DOUBLE BLIND PEER REVIEWED
VOLUME: I, ISSUE: I
January (2025)

LEX GAZETTE
International Multidisciplinary Research Journal

Lex Gazette International Multidisciplinary
Research Journal

OPEN ACCESS

RISING COST OF INDEPENDENT DIRECTORS AND IMPACT ON CORPORATE GOVERNANCE

Mr. Himanshu Tiwari

LL.M (Student), Dharmashastra National Law University

Himanshu Tiwari is a passionate law student pursuing an LL.M. at Dharamshastra National Law University, Jabalpur. With extensive internship experience at the Supreme Court of India and the M.P. High Court, he has honed his expertise in legal research, drafting, and case law analysis. Actively involved in academic and student-led initiatives Contact: thimanshu901@gmail.com

ABSTRACT

This paper discusses the role of independent directors in modern corporate governance by ensuring accountability, transparency, and ethical management. It also explains the primary functions of the independent directors which are oversight of objectives and independence from the company's management. This paper also urges how independent directors protect the interests of stakeholders by making transparent decisions. It also deliberates the contribution of independent directors in corporate governance by providing their expertise in decision-making, enhancing board diversity, and mitigating conflict of interest. This paper also unleashed the evolution of corporate governance in India based on the evolution of the different committees and the laws that govern independent directors. In it the effect of having a good ability of independent directors, the importance of diversity of independent directors, the independently made judgment's impact on the governance, effective functioning of the combination of executive directors, the constitution of the board by the audit committee and the remuneration committee. This paper also emphasizes the impacts on the governance of the corporation of having an independent director as unleashing the effective functioning of the company, enhancing credibility as well as the supervision of independent directors. It also has some highlighted situations where there is a requirement for independent directors such as financial distress or a restructuring plan, family-owned business, regulatory compliance, and risk management, enhancing board multiformity, misappropriation of funds as well as fraud, crises management, and conflict resolution in addition to in case of merger and acquisition the pivotal role of independent director in governing the corporate.

KEYWORDS

Independent Directors, Corporate Governance, Non-executive directors, Impact, Facilitation, Conflict of Interest

Introduction

In sports, there is a concept of having one empire who does not follow the commands of either captain and exercise his duties unbiased and in a neutral way, by having consider the best interest of both the sides. Similarly, a director who does not work within the company but authorized to take decisions in the company's affairs even having authority to manage the affairs of the company. Independence is something which is not an end but is supposed to serve the already settled goals. Various countries ordinarily have different definitions using different set of the criteria in accordance to the jurisdiction of legislature or other governing bodies which are imperative in the given reference[1]. While executive directors consider specific interests and would be confined to the perspective dictated by such interests on the other hand the ability of independent directors to bring an objective based element to board's functioning in the companies' interest and thereby to benefit of interests of the shareholders irrespective of their number of holdings. Therefore, "Independence is not to be viewed merely as independence from Promoter Interests but from the point of view of vulnerable stakeholders who cannot otherwise get their voice heard[2]." The independence of directors addresses concern of the 'Objective Monitoring Model' wherein the independent directors are more expansively monitors corporate decision making. Even courts considered to this model to judgement reconciliation rule for business while consider shareholders primacy[3]. The idea of "director professionalism," which calls for directors with knowledge of important aspects of the company's operations and expertise in their respective fields, should serve as the foundation for independence. These directors must also be skilled in serving as capable, vigilant managers' overseers and advisors. Modern corporate governance theory largely proposes the directors' independence mechanism as a means of reducing agency costs.

Evolution In India

In the Indian Corporate arena, ***Kumar Mangalam Birla*** committee which is formed by Security and Exchange Board of India, brought the concept of Independent Director, therefore ***Clause 49*** *added in* ***the "Listing Agreement between companies and stock exchanges" by SEBI*** *in* ***2001.*** During the same period there was a fall of the US based corporate company Enron, World com and responding to failure and fraud the corporate governance that resulted in material financial loss to investors, congress passed the Sarbanes Oxley Act[4] in US. The Ministry of Company Affairs in 2001 constituted a committee named on, Sir ***Naresh Chandra***,

---

[1] By P. L. Davies et al, '*Corporate Boards in Europe: Accountability and Convergence*,' American journal of comparative law, JSTOR, 61 (2013), https://www.jstor.org/stable/43668157

[2] Ministry of Corporate Affairs, "*Management and Board Governance*", Government of India, https://www.mca.gov.in/mca/html/mcav2_en/home/dataandreports/reports/otherreports/report+of+the+expert+comm ittee+on+company+law/management+and+board+governance1/management+and+board+governance.html

[3] Harvard Law Review, *beyond "Independent" Directors: A Functional approach to bard insurance*, JSTOR, (Mar 5, 2006), https://www.jstor.org/stable/4093581.

[4] The Sarbanes Oxley Act, https://sarbanes-oxley-act.com/.

which stimulate the corporate governance by giving more thought. Following up, after two consecutive years in 2003, SEBI constituted another committee named on *sir* ***Narayan Murthy*** which having similarity with the ***Chandra Committee***. The recommendations of both committees, incorporated in the Cl-49 which was amended in 2004. Subsequently, Murthy committee report accepts the independent directors' definition, given by the "N. Chandra Committee," after an exemption of nine-year term. The adjoined corporate governance framework enclosing the Independent Directors which is based upon Narayan Murthy report's clause 49.

Here are some new law, rules and regulations which governs Independent Directors:

i. The Companies Act, 2013, specifically section 149 (6), and Schedule IV.

ii. SEBI guidelines, specifically Section 16 of SEBI Regulations, 2015.

Significance Of Independent Directors or Non- Executive Directors

A person with good ability is of prime importance in setting and maintaining the standards of corporate governance. They are expected to make primary and positive contributions to the leadership of the company as equal board members.

- The importance of the number of adequate independent directors is that if the number of such directors is more than that they are unable to work collaboratively with their executive colleagues and demonstrative objective and robust judgement independency when required[5].
- The power of independent judgment plays an important role in company management on strategic issues, performance, resources, key appointments as well as the conduct standards. For this reason, the committee recommended that the Board should have at least 3 independent directors, out of them one shall be the company's chairman, provided that he should also be the executive head. Following two should not be present simultaneously.
- Further, independence of judgement means besides the director's fees and shareholding, they must not be dependent on the management and not restrained from any business or any other relationship that could interfere materially the independent decision-making power.
- In the matter of fees, a balance must be struck in recognizance of the value of independent directors' contribution. The fees of directors should include time devoted by them to the affairs of the company. Also, to safeguard their independence, the committee suggests not to take participation in share option scheme for independent directors' good practice and not to make the service as an independent director pensionable by the company.[6]
- The board of a company functions effectively when the board has a combination of

[5] See. Cadbury Report, 1992. para 4.10.
[6] See. Cadbury Committee Report, 1992, para 4.13.

executive directors, who have in-depth business knowledge as well as external non-executive directors, may brought wider perspective to activities of the company, under an accountable and responsible chairperson.[7]

- As a result of their independence from executive accountability, independent directors have two important contributions for governance process particularly.
    1. **1.** The board and executives' performance review. Monitoring whether they are doing their job with integrity. Independent directors should look carefully at the aspects of their responsibilities and must ensure the chairman's awareness for their views.
    2. **2.** To take the lead when there is a potential for an interest's conflict. An important aspect in this regard is that the specific interests of company can varied. The interest of independent directors is less likely to affect directly, in a better position to aid and to solve such a situation.[8]
- With regards to Audit Committee, for the purpose of rising the standard of the corporate governance, the audit committee appointment based on proper constitution is a critical aspect. The effectiveness of such depends on their having a strong chairman and an Independent Director along with other members of the board for the said purpose[9].
- With regards to Remuneration Committee, the board should consist wholly and mainly of non-executive directors and has a non-executive director as chairperson, for recommending the board remuneration of the executive directors in all its forms which may also be drawn from an outside advice according to the need[10].

Impact On Governance of The Corporate Having Independent Director

Unleash the effective functioning of the company:

Typically, non-executive directors play an advisory role in the governance of a company. For example, they bring financial management and legal knowledge and substantial industry experience to have a valuable insight and advices the companies for decision optimization and effectively have negotiation in composite business environment as well as in managing the risk. As it is generally expected that such non-executive or independent directors are skilled individuals, highlighting the quality and effectiveness of the board. In this regard, the UK Corporate Governance Code has clearly;

a. The requirement from non-executive directors is to have constructive questions as well as the strategic guidance and advice of the experts and also to be accountable;

[7] See. supra footnote 7, para 4.3.

[8] See. supra footnote 7, para 4.3.

[9] See. supra footnote 7, 4.37.

[10] See. supra footnote 7, 4.42.

b. Lastly, a member minimum of an audit committee having independent directors should have financial experience.[11]

Enhancing credibility:

The presence of a non-executive director will enhance the credibility of the board to function effectively, also retouch the company's reputation in the market. Here is an incredible example in support of having Independent Director in the board, that is in the US and UK, it is being considered that if there is presence of Independent Director then it is criterion of good and bad corporate governance because of board of directors' control and, so the company have the best management that occurred in 1960s. The separation of power between ownership and control, the insider control problem was not in the plate of shareholders, here monitoring the independent directors' role was an effective as well as significant solution for its problem.

"The governance standards for companies listed on the New York Stock Exchange in the United States require that independent directors must constitute a majority of the board of directors of a listed company. This is also the case in the UK, where at least half of the board, in addition to the chairman, should be independent non-executive directors recognized by the board. The role of independent directors remains prominent and is still chosen by many investors for its credibility. In the case of Uber, Uber unanimously passed a series of resolutions at its board meeting to improve its corporate governance structure to bring in a US $1-1.25 billion investment from a consortium led by SoftBank Group, the most crucial measure of which was the selection of an independent chairman and independent directors[12]".

Supervision:

Here the non-executive directors perform a significant role in executive management overseeing of the company. Along with overseeing the financial reporting in addition to the audit functions, for the purpose of transparency and accountability. The independent directors' role depends on several specialized functioning of the board's committees collectively. The independent directors' percentage is one of the most significant aspects on the board as the board's independence represents through it and also it can also be seen as an objective and professional mechanism.[13] The motive behind the supervisory authority of a director is primarily to protect the rights and interest of the shareholders, and to restrict the problem of "insider control" because it is the grey area of the "Agency problem" and system costs. So,

[11] *UK Governance Code, 2018*, FINANCIAL REPORTING COUNCIL, (Jan 22, 2024), https://www.frc.org.uk/library/standards-codes-policy/corporate-governance/uk-corporate-governance-code/

[12] By Z Junmeng Chang, *The role of independent directors in ensuring good corporate governance*, RESEARCH GATE, (Nov 2023), file:///C:/Users/91989/Downloads/The_Role_of_Independent_Directors_in_Ensuring_Good.pdf

[13] [13] Ye Sun, Yang Yi at el, "*Board Independence, Internal Information Environment and Voluntary Disclosure of Auditors' Report on Internal Controls*" SCIENCEDIRECT, (Jun 2012), https://www.sciencedirect.com/science/article/pii/S1755309112000196.

there is an apparent necessity to keep an eye on insider management. By, firstly, Increase the proportion of the appointment of an Independent Directors, there by decentralizing the decision-making and management powers of the company because they are outsiders and not having involved in the day-to-day life of the company prior to their appointment. Secondly, along with making the business decisions they also oversee and monitor the day- to-day functioning of the company. There is an addition by UK Corporate Governance Code of 2012, among other things that the board must provide an objective and understandable assessment of the current situation and prospects of the company as the main principle.

Why Do Companies Need Independent Director?

The most effective characteristic of any successful company is an effective Board of Directors. The BOD consists specified members for the effective functioning of the company. Among them there is a member known as Independent Director or Non-executive Director. Such Independent Director play a pivotal role in the effective functioning of the company. He functions as to monitor the management of the company along with perform his role as a preserver of the rights of the shareholders and their interests as well. The Shareholders are the very significant part of the corporate functioning; therefore, it is always quintessential to protect their rights and interest.

However, with the very inception of the corporate world there were only executive directors which manages their respected companies along with their colleagues. But as the times passes the needs and the unjust requirements of the people got increases. Such requirement leads to Unjust enrichments, wherein, a person make money or profit on the loss of other person. Along with another practices that is the corporate frauds. Such practices also lead to the downfall of the corporate governances.

The formal origin of the regime of Independent Directors in India was considered in the year of 2000, under Clause 49 of the SEBI guidelines (Listing Obligation and Disclosure Requirements). As a result of which the recognition of independent directors is being provided under section 149 of the Companies Act, 2013 provided as well these directors also appointed and governed by this act. The companies act 2013 and the given schedule in it details the roles and duties of Independent Directors and it also seeks to protect them from frivolous prosecution with having a requirement to exercise diligence by supporting the allegations with proof of knowledge, consent as well as with having a connivance. The responsibilities performed by an independent director is based on information provided by the company's key management, personnel in addition to executive directors. Because of this, the independent directors are only able to raise the red flag in relation to matters that they become aware of during regular company operations and through board procedures; they are not required to carry out on-site investigations.

A survey has been conducted by “Deloitte Touche Tohmatsu India LLP” in collaboration with the “Institute of Directors” for better understanding how the independent directors or the non-executive directors scrutinize the fraud present in the corporate, their readiness to deal with it, and how to mitigate such fraud and risks. In "Corporate Fraud and Misconduct: Role of Independent Director", approximately seventy five percent of independent directors agreed that they could have a significant role to prevent, detect, and respond to the fraud.

To manage the managerial flows in the company the facilitation of independent directors may provide a hand. These directors supervise companies' behavior legally and ethically. They play a role of "Pitamaha Bhishma" for long term companies' decisions. As mentioned above they are required to provide their expertise to prevent fraud and misappropriation by the company or its directors.

Here are some highlighted situations where Independent Director is required: -

a) **Financial Distress or a restructuring plan**; In the event, where there is a need of restructuring of the plan or the financial distress facing by the company, they often look for a non-executive director to suggest a strategic plan and perspectives and financial expertise in addition to the governance. For the implementation and development of effective strategies the non-executive directors facilitate into fasten the company's financial position as well as in recovering its growth.
b) **Family-owned business**; Such business may face challenges related to succession plan, interest conflict, or the need for professionalization. Such director can bridge such gaps and provide necessary advices for the effective governance.
c) **Regulatory Adherence and Risk Mitigation;** these directors ensure compliance with laws, regulations, and corporate governance standards. They effectively help in risk management framework, carry into effect robust internal control systems, and reenforce ethical conduct, along with to navigating complex regulatory landscapes and mitigating compliance risks. Because companies face irregularly in the corporate governances.
d) **Enhancing Board Multiformity**; By the induction of Independent Directors such bring multiformity of skills and expertise in the board. Which ultimately leads to uplift the companies' performance in the financial market, also improve the companies' image in the market. It boosts comprehensive analysis of intricate issues.
e) **Misappropriation of Funds or Fraud**; At most of the time a name of the companies' highlighted because of corporate fraud found in its management. Forensic accounts bring their expertise in uncovering financial irregularities, conducting investigations, and implementing remedial measures to help companies restore order.
f) **Crises Management and Conflict Resolution**; In the said scenario independent directors play a role by providing their expertise advices which help to resolve the said issues, due to their neutrality and the objective assessment of the situation, which helps the board and management to navigate turbulent circumstances. He acts as mediator, facilitate dialogues and finding resolutions that preserve the company's interest.
g) **In the event of mergers and acquisitions**; Here the primary function which the directors have to play that is to protect the interest of the shareholders in the event of mergers and acquisitions. For the said purpose they review deals, T&C, conduct deal due diligence, and

provide neutral advice to the board. Their presence adds credibility and maintains transparency throughout the transaction process.

Initiatives

Independent directors would be able to add an element of objectivity to the Board process in the company's best interests, which would benefit minority interests and small shareholders, while directors representing specific interests would be limited to the viewpoint set forth by such interests. Therefore, it is important to consider independence from the perspective of vulnerable stakeholders who would otherwise be unable to raise their concerns, rather than just from the perspective of promoter interests14. Recently where the stock exchanges BSE and NSE have slapped fines on Oil Refineries and Fuel marketing giants, Indian Oil Corporation, Hindustan Petroleum Corporation, Bharat Petroleum Corporation, explorer Oil India, gas utility GAIL (India) and refiner Mangalore Refinery and Petrochemicals (MRPL) for not meeting the requirements or the listing norms of having the requisite numbers of Independent Directors and Women Directors on their board.[15]

Conclusion

Essentially Independent directors are the linchpin for the modern corporate governance. The role of independent directors surpasses from mere compliances, ethical decision making with management, accountability as well as ensuring the transparency mechanism. These directors with having an unbiased prospective and objective based decision not only providing their valuable oversight over company's decisions but also take care of the interest of minority stakeholders. The expertise of these directors is focused on long term goals and not dependent upon the management which facilitate the management to take the complex and risk-free decisions due to which the company's market reputation increases which promotes the sustainable growth.

Due to the evolution of the corporate governance in India as well as globally, the role and importance of the Independent Directors make a recognition. In shaping the future and ever evolving regulatory business landscape, the integrity and responsibility of the independent directors make them indispensable. Independent directors are the vital agents of the corporate governance for the sustained success as well as for the ethical and robust government

[14] By Sai Venkateshwaran, *Sebi's new LODR amendments empower independent directors, but allowing for a lead independent director is crucial, FINANCIAL EXPRESS, (Jul 5, 2021), https://www.financialexpress.com/opinion/sebis-new-lodr-amendments-empower-independent-directors-but- allowing-for-a-lead-independent-director-is-crucial/2283723/.*

[15] *Oil giants keep rolling in fines: IOC, BPCL & others hit for missing board norms for fifth consecutive quarter*, The Economic Times, (Aug 25, 2023),

https://economictimes.indiatimes.com/industry/energy/oil-gas/oil-giants-keep-rolling-in-fines-ioc-bpcl-others-hit- for-missing-board-norms-for-fifth-consecutive-.

LEX GAZETTE
International Multidisciplinary Research Journal

framework. As corporate governance evolves continuously, the role of the independent directors will continue to grow.

more. It raises ethical concerns surrounding bias, transparency, accountability, and the influence of automation on employment. It also addresses wider ethical issues, such as data privacy, cybersecurity, and the responsible advancement and utilization of technology.