



# Examining The Institution Of Independent Directors To Battle The Menace Of Corporate Frauds

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**Abstract:** In recent times, a lot of corporate frauds and scams have surfaced owing to the failure of corporate governance. The world over has become a cesspool of company malpractices, corporate criminal acts and economic takedowns. A large attribute of such corporate misconduct is the weakening of the institution of independent directors (hereinafter, ID). This is an institution which maintains democracy, integrity, and corporate ethics in a company. Any mitigation of their role, functions or position shall create situations of probable corporate scams. This paper seeks to analyse the efficacy of ID and loopholes critically and comparatively in existing statutory ID framework to battle corporate frauds. The paper has employed a strategic and coherent timeline to phase out the genesis of this institution, role in corporate governance and prevailing need to consolidate its power to address budding corporate misconducts. The author has resorted to an extensive set of books, journals, statutes, and online sources to present his research in a structured and organized manner.

**Index Terms** - Board of Directors, Corporate Frauds, Democracy, Governance, and Independent Directors.

## I. INTRODUCTION

The Independent Directors have been provisioned under Section 149(6) of the Companies Act, 2013 to bring a sense of integrity, judgment, and objectivity on the Board of Directors of a company. Such directors are vital to ensure corporate affairs maintain a strong sense of ethics and values, not compromising on the interests or needs of the shareholders. The entire object of this institution has been fleshed out in Schedule IV of the Companies Act, 2013 to provide a Code of Conduct for this institution to maintain independence and fairness in the top decision-making body. Owing to the non-involvement of personal and ulterior considerations, ID's ensure that corporate affairs are not conducted with any bias, mala fide intention. The essentials enlisted under Section 149(6) for appointment of an ID, warrant the legislative intent behind establishing such an institution in the Indian company law jurisprudence. Company malpractices affect the socio-economic fabric of a country massively; hence, it has been the concerted effort of Ministry of Corporate Affairs (MCA) (hereinafter, MCA) to barricade any further attempts at effecting any form of corporate fraud.

Any company requires an independent and corporate ethics-oriented BoD to conduct its affairs lawfully and in the spirit of company laws. Numerous instances in the past have intimated corporate malpractice crystallizing owing to the lack of a checking mechanism to regulate board resolutions. The first or early instance of this institution stems from the report of "*Financial Aspects of Corporate Governance*" issued by the "*Committee on Financial Aspects of Corporate Governance*" headed by **Sir Adrian Cadbury**. This UK Committee Report gave out global recommendations for addressing the menace of corporate frauds. Since then, any corporate scam in the Indian setup; Satyam Computers, PNB, NSEL, Sahara Group, etc. has been attributed to a weak corporate governance framework.

## II. LITERATURE REVIEW

**Venugopalan (2005)**, in his paper, studies the development and evolution of Independent Director as an institution from UK to India. He identifies the need to protect this institution from aggressive power centralizing developments in Indian companies' law. The author, in this paper, fails to critically examine the position of ID's in light of the new corporate and securities scams surfacing.

**Joshi (2022)**, in her study, highlights the need of having an unbiased and independent BoD for which ID's are crucial. A fair and ethical BoD wins investor trust for the company to successfully raise capital. The author, in this paper, fails to locate the prevailing shortcomings of independent director powers. There is a need to rectify the loopholes in the current corporate governance framework which has not been recognized.

**Samanta (2012)**, in her paper, delves into the shareholder agency theory, where she holds the directors and shareholders to be in a principal-agent relation. Hence, keeping the onus upon the directors (agents) to not act contrary to the interests of the shareholders (principals). The author, in this paper, fails to examine the current power-holding scenario of independent directors, as per MCA Rules, to counter any unethical or corporate malpractice.

**Prakash (2007)**, in her study, investigates the role of independent directors to earn firm value and credibility from an investor perspective. This stems from adequate, correct, and truthful disclosure. The author, in this paper, fails to specifically target the role of ID's in ensuring no scope of corporate scams. Certain kinds of directors abuse their board resolution power to pass orders to their personal or ulterior favour.

**Panicker (2021)**, in his paper, gives a mere titular position to the independent directors considering the TATA-Mistry Group saga. He concludes that the unilateral removal of Cyrus Mistry was against the OECD Principles on Corporate Governance. The author, in this paper, fails to examine the fiduciary duties of the ID's to ensure that no decision of the BoD is ultra-vires the MoA/AoA or manifestly unjust or arbitrary in any manner.

## III. RESEARCH QUESTIONS

1. *Whether the provisioning of Independent Directors has effectively addressed Corporate Frauds?*
2. *Whether the existing powers of ID's need to be revamped to further consolidate Corporate Governance?*

## IV. CRITICAL ANALYSIS

Corporate fraud is a serious menace upon the Indian company law setting. It can be understood to be unlawful, misleading, activities aimed at inflating share price prices, forging financial statements, artificially increasing profits, etc. are all instances of corporate frauds or malpractices. The explanation to Section 447 of Companies Act, 2013 constitutes an action to be fraud if it's done with the intent to abuse the undue advantage of the position to cause wrongful loss to the shareholders of the company. This legislative development has tried to address the soaring instances of failure in truthful and honest financial reporting practices. Majority corporate scams in India have the underlining cause of artificially inflating stocks or profit numbers for companies to attract massive investments from High Net-worth Individuals (hereinafter, **HNI's**) or foreign private equity investors (**PE**). Several issues, the most important of which are lax enforcement of rules, a lack of due diligence and internal control procedures, and unethical business practises, have been blamed for the growth in corporate fraud in India.

**Satyam Scam (2010)** - Satyam Computers was established in 1987 by B. Ramalinga Raju. He misrepresented the tax invoices and bank statements of the company to cause artificial raise in the share prices, to attract investments. The **SEBI** and **CBI** take cognizance of the massive difference in their figures. Subsequently, Mr. Raju and his accomplices, under *Section 447*, were sentenced to 7 years of imprisonment and fine amounting to the tune of Rs. 5 crores.

**Nirav Modi-PNB Scam (2017)** - Nirav Modi, the owner of Firestar Diamonds, obtained massive loans on a buyer's credit with *Punjab National Bank (PNB)*. The letter of undertaking, which functions as a bank guarantee and is subject to the obligation to repay the loan amount if the borrower defaults, typically requires collateral or cash margin. This allows a person to borrow money from the overseas branch of another bank. Although the LOU message was sent via **SWIFT**, it was not recorded in the bank's core banking system. Nevertheless, based on these LOU, funds continued to be transferred to PNB's Nostro account, which is a

foreign exchange account. Hence, the CBI and ED registered a case of unauthorized issue of LoU, beyond its general validity for falsation in audits and collusion with bank officials.

**Harshad Mehta Scam (Indian Securities Scandal) (1992)** - This was one of the highlight corporate scandals in India, wherein Harshad Mehta, a stockbroker, indulged in market manipulation of BSE Ltd. by inflating stock prices to 40 times of their original level. Those stockbrokers who made tonnes of money, abused this financial position to obtain unsecured loans from bank creditors. In April 1992, when the banks found out that they hold millions as useless debt, the entire Indian securities market collapsed.

The entire concept of Independent Directors has acted as a countermeasure in addressing the governance loopholes behind such multi-crore corporate scandals. Such an institution acts as a watchdog in improving the company's *credibility, transparency, and accountability* towards the shareholders. An Independent Director is a non-executive director who represents the interests of the shareholders to ensure that an unbiased and entity which does not have any financial relationship with the company, provides a fair and neutral perspective in boardroom meetings.

*Therefore*, the concept of independent directors has tried to bring fairness and equal representation to the boardroom of a company. There is still a need to revise and revamp the existing laws on independent directors, as the statutory ambiguity in the institution allows certain types of companies to evade compliance or misuse the powers of this institution. There isn't a single remedy that works for all businesses.

## V. CAUSES BEHIND FAILURES OF ID'S TO PREVENT CORPORATE MALPRACTICE

**1. Interference of Controlling Shareholders** – The entire object of having ID's was to ensure a non-executive director representing minority shareholder interests so that the majoritarian opinion does not dominate. However, as per a **2014 OECD Study**, the undue influence exercised by the controlling shareholders in appointing independent directors, takes away the independence of the institution. Committees which are dominated by such shareholders decide the functionalities of independent directors, which is why there is no independence left in this institution.

**2. No Licensing** - Under **Section 138**, internal auditors are provisioned to detect any frauds or financial record manipulation. Further, **Section 177** also provides for an Audit Committee to govern the audit framework of a listed company to follow all *ICAI Standards of Internal Audit*. In case the compliance is not met, there will be withdrawal of the license issued to the concerned chief auditor. There is no such deterrence effect on an independent director of being penalized for permitting facilitation of such corporate frauds in the Board.

**3. Voting by Non-Promoter Shareholder** – Under **Section 188 r/w Regulation 23 of SEBI (LODR) 2015**, promoters of the company are restricted from voting on certain enlisted matters. If the promoter is allowed to cast votes on appointment or removal of the Independent Director, then the modality of the promoter will be controlled by the promoter. *Schedule IV* of the Companies Act, 2013 provides for appointment of Independent Directors by the Board, based on the criteria furnished by the **Nomination and Remuneration Committee (NRC)**.

## VI. CONCLUSION AND SUGGESTIONS

In conclusion, numerous committees on Corporate Governance, starting with the K.M. Birla Committee (1999), have made diligent attempts to improvise the loopholes in board governance frameworks. However, the institution of Independent Director has always remained a riddle. Although, the N.R. Narayana Murthy Committee (2002) set up by SEBI, provided for several qualifications to appoint ID's, as under Clause 49 of the SEBI Listing Agreement. The current framework of ID's need major revision, especially pertaining to the appointment, remuneration, board diversity, licensing practices to protect the independence of this institution in precluding corporate malpractices.

The author makes the following suggestions on the need of revamping existing laws on Independent Directors:

- Clause 49 of the Listing Agreement (Corporate Governance) must be positively constructed, by making necessary positive amendments of the integrity, experience, ability, and aptitude needed to interpret company's financials.
- Section 188 of the Companies Act must be given effect by permitting only non-promoter shareholders to participate in the process of selecting a company's board composition. Further, a cumulative pattern of shareholder voting must be adopted so that independent directors can be elected proportionate to their shareholding. This will reduce the concentration of controlling shareholders to decide the ID's.
- In instances of the Satyam Scam or the Nirav Modi-PNB Scam, ID's were left with passive powers which is why the forging of bank statements and share prices could be done. To prevent such financial frauds, the powers of ID's must be evaluated annually. Appraisal of an ID's performance must be disclosed in the company's annual report. If the shareholders feel that the ID has underperformed, he must be removed in the company's next AGM with the consensus of the BoD, as intimated under Clause VIII of Schedule IV of the Act.

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