

Independent Directors in Ensuring Good Corporate Governance

Jiaqi Li

School of law, University of Leeds, Leeds, United Kingdom

Abstract: This essay primarily analyses the role of independent directors in ensuring good corporate governance. This will begin by analysing the concept of an independent director and the two roles of an independent director in a broad sense. After that, the paper explains why independent directors sometimes fail to achieve the desired results of promoting good corporate governance from two perspectives. In addition to these theoretical analyses, this essay also analyses the practical effects. This essay analyses the practical effects of the independent director system in the UK, the US and India and it analyses what problems independent directors have been used to solve in different countries. In conclusion, this paper argues that factors such as different countries and different corporate structures need to be taken into account when analysing whether independent directors can ensure good corporate governance.

Keywords: Independent director, Corporate governance, Integrity, Wealth maximization task.

1. Introduction

As corporate governance theory continues to improve, the role of the independent director continues to evolve. This essay begins with a theoretical analysis of the concept of the independent director and the two roles of the independent director in a broad sense, namely the regulatory role and the wealth maximization role. In analyzing the role of the independent director, the essay analyses the relationship between the independent director and corporate governance and the factors that influence the exercise of the independent director's functions, which explains why sometimes the independent director fails to achieve the desired outcome of promoting good corporate governance. Secondly, the essay analyses the effects of independent directors in practice in different countries. While independent directors in the UK and the US were created to address the manager-shareholder agency problem in accordance with the structure of their companies, independent directors in India face a different corporate structure and a different approach to the appointment of independent directors, and this paper analyses whether independent directors in India have contributed to good corporate governance [1].

2. The Concept of Independent Directors

The institution of the independent director originated in the United States in the 1950s, when the collapse of major corporations such as Enron Corp. was a measure of whether a company was well governed. It was not initially prescribed by law and has only since been made legally compulsory. On 30 July 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (SOA). The Sarbanes-Oxley Act contains a few reforms aimed at protecting investors, with policies primarily concerned with improving the accuracy and reliability of corporate disclosures. One such reform is the provision on independent directors, which requires companies listed on major stock exchanges to maintain audit committees composed entirely of outside independent directors [2]. Independent directors have only since become more

prominent due to the continued efforts of the Delaware courts and stock exchanges in respecting independent board decisions.

Regarding the concept of independent directors, even those who support them are not clear on what they mean, and the proponents do not share the same definition of independence. Defining an independent director begins with an understanding of independence [3]. Independence: An independent director is one who provides effective and impartial oversight, and since one of the key roles of the board is to oversee executive management, effective and impartial oversight is possible if the board is independent of executive management. Therefore, ensuring that the board's decisions are not influenced by anyone, and independence becomes a primary consideration and a prerequisite.

The importance of independence is most evident in the event of a conflict of interest. "Most regulatory initiatives over the past decades that have refined the concept put special emphasis on independence for board committees, such as the remuneration committee, the nomination committee and the audit committee". Between these committees, the temptation to bring benefits through interpersonal relationships regardless of objective standards has to be acknowledged as a great temptation. For this reason, many regulatory bodies around the world have established standards of independence just to prevent people on these committees from taking advantage of interpersonal relationships and disregarding the rules of objective standards. At the narrowest level, independence refers to the relationship between the director and management, with the director being the representative of the shareholders. At a broader level, independent directors are not only independent in monitoring management, but are also accountable to those involved, such as consumers or the public affected by the company's activities. Some believe that independent directors are elected by shareholders alone and that independent directors also oversee the interests of the supervisory directors; others believe that independent directors should be elected by outside voters, making independent directors fully accountable to their constituents and then, incidentally, to shareholders [4].

Regardless of the view, the basic functions of independent

directors probably fall into two categories: “(1) to motivate managers to fully execute their wealth maximisation mandate in the long and short term; and (2) to ensure the integrity of managers in the allocation of corporate assets between themselves and shareholders.” Although in a formal sense these two functions are carried out by the Board as a whole, independent directors have a special influence and responsibility for these two functions.

3. The Role of Independent Directors

3.1. The relationship between independent directors and corporate governance

With regard to the conceptual aspects of corporate governance, some experts believe that corporate governance is about steering a company on the right path [5]. Mr M. Damodaran, former Chairman of the Securities and Exchange Board of India, describes corporate governance as an ongoing process and one that goes beyond mere legislation. As he said, the legislation relating to corporate governance is only a starting point and the real purpose of corporate governance is to achieve profitability. Companies need to be aware that these corporate governance practices are not done out of fear of sanctions, but that without such corporate governance the company would not be profitable. Mr M. Damodaran sees independent directors as staff who contribute to the board; others see the role of independent directors as “conscience keepers”, The idea is that they can steer the company in the right direction when others may be influenced by other interests for their legitimate benefit [6].

3.2. The Role of Integrity

What are the factors affecting the management of free trade?

Have independent directors contributed to an increase in the integrity and effectiveness of management? It used to be that a norm for controlling management behaviour to ensure integrity was to bar management from engaging in self-dealing or utilising company property for its own advantage. However, this is no longer effective as a preventative deterrent to the kind of self-dealing that was previously considered acceptable [7]. It has been demonstrated through research that there is value in permitting management to engage in self-dealing; nevertheless, such self-dealing necessitates rigorous compliance with the necessity to disclose to and gain the approval of the directors who do not wish to engage in the transaction. However, in the process of evaluating the requirements for such a transaction, the directors or the court do not have precise criteria by which to decide whether the transaction is within the boundaries; rather, they are simply instructed by some generic sense of "fairness." In principle, management may be eligible for a personal benefit, but the value of such benefit cannot exceed the amount of public compensation management has stipulated it will accept. If management earns more than this definition of "fairness" through self-dealing or use of company property, then the excess is at best just indirect remuneration to which management is not entitled. This is because this concept of "fairness" is based on a standard of equality. Whether or not there is an unacceptable level of self-dealing is a question that needs to be answered by the board, and by the independent directors. In this process, the Board refers to the market to judge whether the self-dealing is of benefit to the company [8].

Therefore, at this level, independent directors can regulate

the process of self-dealing and there are undoubtedly benefits to independent directors in regulating self-dealing, but do independent directors actually act as substantive regulators? This question is difficult to substantiate with strong evidence.

Only when the relevant information is disclosed to the independent directors can the independent directors approve the validity of a self-dealing transaction in accordance with the governing rules. However, as the information is difficult to process, based on the judgement of many data, such regulation can take a lot of time and effort. In the context of engaging in self-dealing, these objective issues can be handled or almost are addressed; however, the subjective factors cannot be ignored due to the fact that the independence of independent directors implies a condition of antagonism to others [9]. In principle, independent directors are what make self-dealing possible in accordance with the rules of the market; yet, in practice, independent directors are chosen very infrequently without at least the previous consent of management. In addition to this, we have to consider a situation where there is a risk that management may become disillusioned, and thus the welfare of shareholders, if responsible independent directors prevent excessive management self-dealing.

In summary, the criteria for free trading, the certification of relevant facts and the psychological pressures faced by independent directors have resulted in independent directors not being able to do a very good job of regulating free trading. However, this does not mean that independent directors have not limited management expansion, but only that the effectiveness of independent directors' management may be less than satisfactory [10].

3.3. Wealth maximization task

Independent directors have a responsibility to maximize wealth and, in order to improve the performance of management, the value of independent directors is mainly in providing advice and giving counsel. This function of the independent director is requested by the manager on his or her own initiative, for example, when management consults the independent director. However, according to a recent theory, the function of the independent director is to 'monitor', which involves the independent director identifying management problems, assessing management performance and, where necessary, implementing management plans or even replacing management. But this monitoring function is difficult to achieve.

In addition, how should management's efforts to maximize shareholder wealth be assessed? There is no standard answer to this question and the assessment is an open-ended one [11]. However, management is often not quick to provide key information to the board and the structure of the decision-making process is such that the board cannot easily rely on information provided by management, so there is more scope for the board to act on its own initiative. But to get this oversight right requires a significant investment of time and effort, and these directors are unable to do so without the help of others. In such cases, many people want to let the independent directors take the risk of supervision. Independent directors need to participate in decision-making with inside directors in order to improve regulatory efficiency and achieve the wealth maximization mandate. However, in order to maintain good working and interpersonal relationships, independent directors will rarely make recommendations to management. Therefore, it is difficult to

get independent directors to take the initiative to raise management's shortcomings and give suggestions for correction [12].

And do independent directors play a role in improving management performance and maximizing wealth? The available data provides little evidence that independent directors play a large role. There is some evidence that a significant number of independent directors are more diligent in supervising managers than internal boards; however, there is also evidence that managers do not perform better under independent directors [13]. Other evidence suggests that the most important monitoring role of independent directors is to motivate management, who are required to report to the independent directors. However, these findings only show that independent directors do not play a role in maximizing performance, not that they do not play a role in maximizing wealth.

In conclusion, there are many different views on whether independent directors have a role in maximizing wealth. However, it is indisputable that independent directors do improve efficiency and performance, although the effect is not huge.

4. The practice of Independent Directors

There are significant differences between the countries of origin of independent directors and India in terms of the corporate ownership structures and legal frameworks. India is one of the countries with the most diverse corporate shareholding structures. Due to the decentralised shareholding structure, independent directors were required to be included in the corporate governance requirements of both the United States and the United Kingdom. These rules were created so that independent directors may serve as a management monitoring tool for shareholder interests. However, applying legal principles to a nation like India without taking into account the local corporate structure and related aspects may result in unforeseen and disappointing outcomes.

4.1. The practice of independent directors in the United States

As mentioned earlier in this paper, the US confirmed the relevant provisions for independent directors in the Sarbanes-Oxley Act of 2002. In practice, "American boardroom practice is replete with instances favoring independent directors as a solution to the manager-shareholder agency problem", the independent director was a response to the 'manager-shareholder problem', which was also a problem raised by the legal and economic development of independent directors. The Monitoring Board was set up to monitor managers, again in the context of the 'manager-shareholder problem' caused by fragmented ownership.

When Delaware courts in the United States are faced with a manager-shareholder agency problem, courts often rely on the judgment of independent directors in three main areas: self-dealing transactions, derivative suits, and hostile takeover situations.

In self-dealing transactions, some conflicting transactions are unavoidable, such as executive remuneration. When such conflicts arise, the court defers to the independent directors, who are disinterested in these transactions, and this helps the company to appoint and reward managers.

When it comes to derivative suits, Delaware law states: "whether taking the well-pleaded facts as true, the allegations raise a reasonable doubt as to (i) director disinterest or independence or (ii) whether the directors exercised proper business judgment in approving the challenged transaction." An independent director is one who can bring a derivative action directly to the court without having to make a request to the board of directors to do so. This is because the law requires that when a shareholder wishes to bring an action on behalf of the company against a director or officer of the company, the shareholder must make a request to the board of directors, which in turn will bring the action on behalf of the company. However, boards of directors are generally reluctant to sue their own officers or members, which is why there is an exception for independent directors who can sue directly in court without having to make a request to the board of directors.

Hostile takeovers can involve the interests of the hostile acquirer and the interests of the board of directors, and they often occur in companies without a controlling shareholder. "The directors [were required] to show that they had reasonable grounds for believing that corporate policies and effectiveness existed." Due to the significant increase in hostile takeovers, the court again chose to trust the independent directors' decision on the matter. The court found that the evidence based on a reasonable inquiry was "substantially strengthened Approval of a board of directors consisting of a majority of outside independent directors" Although the court did not attempt to define "independence" in *Unocal*, it subsequently exercised it in *Unitrin Inc. v. American General Corp.* American General Corp. Courts have progressively defined the meaning of "independence" of directors in situations such as hostile takeovers, as well as encouraging companies to appoint independent independent directors to their boards. Thus, the Delaware courts' reliance on independent directors in the event of a hostile takeover situation means that protecting the interests of shareholders from the actions of managers is, in fact, fundamentally designed to address the manager-shareholder proxy problem.

Gradually, provisions for independent directors emerged. The Sarbanes-Oxley Act does not actually provide for the "independence" of independent directors, but it does require that each member of the audit committee of a listed company be an independent director. Subsequent revised rules of the New York Stock Exchange and NASDAQ required a majority of independent directors on the boards of all listed companies, and each exchange defined an independent director.

4.2. The practice of independent directors in the UK

Independent directors have a relatively short history in the UK compared to US companies, but there are many similarities between US and UK corporate governance practices, except for some non-principled issues that are somewhat different. The origins of independent directors in the UK can be attributed to the Cadbury Report in 1992. Non-executive and independent directors are terms that are introduced in the report [14]. Non-executive directors are tasked with "exercising independent judgement on issues of strategy, performance, resources, including key appointments and standards of conduct." The Cadbury Report, in particular, assigns the Non-Executive Directors two key responsibilities: (i) assessing the performance of the Board and senior

management; and (ii) taking the lead in making decisions where conflicts of interest occur. In this light, the role of independent directors is well suited to the Anglo-American context of overseeing managers for the benefit of shareholders, and fundamentally, non-executive directors may contribute to solving manager-shareholder agency problems, whereas as for independent directors, "apart from their director's fees and shareholdings, they should be independent of any business or other relationship that might materially interfere with independent judgment, and not the existence of any business or other relationship." The board of directors of a company is given sufficient power to decide whether each director meets the definition according to the actual circumstances, and it is clear that independence has nothing to do with who holds the company, but rather with manager-shareholder agency issues [15].

In terms of the make-up of the board of directors, each firm is required to have a minimum of three non-executive directors, of which at least two must be independent. In addition, the board of directors is responsible for establishing, among other things, nominating members and audit committees in order to guarantee the credibility of the financial reports. In conclusion, the Cadbury Report was crucial in laying the groundwork for the creation of corporate governance standards in the UK. After that, the growth of corporate governance was driven by two committees, both of which submitted reports in the area of corporate governance: the Committee on Audit and the Committee on Corporate Governance. The Greenbury Committee suggested putting together a Board Remuneration Committee so that firm executives might have their pay more directly tied to their performance. The Hampel Committee has reaffirmed the role of the Non-Executive Directors. The compilation of all of these committee reports resulted in the publication of the Joint Code of Corporate Governance in 1999, the Code sets out certain rules for the listing of UK companies.

The UK has since undertaken a series of reforms in relation to independent directors, which have become an integral part of corporate governance in the UK. For the UK, the problem is similar to that of the US, namely the "manager-shareholder problem" caused by the separation of ownership and control. One professor pointed out that since most companies do not have a controlling shareholder, independent directors are meant to solve the "manager-shareholder problem". Due to the fact that the majority-minority agency dilemma does not exist in the United Kingdom, we do not observe any preference from policymakers or the judiciary for making use of the independent director institution in regard to the problem at all [16].

4.3. Practice of independent directors in India

As emerging economies open up to foreign investment, some concepts of corporate governance are beginning to take root and independent directors are being introduced. In 2000, the Securities and Exchange Board of India inserted Clause 49 into the equity listing Agreement, which sets out the corporate governance code applicable to all listed companies of a certain size. Against the background of India's majority-minority agency problem, the function of independent directors is most likely to consist of reviewing and approving related transactions that include the controlling shareholder's self-transaction. This is due to the fact that Article 49 does not give a separate mandate or function for the independent directors, nor does it identify to whom the independent

directors owe their allegiance. As a result, this situation has arisen. However, in India, there is a requirement for an audit committee, which has a disclosure obligation only in respect of connected transactions. Apart from the Audit Committee, the Board is only required to set up one committee, namely the "Shareholders/Investors Grievances Committee", the establishment of which is mandatory. Although it is not mandatory for this committee to have any independent directors, in practice it does include some independent directors. Regarding the compensation committee, this is not a requirement, and it is up to the firm to determine whether or not to establish one. The decision is left up to the corporation. The fact that there is no obligatory obligation in India to establish a nomination committee in order to nominate independent directors means that the controlling shareholder has a large amount of influence over the nomination and appointment of independent directors. This creates a barrier for the preservation of the interests of minority shareholders since it is likely that the interests of the controlling shareholder will be the only thing considered by the independent directors selected by the controlling shareholder. In a situation like this one, independent directors do not regulate the management or the shareholders, and it is unreasonable to anticipate that independent directors will fill any regulatory tasks. Independent directors are not subject to any regulatory oversight.

In short, independent directors cannot be expected to exercise any meaningful oversight in light of the economic and legal context in India, so independent directors are not well placed to enhance corporate governance.

5. Conclusion

In general, independent directors do play an important role as shareholder advocates and play an important role in regulating management and maximizing wealth. It is only that independent directors are subject to certain factors in carrying out their functions, such as the free-trade standard, certification of relevant facts and the psychological pressure faced by independent directors. As a consequence, the function of the independent director is not fully effective, but this does not negate the fact that independent directors play a role in promoting good corporate governance. In addition to this, independent directors would have played a significant role in promoting corporate governance under the corporate structure in the UK and the US, but conversely, in India, the different corporate structure and different legal provisions have resulted in the independent directors not being very effective in promoting good corporate governance. Therefore, when analyzing whether independent directors ensure good corporate governance, factors such as different countries and different corporate structures need to be taken into account.

References

- [1] Umakanth Varottil: Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, *Hastings Business Law, Journal* 6 (2010) No.2, p.281-376.
- [2] Petra, S.T.: Do outside independent directors strengthen corporate boards?, *Corporate governance (Bradford)*, Vol.5 (2005) No.1, p.55-64.
- [3] Brudney, Victor: The independent director: heavenly city or Potemkin village?, *Harvard Law Review*, (1982), p.597-659.
- [4] Ringe, WG.: Independent Directors: After the Crisis, *Eur Bus Org Law Rev*, Vol.14 (2013), p.401-424.

- [5] R. Nolan: The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report' in J. Armour and J. McCahery, eds. *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford, Hart Publishing 2006), p.367.
- [6] Mittal, Pranav: The role of independent directors in corporate governance, *NUJS L, Rev. 4* (2011), p.285.
- [7] Prime Directors, CII Summit Stresses on Importance of Independent Directors in Corporate Governance, (September 14, 2005).
- [8] Alancik and Pfeffer: Effects of Ownership and Performance on Executive Tenure in U.S. Corporations, *ACAD. MGMT. J.*, Vol.23, p.662.
- [9] Salamon and Smith: Corporate Control and Managerial Misrepresentation of Firm Performance, *BELL J. ECON.*, Vol.10 (1979), p.319-327.
- [10] Varottil, Umakanth: Evolution and effectiveness of independent directors in Indian corporate governance, *Hastings Bus. LJ*, Vol.6 (2010), p.281-376.
- [11] *Grobow v. Perot*, 539 A.2d 180, 186 (citing *Aronson v. Lewis*, 473 A.2d 805 at 814 (Del. 1984) [hereinafter *Aronson*]).
- [12] FINANCIAL REPORTING COUNCIL: COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, REPORT, 1992. [hereinafter *Cadbury Report*].
- [13] Richard Greenbury, et al.: *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard, Greenburv, Conf. of British Indus.*, (July 17, 1995).
- [14] FINANCIAL REPORTING COUNCIL, COMMITTEE ON CORPORATE GOVERNANCE, FINAL REPORT, 1998.
- [15] FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE, 1999.
- [16] SECURITIES AND EXCHANGE BOARD OF INDIA, CIRCULAR No. SMDRP/POLICY/CIR-10/2000 (Feb. 21, 2000).