(1): A company may, by ordinary resolution, remove a director (not being a director appointed by the Central Government in pursuance of section 408) before the expiry of his period of office.

131 Varottil, supra note 16, 315.

132 See supra text accompanying notes 129-130.

cast all his votes in favour of one candidate or may distribute them among any number of candidates.\textsuperscript{134} This method of voting is usually preferred by minority shareholders because it gives them the opportunity to elect some members of the board if they can unite behind a few candidates.\textsuperscript{135} Both under § 265 of the Companies Act, 1956 and § 163 of the Companies Act, 2013, director election by proportional representation is an option that may be included in the company’s articles.\textsuperscript{136} If a company chooses to implement it, it can potentially lead to a more equitable voting system for directors, and the minority shareholders would have a better chance of getting their nominees on board despite resistance from the majority. However, very few companies if any have yet implemented this system of voting. As implementing this system would reduce the influence that the majority shareholders have over the company, they are understandably unwilling to allow this into the company’s constitution.\textsuperscript{137} It would require alteration of the company’s articles of association, which would need a special resolution of the shareholders. This is virtually an impossible proposition if there is a controlling shareholder in the company.\textsuperscript{138} Dalebout writes that expecting the majority to introduce cumulative voting in order to protect the interests of the minority is like hens pleading with the fox for protection.\textsuperscript{139}

Hence perhaps the only way proportional representation can be implemented at the policy level is by making it a mandatory legal requirement.\textsuperscript{140} However, it would be an extremely bold step as very few jurisdictions anywhere in the world have used this method as a mandatory requirement.\textsuperscript{141} In the 1950s, twenty-two US states had adopted mandatory cumulative voting for board elections; however very few currently prescribe it as a mandatory requirement and none of those that do is a major commercial state.\textsuperscript{142} Even in the states that had historically prescribed mandatory cumulative voting were not successful in implementing it, as the majority shareholders had found various


\textsuperscript{135} Id.

\textsuperscript{136} Companies Act, 1956, §265:Notwithstanding anything contained in this Act, the articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a public company or of a private company which is a subsidiary of a public company, according to the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise, the appointments being made once in every three years and interim casual vacancies being filled in accordance with the provisions, \textit{mutatis mutandis}, of section 262. The provision under § 163 of the Companies Act, 2013 is nearly identical.

\textsuperscript{137} Dalebout, \textit{supra} note 134. Also see, Varottil, \textit{supra} note 16, 317.

\textsuperscript{138} Companies Act, 1956, §31.

\textsuperscript{139} Dalebout, \textit{supra} note 134, 1201.

\textsuperscript{140} But see, SEBI Consultative Paper, \textit{supra} note 133, ¶11.2 (The SEBI Consultative Paper does not recommend that the cumulative method of elections be made mandatory).

\textsuperscript{141} Jeffrey N. Gordon, \textit{Institutions as Relational Investors: A New Look at Cumulative Voting}, 94 \textit{Colum. L. Rev.} 124, 165. Also see Davies, \textit{supra} note 19, 13.

\textsuperscript{142} Id., Gordon.
ways to dilute their impact, ultimately resulting in a near extinction of the system.\textsuperscript{143}

One of the principal objections against the system is that it may lead to minority shareholders infiltrating the board with troublemakers, which will reduce the board’s efficiency and effectiveness.\textsuperscript{144} However this problem is more likely to arise in companies where an organised minority seeks to manipulate a disorganised majority.\textsuperscript{145} This is not the case for most Indian companies, where most minority shareholders remain apathetic allowing the majority to run the company as it wishes. I believe that if cumulative voting is introduced, it may lead to more unity amongst institutional investors, who would counter the high handedness of the majority in order to safeguard the interests of an otherwise dispersed minority. Institutions have strong financial interests in the company, and hence they are unlikely to indulge in disruptive behaviour.\textsuperscript{146} The economic interests of the institutional investors are often aligned with those of the retail investors. The prime goal for both constituencies is improvement in the functioning and accountability of the boards with the ultimate goal that this will lead to greater profits and consequently better return on equity.\textsuperscript{147} I understand that the criticisms against this system of voting (and its eventual abandonment in the US) may lead to a presumption against its being an acceptable voting format. However it must be borne in mind that most of the criticism has come from American academics who have studied its failings in the American context where the corporate system is very different from that in India. Given the fundamental differences in the shareholding patterns between the two jurisdictions, I believe that the system of proportional representation may lead to the otherwise apathetic body of small shareholders to rally around the institutional investors and form an effective second bloc. This may lead to better performance and desirable results.

Only recently, GlaxoSmithkline Consumer Healthcare Ltd. became the first Indian listed company to adopt cumulative voting for director appointment in the 2013 AGM. Proxy advisory firm, Institutional Investor Advisory Services in their comment on the development reported that this

\textsuperscript{143} Dalebout, \textit{supra} note 134, 1206 (The ways in which companies nullified the effects of mandatory cumulative voting included reducing the total number of directors in the company; dividing the directors and/or shareholders into different classes; using unequal voting rights for different classes of shareholders; and also included the rather drastic measure of removal of minority directors without cause).
\textsuperscript{144} Gordon, \textit{supra} note 141, 167-169.
\textsuperscript{145} Id., 170.
\textsuperscript{146} Id., 171, 173.
\textsuperscript{147} Id., 171. \textit{Also see}, Varotttil, \textit{supra} note 16, 342 (Varotttil writes: “In the U.S., hedge funds and other institutional shareholders effectively monitor and sometimes agitate against inefficient boards and managements and also help shape general corporate governance norms. They are ably aided by proxy consultants such as RiskMetrics to build coalitions of institutional investors to adopt an ‘activist’ role in companies”).

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system “...can be a powerful tool for minority shareholders” and can lead to better governance if there is “…a greater willingness on the part of institutional investors to work collaboratively on their voting strategy”.\textsuperscript{148} Whilst I believe that proportional representation may well be a potential solution to the majority-minority divide, more research is needed before a firm recommendation can be made in its favour.

2. Alternatives to Cumulative Voting

Apart from introducing mandatory proportional representation, the preferential treatment to the minority may also be extended in other ways. One suggestion is to change the nomination process by requiring that independent directors be nominated exclusively by the existing independent directors.\textsuperscript{149} This would remove the overarching and overbearing influence of the management and the controlling shareholders from the nomination process although their influence will still be felt at the election process. Implementing this system will require that companies have strong nomination committees staffed exclusively by independent directors. However if the existing independent directors are not themselves independent in the substantive sense of the term, there is a risk of a self-perpetuating process of one bad board bringing on another equally ineffective board. It is also arguable that a stipulation requiring independent directors to be nominated exclusively by the existing independent directors, will make them removed from the management and hence make them more akin to an external supervisor rather than being an internal monitor as they are supposed to be.\textsuperscript{150} In any event even if this process were to be implemented, the actual election would continue to be dominated by the majority shareholders and they would vote down nominees that they do not want on the boards.

Another and perhaps more radical idea that has been mooted in academic circles is a system of election where the independent directors are elected by the minority shareholders alone without the presence of the controlling shareholders.\textsuperscript{151} I realise that setting the thresholds to determine who can and cannot vote in these elections may require a fair amount of thinking on the part of policymakers. The question that arises is whether this ‘majority of the minority’ election process should exclude from voting, only the promoter and its group, or should the threshold be set lower and anyone with more than a certain percentage of shareholdings should be deemed ineligible. I do not

\textsuperscript{149} Brudney, \textit{supra} note 42, 621.
\textsuperscript{150} \textit{Id.}
\textsuperscript{151} Varotttil, \textit{supra} note 16, 360.
suggest a mere re-wording of § 252 of the Companies Act, 1956 or § 151 of the Companies Act, 2013, which allows public companies to appoint a small shareholders’ director.\textsuperscript{152} It is understood that this provision has not so far been effective not least because of the apathetic conduct of the small shareholders, and the logistical issues arising out of having a body of highly dispersed body of retail investors.\textsuperscript{153} In light of these, the best way to ensure better minority protection is by giving more powers to the institutional investors. In my opinion, the ‘majority of the minority’ elections should not use an upper limit of shareholding to define the electorate as is currently set under § 252, but should rather only exclude the promoters and shareholders related to the promoters. Such a stipulation will potentially lead to more interest from the institutional investors who, given their common interests with the retail investors, are more likely to protect the small shareholders. Also in light of the broader monitoring role that the independent directors are expected to play, restricting their membership only to representatives of the small shareholders (defined by strict thresholds) may be counter-productive.

There is also a concern that the ‘majority of the minority’ elections may lead to ‘abuse by minority’ as the directors elected through this process may protect the interests of the minority with excessive zeal thus prejudicing the legitimate interests of the majority.\textsuperscript{154} To alleviate this concern, I suggest that if this form of election were to be implemented, the number of independent directors on the board should be capped to reflect the percentage of non-controlling shareholders in the company. Whilst working out the exact percentage will require further research taking into consideration, the interests of both the majority and the minority, it is essential to ensure that the few independent directors that are on the board are genuinely independent. This will ensure that while a section of the board represents the controlling shareholder, the other section vigilantly offers resistance on behalf of the minority. Whist there is an undeniable merit in clarifying the fact that the independent directors are expected to protect the interests of the minority shareholders, adequate steps need to be taken in order to not create fissures within the board.\textsuperscript{155} It has to be borne in mind that the key to the success of any corporate board is its

\textsuperscript{152} Companies Act,1956, §252 states that a public company having a paid-up capital of five crore rupees or more; and having more than a thousand small shareholders (defined as holding shares of nominal value of twenty thousand rupees), may have a director elected by such small shareholders. The procedure for the appointment has been prescribed under the Companies (Appointment of the Small Shareholders’ Director) Rules, 2001.

\textsuperscript{153} Tania Kishore Jaleel, As a Small Shareholder, Your Path to a Company’s Board is Blocked, BUSINESS STANDARD (Mumbai) August 21, 2012 (Jaleel quotes Mumbai based corporate lawyers to assert that contrary to popular belief, the company has sole discretion on whether to appoint a small shareholders’ director. Also there are logistical issues involved, as not enough small shareholders may choose to vote).

\textsuperscript{154} SEBI Consultative Paper, supra note 133, ¶11.1.

\textsuperscript{155} Leech & Mundheim, supra note 30, 1805, 1830 (Whilst the independent directors should be primarily responsible for safeguarding the interests of a particular section of stakeholders, the law should not encourage a scenario where a part of the board views itself as the adversary

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 collegiality and whilst the independent directors should have clearly defined duties towards the minority shareholders, they should not be required to act as auditors but as robust sounding boards.\textsuperscript{156}

\textbf{B. SPECIAL SAFEGUARDS FOR INDEPENDENT DIRECTORS}

Apart from changes to the election procedure, there are other ways to ensure that the independent directors are empowered enough to be able to perform their duties well. It must be acknowledged in law that the independent directors owe their duties to a special constituency, which in the Indian context should be the minority shareholders. However, it must be made clear that the position of the independent director is not one of an adversary of the management and the controlling shareholder, but that of a vigilant monitor. I believe that some of the special rules outlined below may go some way in solving the problems discussed here.

1. Rethinking the removal procedure

As discussed earlier, one of the ways of strengthening the institution of independent directors is to give them better security of tenure. This end may be achieved by making the removal process more difficult. As the law stands today, any director (including an independent director) can be removed by a simple majority of the body of shareholders subject only to an opportunity for the director to be heard prior to his removal.\textsuperscript{157} Whilst removal of directors is not a common practice, its very existence and the stigma attached to a potential removal can be a considerable deterrence against directors taking a bold stance. I suggest that special protections should be created as far as independent directors are concerned. Following on from formally acknowledging that the independent directors owe their duties to the minority shareholders in particular, their removal may be made subject to a vote by the minority shareholders alone. An alternative to this would be to create a rule stating that independent directors will not be removed without a proper cause. It is also worth considering whether the same protection that the Companies Act, 2013 gives to the statutory auditors should also be extended to the independent directors so as to give them a better security of tenure, allowing them the freedom to carry on their mandate without having to worry about the consequences of attracting the displeasure of powerful people in the company.

\textsuperscript{156} Khanna & Mathew, \textit{supra} note 49, 37 (Based on interviews, Khanna & Mathew find that all the interviewed independent directors viewed their primary role as being strategic advisers to the promoters).

\textsuperscript{157} Companies Act 1956, §284 (3) (The position is nearly identical in the UK under §169 (2), UK Companies Act 2006).
2. Relaxing the liability regime

Another major issue has been the liability that an independent director faces for problems arising in the company during his tenure. This prospect of facing severe liability including potential criminal liability can make him excessively cautious. Although § 5 of the Companies Act, 1956 said that criminal liability will attach to non-executive directors only if no whole-time or managing directors are available, it has been observed that the authorities have often proceeded against independent directors as well. The position of the non-executive director has perhaps been made even more precarious by § 2(60)(vi) of the Companies Act, 2013, which imposes personal liability on any director who is aware of a contravention by having taken part in the board process. Whilst this due diligence requirement is legally sound, it may not work out well in practice. Umakanth Varottil illustrates this problem by describing the plight of the independent directors of Nagarjuna Finance Limited after the company had failed to repay depositors’ money. I agree that painting all directors with the same brush is unfair as the independent directors are often in possession of less information and are less acquainted with the workings of the company. It is obvious that such hounding will certainly serve as a disincentive for people with good credentials to take up independent directorships. Khanna and Mathew have noted that the aftermath of the Satyam scandal led to at least 620 independent directors resigning from boards in 2009. Perhaps in light of this and other similar cases, the government has taken some steps to better protect the independent directors. On July 29, 2011, the Ministry of Corporate Affairs issued Master Circular No. 1/2011, which states that the Registrar of Companies should take extra care before proceeding against non-executive directors. The circular clarifies that the non-executive directors should not be held liable for any lapse by the company or its officers which occurred without the non-executive director’s knowledge, consent or connivance, provided that he had acted diligently. Whilst the Companies Act, 2013 does clarify that directors should be held liable only for breaches that take place with their consent, it does not recognise the light-touch approach towards non-executive directors that the circular appears to have intended.

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160 Varottil, supra note 16, 343-344. Also see, Rajesh Chakrabarti & Krishnamurthy V. Subramanian et al, *Independent Directors and Firm Value: Evidence from an Emerging Market*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1631710 (Last visited on August 1, 2013) (Chakrabarti & Subramanian quote Prithvi Haldea, “…many (independent directors) are worried that their life’s reputation can be ruined overnight and they in fact not only become persona non-grata, but also invite media ridicule and government prosecution. Is the fee they earn enough for them to expose themselves to such risks, is a question many are asking?”)

161 Khanna & Mathew, supra note 49, 36.
While these are welcome developments, more work is needed to be done to further clarify this position. Following on from the suggestion made earlier in this paper that the independent directors should have separate meetings and voting sessions, I suggest that independent directors should be held accountable only for actions transacted in those exclusive sessions. In these sessions which are exclusive to independent directors, the directors would be freer to reflect upon the deliberations that had taken place and their consent or otherwise would be better informed and more independent. I believe that modifying the liability regime on these lines will make the independent directors more secure, and hopefully will go some way in making them more confident monitors.

3. Lead Independent Director/Non Executive Chairman

Another suggestion is the introduction of the concept of a non-executive chairman or a lead independent director. This practice is mandated for FTSE 350 companies by the UK Corporate Governance Code, and requires that the offices of the Chairman and the Chief Executive Officer be kept separate. The Chairman is required to be chosen from amongst the independent directors on the board. The position of the lead independent director in American boards occupies a similar position, although there is no requirement for the offices of the CEO and the Chairman to vest in different persons. In India there is curiously no such requirement although Clause 49 of the Listing Agreement recognises the benefit of having a non-executive chairman and allows some relaxation on that basis. However, the Companies Act, 2013 does not include this special relaxation, but rather sets the requirement for independent directors at a uniformly low level of one-third of the board. Whilst some Indian companies have started having non-executive chairmen or lead independent directors, it has not become common practice yet. However, the SEBI Consultative Paper suggests introducing the concept, although it recognises that it may result in undesirable consequences of creating a power base within the body of independent directors. Whilst this is a valid concern, I believe that the benefits to be derived from the institution of a lead independent director would far outweigh its drawbacks.

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162 UK Corporate Governance Code, supra note 75, ¶A.2.1: The roles of chairman and chief executive should not be exercised by the same individual.
163 UK Corporate Governance Code, supra note 75, ¶A.3.1: The chairman should on appointment meet the independence criteria set out in B.1.1 below. A chief executive should not go on to be chairman of the same company.
164 Clause 49 of the Listing Agreement says that if the chairman of the board is an executive, at least half of the board must be independent directors; whilst if the chairman is non-executive, the proportion of independent directors required is reduced to a third of the size of the board.
165 Out of the thirty companies in the BSE SENSEX, only five companies have a non-executive chairman. In eleven out of the thirty companies (including all six state owned companies), the offices of the Chairman and the Managing Director were vested in the same person. See, Annexure for details.
166 SEBI Consultative Paper, supra note 133, ¶11.11.
A lead independent director or a non-executive chairman can reduce the dominance of the executive members of the board, and can make the independent directors more effective. The office of the lead independent director is also one of the takeaways from the Milgram experiments.\textsuperscript{167} Based on Milgram’s findings, Morck has suggested that if there are two figures within the same organisation who compete for authority, the chances of the independent directors being submissive to the dominant executive would be significantly lesser. It is expected that the lead independent director will effectively counter the influence of the executives on key issues. There are higher chances that the independent directors would rally around the non-executive chairman/lead independent director, and would take their monitoring role more seriously. To that end, it is important that the lead independent director should not be an office that is subject to rotation as suggested in the SEBI Consultative Paper.\textsuperscript{168}

One of the major criticisms against the office of the independent director in general is that, often the concept of collective responsibility of the board leads to individual directors shirking from their responsibilities. Given that, I feel that if the lead independent director’s office is one that follows a rotating arrangement, it will create the problem of no one taking their position as leader seriously.

\textbf{VI. CONCLUSION}

In this paper, I have discussed how the institution of the independent director as it exists, is ill suited to deal with the majority-minority problem in Indian corporate boards. The reason perhaps is that the genesis of the institution lay in a corporate setting that is fundamentally different from that in India. This fact has been surprisingly under-theorised. However, recently there has been more critical analysis of this issue. Despite its many flaws, there is a general understanding that the institution has become such an integral part of the corporate governance framework in India that it would not be prudent to abolish it. I agree with Dr. Varottil that independent directors, whilst not necessary in the Indian setting can still serve an important purpose.\textsuperscript{169}

For this however, it is essential that there must be a formal acknowledgement that the main role that the independent directors will play is to act as the guardians of the minority shareholders against excesses of the majority. To that end, certain fundamental legal provisions must be changed so that the nomination and election procedure gives primacy to the minority shareholders.

\textsuperscript{167} Milgram had concluded that if there were two persons sharing the same space who compete for authority, it is more likely that the others present in the room would be able to act more rationally rather than being subservient. If the others present in the room lean towards the arguments put forth by one of the two competing figures, they are more likely to rally around that person.

\textsuperscript{168} SEBI Consultative Paper, supra note 133.

\textsuperscript{169} Varottil, supra note 16, 349.
Also, the functioning styles of corporate boards should be amended to allow the independent directors to be able to monitor the executive directors more effectively. Apart from these, there have been concerns about the quality of independent directors and whether they have the skills required for the job. To deal with this problem, there must be greater emphasis on training and orientation.\textsuperscript{170} There has even been a suggestion that a cadre of professional directors and/or a certification process similar to that for other professions like auditors, accountants etc. be introduced. The Companies Act, 2013 envisages creation of a central database of independent directors, which may be the first step towards formal regulation of the institution.\textsuperscript{171} Understanding how this will span out in practice will require further research.

Policymakers may also look for inspiration from other jurisdictions facing a similar majority-minority problem. Some of these models have been discussed earlier in the paper. Whether or not the institution can be ever customised perfectly is yet unclear; however efforts in the right direction will go a long way.

\textsuperscript{170} Khanna & Mathew, supra note 49, 39 (Some interviewees contacted by Khanna & Mathew reported that the training material for independent directors in India were inadequate).

\textsuperscript{171} Companies Act, 2013, §150.

April - June, 2013
### ANNEXURE

#### BSE SENSEX COMPANIES – PROMOTER/PUBLIC RATIO**

<table>
<thead>
<tr>
<th>Company</th>
<th>Promoter</th>
<th>Public</th>
<th>Chairman</th>
<th>Managing Director</th>
<th>State?</th>
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<tr>
<td>Bajaj Auto Limited</td>
<td>50.03</td>
<td>49.97</td>
<td>Rahul Bajaj</td>
<td>Rajiv Bajaj</td>
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<td>Bharat Heavy Electricals Ltd</td>
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<td>34.77</td>
<td>Sunil Bharti Mittal</td>
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<td>Cipla Limited</td>
<td>37.20</td>
<td>62.80</td>
<td>Dr. Yusuf K Hamied</td>
<td>Mr. Subhan Saxena</td>
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<td>G V Prasad</td>
<td>Satish Reddy</td>
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<td>Aditya Puri</td>
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<td>Dr. Brijmohan Lall Munjal</td>
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<td>Hindalco Industries Ltd.</td>
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<td>Kumar Mangalam Birla</td>
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<td>Hindustan Unilever Ltd.</td>
<td>52.48</td>
<td>47.52</td>
<td>Mr. Harish Manwani (Non Executive)</td>
<td>Nitin Paranjpe</td>
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<td>HDFC</td>
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<td>Deepak Parekh (Non Executive)</td>
<td>Renu Sud Karnad</td>
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<td>ICICI Bank Ltd.</td>
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<td>Y. C. Deveshwar</td>
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<td>Director</td>
<td>Director</td>
<td>Shareholding Available?</td>
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<td>53.03</td>
<td>Mukesh D. Ambani</td>
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<td>State Bank of India</td>
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<td>Anil Agarwal</td>
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<td>Sun Pharmaceutical Industries Ltd.</td>
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<td>Israel Makov (Non-Executive)</td>
<td>Dilip S. Shanghi</td>
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