Independent Directors and their Constraints in China and India

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Although the concept of the independent director evolved in the U.S. and the U.K. (that are outsider systems with companies maintaining diffused shareholding), it has been transplanted to several other countries (including those that are insider systems with concentrated shareholding). The recipients of the concept include the two leading emerging economies of China and India. Available empirical studies have not been optimistic regarding the role that independent directors can play in these countries as compared to the U.S. and the U.K. where the concept originated. This article discusses the various constraints operating in China and India that undermine the efficacy of independent directors. The wide spectrum of constraints comprises structural, legal, cultural, and political constraints. A study of these concludes with some pointers for reform in China and India so as to bolster the independent director institution as a measure of enhanced corporate governance.

INTRODUCTION

As the board of directors ("board") has the principal authority for a company's governance, the structure and composition of the board would necessarily have an impact on the manner in which the company is governed. Among the various structural changes that have occurred in recent years to improve the way in which companies are governed, the introduction of the concept of an independent director occupies a prominent position. As an important aspect of legal reform in the field of corporate governance, policy makers are increasingly placing reliance as well as responsibility on independent directors to ensure that companies demonstrate high levels of corporate governance.

Independent directors are those members of the board who are not executives of the company (presently or in the recent past) and are otherwise independent of management and free from any business or other relationship with the company which could materially interfere with the exercise of their independent judgment.[1] Such directors should not have any material relationship with the company or its management, other than in their capacity as directors or members of any of the board committees.

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1. Financial Reporting Council, Report Of The Committee On The Financial Aspects Of Corporate Governance, ¶4. 12. (1992) *available at* http://www.ecgi.org/codes/documents/cadbury.pdf. ("Financial Reporting Council 1992").

The concept of independent directors was ushered into the corporate system voluntarily as a good measure of governance, and was initially not mandated by law. The history of independent directors can be traced to the 1950s in the United States (U.S.) when certain directors who were not part of the company's management were appointed to its board.[2] Gradually, the number of independent directors on corporate boards began to increase.[3] Director independence assumed greater importance when courts[4] and stock exchanges[5] began to look at companies with independent directors more favorably. Eventually, it acquired the status of a mandatory provision contained in a statute.[6] In the United Kingdom (U.K.), the trend towards independent directors was set in motion in 1992 with the Cadbury Committee Report,[7] and board independence has now become an integral part of corporate governance in the U.K.[8]

It is pertinent to observe that not only have the U.S. and the U.K. been at the vanguard in the evolution of the requirement of having independent directors on a board, but that both these jurisdictions possess a distinctive characteristic in that they follow the classical "outsider" model of corporate governance.[9] These regimes are dominated by companies with dispersed equity holdings with large institutional ownership.[10] Dispersal of shareholding in public companies results in the collective action problem, which prevents shareholders from taking an active part in key decisions involving the company that are otherwise within the shareholders' domain under corporate law, and also impedes their basic decision-making power of electing the directors who are delegated management rights by the shareholders. This creates a conflict in the form of

2. 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, 1473 (2007).
3. *Id.* at 1478.
4. On the judicial front, Delaware courts place reliance on decisions of disinterested or independent directors in legitimising several actions in relation to self-dealing transactions, derivative suits and demand futility claims, and defensive measures against hostile tender offers. *See* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 904-910 (1996).
5. The New York Stock Exchange ("NYSE") and Nasdaq Stock Exchange ("NASDAQ") have emphasized the importance of independent directors on boards of listed companies. *See* NYSE, LISTED COMPANY MANUAL (2003) ("NYSE Listed Company Manual"), *available at* http://nysemanual.nyse.com/lcm/; NASDAQ Stock Market, Inc., Market Place Rules (2003) ("NASDAQ Rules"), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.
6. Sarbanes-Oxley Act, 18 U.S.C. § 301 (2002).
7. Financial Reporting Council 1992, *supra* note 1, at ¶4.11.
8. Financial Reporting Council, The UK Corporate Governance Code, ¶¶A.4, B.1 (2010) available at http://www.frc.org.uk/corporate/ ukcgcode.cfm. ("Financial Reporting Council 2010")
9. *See* Stilpon Nestor & John K. Thompson, *Corporate Governance Patterns in the OECD Economies: Is Convergence Under Way? available at* http://www.oecd.org/dataoecd/7/10/1931460.pdf.
10. They follow the idea of separation of ownership and control of companies, which was originally propounded by Berle and Means. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66 (1932).

an agency problem between the shareholders and the managers (also referred to as the "manager-shareholder agency problem").[11] The role of corporate law in the U.S. and the U.K. is primarily to address this agency problem, and the concept of a monitoring board and the institution of independent directors have seemingly been introduced to provide protection for shareholder interests against actions of managers in public companies with dispersed shareholders.[12]

The concept of the independent directors evolved and extended beyond the confines of the U.S. and the U.K., where it originated. Due to the wave of reforms that emerged in response to the corporate governance scandals of the last decade, this concept rapidly spread to other economies as well. Among the countries to which the concept was transplanted, some jurisdictions follow the "insider" model of corporate governance. These regimes are dominated by companies whose ownership and control are relatively closely held by identifiable and cohesive groups of insiders who have long-term stable relationship with the company.[13] These include emerging economies such as China and India, where the concept of independent directors has been introduced in the last decade as a mandatory requirement for all companies listed on a stock exchange.[14]

In China, the independent director requirement was made mandatory in 2001 by virtue of the *Notice on Release of Directive Opinions on the Establishment of Independent Director System in Listed Companies*.[15] At least one-third of the members of a board of a listed company are to consist of independent directors. An independent director is one "who bears no duty in a company other than that of a director and engages in no such relation with the listed company and the major shareholders he/she works with as to possibly influence his/her objective judgment".[16] The requirement was made mandatory in India

11. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).
12. REINIER R. KRAAKMAN *ET AL.*, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 64 (2009).
13. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 474 (1999) ["Around the World"].
14. There are several reasons that merit the choice of China and India as case studies for this article. Both are leading emerging economies and form part of the BRIC countries (Brazil, Russia, India and China) whose present growth trajectory is expected to put them amongst the world's largest economies in a few years. *See* Global Economics Paper No. 99, Dreaming With BRICs: The Path to 2050 (2003), *available at* http://www2.goldmansachs.com/ideas/brics/book/99-dreaming.pdf. Among the BRIC countries, this study has been confined to China and India as they exhibit similarities as far as their economic growth pattern is concerned. Not only are both these nations part of the greater Asian continent, but they are also at similar stages of economic development, having transitioned over the last few years from state-controlled economies to more market-based economies.
15. *See* Zhengjianfa, No. 102, (2001), *available at* http://www.eastlaw.us/chineselaws/corpsec/corpgov-id.htm ("Independent Director Opinion"). This supplements the broader corporate governance norms set forth in the Code of Corporate Governance for Listed Companies in China, issued in 2001, *available at* http://www.eastlaw.us/chineselaws/corpsec/corpgovcode.htm.
16. *Id.* at para. 1(1). In addition to the general definition above, there are specific exclusions

in 2000 by virtue of the introduction of Clause 49 to the Listing Agreement [hereinafter *Clause 49*] that listed companies are required to enter into with stock exchanges.[17] In India, if the chairman of the board is an executive or if such person is a promoter or related to a promoter, then at least one-half of the board should comprise independent directors. In other cases, one-third of the board should consist of independent directors.[18] Board independence, in India, is defined with reference to some general parameters[19] and some specific exclusions,[20] similar to China.

Both in China and India, companies have historically been largely controlled (by virtue of high shareholding levels) by business families or by the state. The concentrated shareholding pattern continues even in publicly listed companies,[21] although there are some exceptions where companies in China and India have gradually moved to an outsider model of corporate governance.[22] This presents a different agency problem altogether. As there is no dispersion of shareholding, the agency problem between shareholders and managers matters less. This regime instead exacerbates the agency problem between controlling shareholders and minority shareholders (also referred to as the "majority-minority agency problem").[23]

These circumstances have resulted in a curious situation wherein the concept of independent directors that has evolved in jurisdictions featuring the outsider system (where there is a separation of ownership and management) has been directly transplanted to an entirely different corporate system i.e., the

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enumerated. These include certain employment, business, familial or investing relationships that directors may have with the company. *Id.* at para 3.

17. Securities and Exchange Board of India, SMDRP/POLICY/CIR-10/2000 Feb. 21, 2000, *available at* http://www.sebi.gov.in/circulars/2000/CIR102000.html.
18. Listing Agreement, clause 49(I)(A).
19. According to Clause 49 of the Listing Agreement, independent director is defined as a non-executive director who:

    > apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director.

20. These are family relationships, executive appointments, business relationships and substantial shareholding of the director in or with the company.
21. For China, *see, e.g.*, Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 131 (2006); Yuwa Wei, *An Overview of Corporate Governance in China*, 30 SYRACUSE J. INT'L L. & COM. 23, 38-39 (2003). For India, *see, e.g.*, Rajesh Chakrabarti, *Corporate Governance in India – Evolution and Challenges*, 11 (2005), *available at* http://ssrn.com/abstract=649857; Shaun J. Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, 3 COLUM. BUS. L. REV. 800. (2007).
22. Since the exceptions are only rare, and companies still continue to be dominated predominantly by family groups or the state, China and India are considered to be insider systems.
23. *See* Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) NLSIU L. REV. 1 (2009).

insider system where the agency problem is between controlling and minority shareholders.

Apart from differences in the shareholding pattern of companies between the U.S. and the U.K. on the one hand and China and India on the other, there are other significant factors that distinguish the impact of corporate governance in these two sets of jurisdictions. For instance, while the U.S. and the U.K. largely adopt a market-based approach towards corporate law and governance, both China and India continue to depend largely on state involvement through rule-based regulatory regimes that govern corporate activity. The U.S. and the U.K. possess relatively robust legal regimes and court systems, while the legal systems in China and India continue to be at an evolutionary stage when it comes to effectively enforcing corporate governance norms. These systems are also divided by cultural differences. These fundamental differences raise important questions regarding the effective implementation of independent director norms across jurisdictions such as China and India that have recently adopted them.

A few recent empirical studies have examined the effect of appointing independent directors in China and India.[24] These studies, both qualitative and quantitative, have not been optimistic regarding the role that independent directors can play in enhancing corporate governance in these countries. Using China and India as examples, this article seeks to analyze the possible constraints faced in insider economies in general and in China and India in particular, which may raise doubts regarding the efficacy of the institution of independent directors in such economies.

The next Part contains a brief survey of the literature surrounding the efficacy of independent directors in the outsider systems of the U.S. and the U.K. on one hand, and the insider systems of China and India on the other.

I. Determining the Effectiveness of Independent Directors

A. *U.S. and U.K.*

Several quantitative studies have been conducted to determine the presence of any statistically significant relationship between board composition (primarily the level of independence) and shareholder value. Various parameters have been used, including corporate performance in general (reflected by stock price), and those involving discrete transactions where there are potential conflicts between shareholders and the management.[25] Some studies have found

24. These are discussed in some detail below, *see infra* Part B.
25. *See* Lin, *supra* note 4, at 921; Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921, 923 (1999) ("Bhagat & Black (1999)").

a positive correlation between board independence and shareholder value.[26] This positive correlation indicates that the market views the appointment of independent directors as enhancing shareholder interest.[27]

On the other hand, more recent studies cast a shadow of doubt on the positive correlation of board independence with corporate governance and company performance. In their meta-analysis conducted in 1999, Professors Bhagat and Black find no convincing evidence that *increasing* board independence will improve company performance.[28] On the contrary, they find evidence that firms with a super-majority of independent directors perform worse than other firms.[29] Their findings are also buttressed by a subsequent study they performed in 2002.[30] Other commentators have also concluded their studies with suggestions that firms with more independent directors may perform worse.[31] The resulting evidence can, at best, be said to be mixed.

Qualitative studies too have been undertaken to determine the effect of board independence on corporate governance. First, the growth of the independent director concept can partly be attributed to the "reputation capital" theory.[32] According to this theory, independent directors are "disciplined by the market for their services which prices them according to their performance as referees".[33] Independent directors have an incentive to develop their reputations as they are directors, executives or key decision-makers in other companies.[34] This in turn creates a market for independent directors that rewards good performance and punishes poor performance.[35] Second, equity ownership in companies on whose boards they serve operates as an incentive for independent directors to

26. An extensive analysis of empirical studies would be out of place in this article. For more exhaustive analyses of empirical studies, *see* Lin, *supra* note 4; Bhagat & Black (1999), *supra* note 25; Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) ("Bhagat & Black (2002)").
27. *See* Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 RAND. J. ECON. 589 (1988); Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L. ECON. & ORG. 101 (1985).
28. Bhagat & Black (1999), *supra* note 25, at 950.
29. *Id.* at 922.
30. *See* Bhagat & Black (2002), *supra* note 26, at 263.
31. *See* David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996); Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANALYSIS 377 (1996).
32. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293-94 (1980).
33. *Id.* at 294.
34. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983).
35. *See* Lin, *supra* note 4, at 917. *See also* Lawrence Abbott, Young Park & Susan Parker, *The Effects of Audit Committee Activity and Independence on Corporate Fraud*, 26 MANAGERIAL FIN. 55, 56 (2000); Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 5, 16 (2006).

perform their role diligently. If such directors own shares of the companies, they increasingly associate themselves with the fortunes of those companies.[36] So long as they hold a financial stake, they have an incentive to monitor the actions of the managers so as to protect the interests of the shareholder body (of which they are a part). The third rationale for independent directors could be deterrence: the threat of sanctions, which include civil and criminal liability.[37] However, existing empirical evidence indicates that the incidence of personal liability of independent directors is in fact rare.[38]

Although there are several justifications for the role of independent directors, there is also no dearth of skeptics. In an influential study of corporate boards Myles Mace,[39] interviewed various participants in the corporate sector, based on which he found that the role of directors was largely advisory and not of a decision-making nature. While the management takes the decisions in the company, the board merely serves as a source of advice and counsel to the management.[40] Other studies are skeptical due to various factors. These include: (i) informational imbalances where management has substantially greater information about the company than independent directors, who obtain only so much information as the management itself provides,[41] (ii) control and dominance of the chief executive officer (CEO) with ability to sway the independent directors,[42] (iii) the lack of time and expertise to analyze all available information and to make a meaningful contribution, because independent directors are usually busy professionals who have their other primary occupations to attend to,[43] and (iv) the need to comply with boardroom norms that preclude open criticism of the management.[44]

Even though there are mixed results as to its efficacy in the outsider systems, there is no evidence against independent directors that is so overwhelming as to form a basis for discarding the concept altogether. Perhaps it only signifies over-reliance by policymakers on the importance of independent directors as an efficacious monitoring mechanism for companies. In that sense, independent directors cannot be expected to fulfill all the tasks assigned to them, and it would

36. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 177-78 (1989).
37. Abbott, Park & Parker, *supra* note 35, at 57;
38. This finding has been extracted from an influential series of academic studies of independent director liability within the U.S. and across countries: *See, e.g.*, Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006); Bernard Black, Brian Cheffins & Michael Klausner, *Liability Risk for Outside Directors: A Cross-Border Analysis*, 11 EU. FIN. MGMT. 153 (2005); Black, Cheffins & Klausner, *supra* note 35.
39. MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971).
40. *Id.* at 179.
41. Lin, *supra* note 4, at 914-16. *See also* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 144 (1976).
42. Lin, *supra* note 4, at 913-14.
43. MACE, *supra* note 39, at 30; LORSCH & MACIVER, *supra* note 36, at 87.
44. Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?* 95 HARV. L. REV. 597, 612 (1982).

be impractical for policy makers to ascribe such a role to them. The persistence of the independent director concept in the U.S. and U.K., despite lack of solid empirical evidence in its favour (and the rapid spread of the concept to other countries), can also be explained by the lack of effective alternative institutions or mechanisms that may perform a similar role. It is therefore arguable that a less optimal solution to a problem (namely the agency and monitoring problem) is better than no solution at all.

B. *China and India*

As far as China and India are concerned, there has been less of a correlation between board independence and corporate performance as revealed by quantitative studies. Although some studies have been conducted in China,[45] there have been very few in India.[46] Nevertheless, they reveal a substantial lack of implementation of the independent director norms in these countries. For instance, studies in China have shown that controlling shareholders play an important role in the appointment of directors, including those that are independent.[47] Furthermore, the qualifications and competence levels of persons appointed to the post are less than optimal.[48] Surveys indicate that independent directors are unaware of their roles and the constituencies they are required to protect.[49] Somewhat similar results ensue from empirical surveys conducted in India as well.[50]

In essence, if we found that in the case of the U.S. and the U.K. there are mixed results in relation to the positive effect of independent directors on corporate performance, the few studies in the Chinese and Indian contexts in fact go to show less of an effect. Consequently, viewed from the standpoint of correlation with corporate performance, independent directors have arguably

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45. Jenny J. Tian & Chung-Ming Lau, *Board Composition, Leadership Structure and Performance in Chinese Shareholding in Companies*, 18 ASIA PACIFIC J. OF MGMT. 245 (2001) (finding no correlation between the presence of independent directors on corporate boards and the performance of those companies); *See also* Jing Liao, Martin R. Young & Qian Sun, *The Advisory Role of the Board: Evidence from the Implementation of Independent Director System in China* 4 (Massey U. College of Business, Research Paper No. 1, 2009), *available at* http://ssrn.com/abstract=1361202. For an analysis of further studies, *see* Clarke, *supra* note 21, at 205.
46. *See generally* P. Krishna Prasanna, *Corporate Governance – Independent Directors and Financial Performance: An Empirical Analysis* (Indian Institute of Capital Markets, 9th Capital Markets Conference Paper, 2006), *available at* http://ssrn.com/abstract=877807.
47. *See, e.g.*, Chao Xi, *In Search of an Effective Board Monitoring Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 CONN. J. INT'L L. 1, 17 (2006).
48. *See* Clarke, *supra* note 21, at 207.
49. *Id.*, at 171-72.
50. Vikramaditya Khanna & Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence*, 22(1) NLSIU. L. REV. 35 (2010). For a discussion of other surveys regarding the effectiveness of independent directors in India, *see* Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281 (2010).

not played a significant role in Chinese and Indian corporate governance. The ancillary conclusion is that even if independent directors could have played an effective role in corporate performance, the current system of norms and structures and the context in China and India do not enable them to play that role.

While qualitative studies in China and India are limited, they provide little hope for the independent director institution. Anecdotal evidence through high profile cases in these countries indicates that independent directors are vulnerable to dominance by controlling shareholders and hence, do not play an effective role in corporate governance. For instance, in the case of Leshan Electric Power Co. Ltd. in China, independent directors were asked to resign from the company for seeking further information and an independent audit before approving the financials of the company.[51] Similarly, when the independent directors of Inner Mongolia Yili Industrial Co. Ltd. raised alarm bells about the company's trading in treasury bonds, the management and controlling shareholders instigated the supervisory board to remove the independent directors.[52] In the Xinjiang Tunhe case,[53] the company steamrolled decisions through the board without meaningfully consulting the independent directors and obtaining their views. As far as India is concerned, the massive financial fraud to the magnitude of billions of dollars brought to light in early 2009 in a leading technology company, Satyam Computer Services Ltd., raises significant doubts about the role of independent directors in insider systems when they are beholden to the controlling shareholders.[54]

Although it is not possible to make a direct comparison of the empirical studies in the U.S. and the U.K. on the one hand, and in China and India on the other, owing to different parameters adopted in the various studies, it is nevertheless possible to conclude that the appointment of independent directors in insider systems as compared with outsider systems has not enhanced corporate governance standards.[55]

With this background, I now deal with the various constraints operating in China and India that may likely explain this outcome.

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51. *See* Jie Yuan, *Formal Convergence or Substantial Divergence? Evidence from Adoption of the Independent Director System in China*, 9 ASIA-PAC. L. & POL'Y J. 71, 94-95 (2007); Xi, *supra* note 47, at 18.
52. *See* Xi, *supra* note 47, at 18; Yuan, *supra* note 51, at 97.
53. *See* Yuan, *supra* note 51, at 95-97.
54. The role of the independent directors of Satyam has been the subject matter of much analysis, academic and otherwise. *See, e.g.*, Varottil, Independent Directors in India, *supra* note 50, at 332-43; Khanna & Mathew, *supra* note 50, at 40-41; Ashish K. Bhattacharyya, *Satyam: How Guilty are the Independent Directors?* BUSINESS STD., Jan. 12, 2009; *Shyamal Majumdar, 'Nodders' in the Boardroom*, BUSINESS STD., Dec. 25, 2008.
55. On a related note, academics have argued that the metrics for assessing corporate governance arrangements should be separate for companies without a controlling shareholder and those with a controlling shareholder. *See* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263 (2009).

II. Structural Constraints: Differences in Shareholding Structures

The first and perhaps the most significant constraint is the differing corporate structures of the insider systems and the outsider systems. The genesis of the independent director concept is directly relatable to the outsider system. The corporate structure in outsider systems is one of diffused shareholding, which results in significant power in the hands of managers, who are susceptible to shirking and to appropriating corporate assets for their own benefits. Therefore, the independent director evolved as a monitor of managers in order to protect the interests of the shareholder body as a whole. There is some element of unassailable logic to this approach.

In insider systems, the situation varies significantly. This is due to the difference in corporate structures in insider systems. Due to the presence of dominant shareholders in most companies, the manager-shareholder agency problem is less significant. Controlling shareholders are able to exercise their voting power and overall dominance to hire and fire managers. In that sense, there is a merger of interests between controlling shareholders and managers. From the perspective of the agency problem, controlling shareholders and managers are one and the same. The constituency that is omitted from this matrix is the minority shareholders. That is the interest group that requires protection through corporate governance. It is this mismatch of objectives of corporate governance with the agency problem that has resulted in the sub-optimal implementation of the independent director concept in insider systems.

The incongruity of the independent director concept in the insider system is amplified by the fact that the concept did not originate in the outsider system with an intention to address the majority-minority agency problem. To take one example, stock exchange requirements in the U.S.[56] exempt controlled companies from mandatorily carrying independent directors on their board.[57] The stance of the U.S. regulators clarifies two important issues: (i) it drives home the point that the independent director has been conceived of as a monitor of managers, in order to protect the interests of the shareholders as a whole (*i.e.*, in situations where the shareholding is diffused); and (ii) in case of controlled companies, the shareholders (albeit dominated by the controlling shareholders) and the managers form one and the same constituency and therefore, the shareholders do not require protection from the actions of managers.

If the independent director has not been conceived to deal with the majority-minority agency problem, then what is the rationale for its transplantation to the insider systems? Is it really the case that the concept would act to resolve (or

56. *See* NYSE Listed Company Manual, *supra* note 5, § 303A.00; NASDAQ Rules, *supra* note 5, R. 5615(c).
57. A controlled company is one where more than 50% of the voting power is held by an individual, a group or another company. *Id.*

at least attempt to resolve) the majority-minority agency problem in the insider systems? The existing discourse in comparative corporate governance does not attempt any answers to these important questions, and the academic literature on this aspect is surprisingly dismal.[58]

The structural constraints operate in two specific instances, the first relating to the appointment process and the second to the precise role of independent directors. These deserve elaboration.

A. Appointment of Independent Directors

If the function of independent directors is to ameliorate the majority-minority agency problem, then their appointment process should take this into account. In other words, if minority shareholders are to be the real beneficiaries of monitoring (by independent directors) of the actions of controlling shareholders (and thereby the managers), then minority instead of controlling shareholders should appoint independent directors, as I detail later. But, this is not the case at all in the insider systems. Independent directors continue to be appointed in the same manner as other (executive or non-independent) directors.[59]

The *de jure* and *de facto* powers of controlling shareholders enable them to appoint independent directors who are likely to share their vision and perception with reference to a company's business, strategy and the future. It is highly unlikely (and virtually a rarity in practice) that controlling shareholders will consent to the appointment of any person who will be inimical to their own interests in the company, when those interests are enjoyed at the cost of the minority shareholders.

Furthermore, independent directors are capable of being elected to a board for multiple terms. Hence, such directors are likely to be guided by whether the consequences of their actions will result in their reappointment. In this situation too, controlling shareholders are in a position to influence the decision of whether an independent director's term is likely to be renewed

58. For example, neither the Independent Director Opinion in China or Clause 49 in India nor any of the other numerous prior efforts through rule-making or through committee reports has expressly identified this incongruity operating with respect to controlled companies, which appears to be a serious shortcoming in the transplantation process. As a noted Indian industrialist bemoans: "I find the lack of mention of this fact in the outpouring of verbiage on this issue in our country quite amazing." *See* Rahul Bajaj, *How Independent Can a Director Be?* BUSINESS STD., Jul. 29, 2005 *available at* http://www.business-standard.com/india/news/rahul-bajaj-how-independent-candirector-be/214800/.

59. Although in both China and India the independent directors are required to be formally independent of both the management as well as controlling shareholders, their appointment is still subject to the voting influence of controlling shareholders. In both these countries, the appointment of directors is effected through the straight voting method whereby a group of shareholders controlling a majority of votes can influence the composition of the entire board. For details regarding straight voting and its comparison with cumulative voting, *see* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339 (1984).

or not. Another power that controlling shareholders can exercise in extreme cases is to remove independent directors from the board. This power can be exercised in China and India by a simple majority of shareholders present and voting at a shareholders' meeting.[60] If independent directors can be removed at the will of controlling shareholders, it is not realistic to expect such directors to act in a manner that may displease controlling shareholders.[61] This then leads to a discussion of the precise role and functions that independent directors are expected to discharge.

B. Role and Allegiance of Independent Directors

There is generally an overwhelming body of guidance available to independent directors in outsider systems as to their role on corporate boards and the constituency whose interests they are to protect. The concept of independent directors evolved along with the monitoring board.[62] In that sense, independent directors were viewed as monitors of management. However, when transplanted into insider systems, the role of independent directors and the constituencies that deserve their protection becomes unclear. Either there is no clarity in the law on this aspect or, even where there is some semblance of guidance, it is appallingly inadequate (with countervailing factors diminishing the effect of such clarity in practice).

In insider systems, minority shareholders require the protection of independent director monitoring. However, with some broad exceptions,[63] there is no substantive duty on independent directors in China and India to act in the interests of minority shareholders. For this reason, independent directors often tend to commingle the interests of controlling shareholders and minority shareholders, which is not warranted in many circumstances, especially where there are related party transactions involving controlling shareholders. In case

60. *See, e.g.*, Indian Companies Act, 1956, No. 1, Acts of Parliament, 1956, sec. 284.
61. When it comes to practice, the weapon of removal may be exercised by controlling shareholders to a lesser extent. This is because removal could result in adverse publicity to the company itself. For instance, stakeholders and the stock markets may seek further information on the background of removal, and if it is related to disagreements on the business, strategy or even any compliance-related matter, that could not only affect the reputation of the company in the market, but could even invite regulatory probes. Hence, it is likely that the weapon of removal may be exercised sparingly by the controlling shareholders. However, the very existence of that right in the hands of the controlling shareholders could impinge upon the true independence and impartiality of the independent directors.
62. *See* Gordon, *supra* note 2, at 1477; EISENBERG, *supra* note 41, at 164-65.
63. For China, *see* the Independent Director Opinion, *supra* note 15, at ¶1(2) (stating that independent directors have a special duty to "especially prevent the legal rights and interests of medium and minor shareholders from being violated"). For India, *see* Ministry of Corporate Affairs, Government of India, Corporate Governance Voluntary Guidelines, ¶ II.D.iii (December 2009), *available at* http://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf ("Voluntary Guidelines") (providing that for every agenda item at the board meeting, the independent directors should offer their comments on an impact analysis on minority shareholders).

of related party transactions, the interests of controlling shareholders and minority shareholders tend to be at variance. Unless independent directors are required specifically to consider the interests of minority shareholders, there could be a decline in the value of minority shareholder interests in the company owing to value-reducing transactions between the company and controlling shareholders.

Apart from matters relating to corporate structures, the fundamental differences in legal systems across jurisdictions have a bearing on corporate governance mechanisms, a matter I shall turn to now.

III. LEGAL CONSTRAINTS: LAW AND ITS ENFORCEMENT

In this Part, I rely upon three broad propositions.[64] First, different characteristics of corporate structure and governance operate in the common law and civil law systems. Second, the enforcement of legal rules is as important as legislating the rules. Following from these is the third proposition that advanced legal regimes (including both law-making as well as enforcement) engender market regulation or self-regulation models that involve gatekeepers such as independent directors, while less advanced legal regimes rely on active state involvement through regulation of business (or corporate) activity. I now test each of these three propositions in the context of the independent director institution.

A. *Legal Characteristics of Corporate Structures*

When it comes to board structures, two models are prevalent in corporate systems around the world. The first is a unitary board, which exists in nearly

64. I draw some strands here from the "law matters" thesis developed by a group of economists ("LLSV"), which propounds that corporate ownership and governance in various jurisdictions depend upon the level of legal protection available to investors. These studies are encapsulated in a series of articles published in the late 1990s. These are, Rafael La Porta *et al.*, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta *et al.*, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); La Porta *et al.*, *supra* note 13 and Rafael La Porta *et al.*, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000). Countries are divided into categories depending on the legal families to which they belong. Legal protection is determined in terms of both laws on the statute or rule books as well as the enforcement of those laws. LLSV states that common law systems fare better than civil law systems when it comes to corporate governance and investor protection. Although the LLSV thesis has been subjected to a battery of criticism, it nevertheless offers an elegant theoretical platform to test the efficacy of the transplantation of the independent director concept from the outsider systems to the insider systems. The purpose of this discussion is not to support or critique the LLSV thesis in any general manner or to examine its intricacies. That is not necessary as it is extraneous to the scope of this article. For a further discussion of the interplay between the "law matters" thesis and political determinants in corporategovernance in China and India, *see* Nicholas C. Howson & Vikramaditya Khanna, *The Development of Modern Corporate Governance in China and India*, *in* CHINA, INDIA AND THE INTERNATIONAL ECONOMIC ORDER 513 (M. Sornarajah & Jiangyu Wang, eds., 2010); John Armour & Priya Lele, *Law, Finance and Politics: The Case of India*, 43 LAW & SOC'Y REV. 491 (2009).

all common law countries.[65] The other is a two-tier board, which exists in a number of civil law countries, especially within the European Union.[66] Within this matrix, it is interesting to note that the origins of the independent director can be traced to the unitary board structure that was prevalent in the common law countries of the U.S. and the U.K. Hence, the independent director concept evolved as a means of strengthening the unitary board so as to introduce or enhance its monitoring functions. However, the concept has been transplanted to both common law and civil law countries. From this perspective, the transplantation of the independent director concept from the U.S. and the U.K. to India is understandable since all three countries follow a unitary board structure. However, its transplantation to civil law countries such as China that follow a two-tier board structure is surprising. A number of issues arise from this mismatch of board structures and the use of the independent director concept across both systems.[67]

Chinese corporate law and governance norms have been transplanted from other legal systems even prior to the introduction of independent directors. The two-tier board system was introduced for the first time in China's PRC Company Law, 1993 and was transplanted from the German system.[68] In this system, a company has two boards, a board of directors (which is otherwise known as a management board) and a board of supervisors (otherwise known as a supervisory board).[69] Under the PRC Company Law, 1993, the primary functions of the supervisory board were: first "to supervise the management of the company, and second, to examine the financial affairs of the company".[70] In other words, the supervisory board is effectively carrying out monitoring functions. However, the performance of the supervisory boards has been found to be unsatisfactory. This is largely because of the improper transplantation of that concept from Germany.[71] As commentators have observed, the power of the supervisory board in China are insignificant compared to those of the

65. *See* Kraakman, *supra* note 12, at 56.
66. *See* Donald Clarke, *Lost in Translation? Corporate Legal Transplants in China* 5 (The George Washington Univ. Law Sch. Pub. Law & Legal Theory Working Paper No. 213, 2006) *available at* http://ssrn.com/abstract=913784.
67. Since this mismatch in board structures primarily relates to China (between the countries focused on in this article), the discussion herein is confined to that country. This issue is not relevant to the case of India.
68. Xi, *supra* note 47, at 3.
69. *Id.*
70. *Id.*
71. As noted below:

> In essence, the [board of directors] in a German stock corporation is responsible to the [supervisory board] to a very large extent as the members of the [board of directors] have to be appointed and removed by the latter, and seek consent from the [supervisory board] regarding important business decisions

See JiangYu Wang, *The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies*, COMPLIANCE & REGULATORY J. 47, 49 (2007).

supervisory board in Germany.[72]

Unlike in Germany, supervisory boards in China are appointed by the controlling shareholders and are subject to capture by them. Hence, it cannot be reasonably expected that the supervisory board will appropriately monitor the actions of controlling shareholders. The legal provisions for the appointment of supervisors as well as the role of supervisors and their authority require considerable strengthening. Curiously enough, the Chinese authorities appeared to have a preference for enhancing monitoring activity through the introduction of independent directors rather than by strengthening the supervisory board.[73] To that extent, the *Independent Director Opinion* does not seem to have paid much regard to the existence of the supervisory board, and it prompts the independent directors to operate as a stand-alone institution.

This gives rise to a peculiar situation. Both supervisors and independent directors possess monitoring responsibilities. However, there is no clear demarcation of the roles of the two institutions, due to which there will be an inevitable overlap in their functions.[74] Moreover, both the institutions suffer from the same defects, *i.e.*, they are subject to the influence of the controlling shareholders as they are both elected by such shareholders. The existence of two different institutions for monitoring controlling shareholders (and managers) when they are both subject to capture by the constituency they are required to monitor complicates the situation further. In practice, this overlap has made the role of independent directors ineffective.

B. *Robustness of the Legal System for Enforcement of Independent Director Norms*

Academics have raised concerns about the current disposition of director independence, whereby independence is conferred as a status upon persons who qualify as such under certain criteria.[75] They call for a more contextual

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72. As noted below:

> What distinguishes the Chinese board structure from the two-tier system [in Germany], however, is both the appointment method of members of the board of directors (directors) and the accountability structure. Directors are appointed by the general shareholders' meeting, not by the supervisory board, and they are made accountable to the shareholders, not to the supervisory board.

See Xi, *supra* note 47, at 3.

73. *Id.* at 13 (noting that "China's regulatory authorities seemed to have favored a more independent board of directors over a stronger supervisory board").

74. *See* Yuan, *supra* note 51, at 102 (observing that the "coexistence of two monitors can lead to free-rider problems where each institution relies on the other to fulfill the responsibility of oversight").

75. The criteria are usually negative in nature, i.e., the absence of any material relationship with the company, its managers or controlling shareholders. This is gauged by the "lack of ties through the use of two metrics: (1) lack of financial ties to the corporation, and (2) lack of familial ties to the managers of the corporation". *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 450 (2008). With some exceptions, there are no positive parameters attached to independence.

approach where instead of determining status *ex ante*, it is based on the actual behaviour of directors. Delaware courts are at the centre of this debate.[76] The Delaware approach ensures that the independence enquiry is substantive rather than merely a formal or status-based one.[77]

The substantive approach requires the judiciary to determine whether each individual was in fact independent from the company, its management and controlling shareholders, and whether the specific actions of the independent directors display fairness and impartiality. It is not sufficient for the legislature to lay down black-letter law, but that law must be effectively implemented taking into account the facts of each case. In the absence of such a system, parties can appoint independent directors in a manner as to stay outside the proscription of the law although it may violate the spirit or essence of the law. For instance, it is possible for companies to appoint persons who have no financial or pecuniary relationship with the company as independent directors, but such persons may have social or other relationships that may impinge on their independent decision-making. If bright-line rules are followed, such directors may be considered independent, whereas if the essence of such appointments is considered, the outcome may be different.[78]

In common law countries such as the U.S. (particularly in the state of Delaware) and the U.K., the courts have an important role to play in interpreting the rules, in determining the actions of independent directors (and other corporate actors) on the facts of each individual case, and in ascertaining whether there has been a breach of duty by independent directors. Courts quite often exercise their power, to re-characterize transactions if they have

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76. *Id.* at 465. As Professor Rodrigues observes:

> In contrast to the standard corporate governance definition of independence, which equates independence with outsider status, Delaware courts conduct a more nuanced inquiry into independence in two ways. First, Delaware courts examine a director's behavior as an indicator of independence, creating a contextual approach—rather than looking only to rigid proxies like the lack of familial or financial relationship—in gauging the lack of improper influence or conflicts of interest. Second, Delaware examines each conflict specifically, looking at a mix of factors rather than a preprogrammed set.

77. *Id.* at 475-76 (noting that "Delaware courts delve far deeper into what one might call "true" independence than the rules of the Sarbanes-Oxley Act and the exchanges require" and that "[t]he very ability of Delaware to reserve the power to examine these other facets of human relationships give its bite"). Professors Kahan and Rock go on to observe:

> Delaware in contrast to other jurisdictions, employs both formal and substantive scrutiny before it gives weight to actions by outside directors. For an outside director to be deemed "independent," the absence of an executive position or of a financial interest in the transaction is not sufficient. Rather, to be regarded as an independent director, an outside director must act independently and take her role as such seriously.

See Marcel Kahan & Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 904 (2002).

78. An oft-used example under Delaware law is the case of Oracle where Chancellor Strine held that social ties between the outside directors and the managers may have a role to play in analysing the independence of such directors. *See* In re Oracle Corp. Derivative Litigation 824 A.2d 917 (Del. Ch. 2003).

been structured with a view only to by-pass legal proscriptions.[79] Moreover, a robust body of case law laid down by the judiciary also provides certainty to corporate actors such as independent directors by presenting them with a principles-based regime to determine the validity of their actions. To that extent, the independent director concept receives ample support from the court system in common law jurisdictions.

However, the factors discussed above are (nearly) absent in most insider systems, including China and India. Being a part of the civil law system, Chinese laws are mostly codified in statutes and regulations.[80] Although courts do interpret these laws, their role is more minimal when compared to common law systems.[81] The principle of *stare decisis* is gradually creeping into the Chinese legal system, at least at the upper echelons,[82] perhaps due to the influence of globalisation, but it is still far from the type that is practised in common law systems. It is not possible to expect the kind of dynamism and activism from Chinese courts that is demonstrated by common law courts (*e.g.*, Delaware courts). Common law courts provide principles-based guidance of various aspects relating to independent directors such as their appointment, role and the validity of their actions.

The position is different in India. It follows the common law system and, to that extent, courts can be expected to interpret the law and provide principles-based guidance. However, the difficulty arises, not with the substantive law itself, but with the enforcement of corporate governance norms, which is in turn relate to judicial administration and the regulatory set up.[83] Due to delays that subsist in judicial or regulatory determination, it would not be prudent to adopt a principles-based approach for defining board independence. For example, the validity or otherwise of a director's action must be capable of timely determination if it is to serve as a source of guidance for other

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79. An example of transactions where courts, particularly in the developed world, quite often exercise their powers to recharacterize legal structures and documents pertains to structured finance and securitisation. *See* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004).

80. *See* Nicholas C. Howson, *Regulation of Companies with Publicly Listed Share Capital in the People's Republic of China*, 38 CORNELL INT'L L.J. 237, 242-43 (2005). *See also* Jiangyu Wang, *Overview of the Chinese Company Law in Company Law in China* 9 (2008), *available at* http://ssrn.com/abstract=1222061.

81. Wang, *supra* note 80, at 14. Wang outlines the role of Chinese courts as follows:

> China's legal system is officially a civil law system, which essentially means that courts are supposed to play a passive role. As Peerenboom (2006) observes, unlike their counterpart in common jurisdictions, Chinese courts theoretically do not possess the power to "make law". "Their role is to apply law to the facts. If the laws or regulations are unclear, the courts are supposed to seek guidance and clarification from the entities that promulgated the laws or regulations."

82. *Id.* at 15.

83. The Indian judiciary is overburdened with nearly 30 million cases pending at various levels in the judicial hierarchy. *See* Jayanth K. Krishnan, *Globetrotting Law Firms*, 23 GEO. J.L. & ETHICS 57, 70 (2009).

independent directors. The delays in the Indian judicial system foreclose the availability of certainty to corporate actors such as independent directors. Although India follows the common law system and is no stranger to judicial activism and dynamism, there is doubt as to whether the courts would be in a position to determine issues on corporate matters effectively so as to provide adequate principles-based support to independent directors of the kind that is available in the outsider systems of the U.S. and the U.K.

C. *Market Regulation versus State Regulation*

At a broad level, the U.S. and the U.K. follow a market-based model of corporate regulation. This is due to their focus on efficient stock markets, the existence of a robust legal system and a sophisticated group of reputation intermediaries (otherwise known as gatekeepers) such as accountants, investment bankers, lawyers and even independent directors.[84] In these systems, the state only lays down default rules (as opposed to mandatory rules), which the various actors themselves largely implement. The rules relating to self-dealing in Delaware[85] and the U.K. Corporate Governance Code[86] are emblematic of this approach.

Given this background, in these systems independent directors are considered to be an effective alternative to state regulation. Professor Brudney addresses this question directly,[87] and points to the fact that the "theoretical justification for the independent director's role as monitor of integrity is that he functions as a market substitute that is less costly than regulation".[88] It is stated that "the independent director is less costly than governmental regulation by an amount that outweighs its shortcomings".[89] The U.S. and the U.K. therefore consider independent directors as an integral part of market regulation that leads to minimal intervention by the state in corporate affairs.

In China and India, the state plays a significant role in the regulation of corporate activity through imposition of mandatory rules. There is a perceived unwillingness on the part of the state to confer self-regulatory power on market players. This is partly due to the fact that reputational intermediaries are only beginning to play an important role in these systems. Independent directors

84. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001).
85. *See supra* note 4 and accompanying text. These rules provide substantial deference to the decisions of independent directors while approving self-dealing transactions.
86. *See supra* note 8 and accompanying text.
87. *See* Brudney, *supra* note 44, at 622. He cites the example of how self-dealing transactions were earlier prohibited altogether in Delaware, but have since been permitted through the justification of approval by independent directors.
88. *Id.* at 653.
89. *Id.* at 655. Professor Brudney, however, cautions by saying that the independent director concept should not be supported by a mere hostility towards state regulation, and that greater evaluation of the costs and benefits (of independent directors as an alternative to state regulation) needs to be conducted. *Id.* at 659.

too form part of the same cohort. To that extent, it cannot be said that independent directors are a substitute to state regulation in China and India. This is clear from the limited powers conferred upon independent directors in these systems.[90]

In addition to the discussion above, it is necessary to note that independent directors cannot function in isolation. They form part of a system of norms and institutions that enhances corporate governance. Those institutions include gatekeepers such as accountants, lawyers, investment bankers and even regulators and courts.[91] Other factors include the existence of a market for control, and the possibility of takeovers as a threat to the incumbent management's laxities. As far as the U.S. and the U.K. are concerned, legal structures ensure the presence (at least to a large extent, if not entirely) of systems and institutions referred to above that support the independent director. However, such systems and institutions either do not exist in insider systems such as China and India, or do not perform their roles effectively. In such a scenario, it is not possible to expect independent directors to perform without effective support from these complementary institutions. To take one illustration, the independent directors of Satyam were unable to unearth frauds on their own in the absence of effective financial reporting and auditing mechanisms within the company. Furthermore, the availability of advanced accounting standards would certainly equip the functioning of independent directors as they will have access to accurate financial information pertaining to the company to determine the performance of management and, if required, challenge the management's performance.[92]

IV. Cultural Constraints: The Individual and the Collective

A discourse in comparative governance that is important, but one which is yet to gain considerable traction, is the role of cultural and anthropological factors in the successful transplantation of corporate governance norms.[93] Professor

90. For example, independent directors are not specifically conferred the powers to approve self-dealing transactions. While they can acknowledge and express their views on such transactions under the Independent Director Opinion in China (¶5(1)(a)), no such provisions are contained in Clause 49 in India. Moreover, the reluctance of the state to cede its regulatory domain is also evident from the peculiar provision in the Independent Director Opinion that requires all independent director nominees to be approved by the China Securities Regulatory Commission ("CSRC") before they are in fact appointed (¶4(3)). This, in an elementary sense, is tantamount to independent directors being treated as agents of the state.

91. *See generally* John C. Coffee, Gatekeepers: The Professions and Corporate Governance (2006).

92. Professor Gordon details the correlation between the role of independent directors and transparency in financial information. *See* Gordon, *supra* note 2, Part III. Strengthening financial disclosure requirements will result in availability of high-quality information thereby bolstering the ability of independent directors to more closely monitor the actions of managers and controlling shareholders.

93. One commentator laments the paucity of discussions on this issue. *See* Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34

Licht has propounded that cultural differences are one of the reasons for the disparity in corporate governance regimes among countries.[94] He finds that the inability of countries to change their culture results in path dependence, which comes in the way of radically transforming corporate governance regimes in countries.[95] Whenever the law reform process (including that which is by way of transplantation of norms) omits cognizance of cultural differences between systems, it can result in failure of reforms.[96]

I will now apply this theory to the subject matter of this article. The concept of independent directors evolved in the Anglo-American culture (also known generally as Western culture and attitudes).[97] Interestingly, the cultural factors in those systems make the role of the independent director more adaptable and relevant to them. First, in that culture the individual is the basic unit of society, and hence all matters yield to individual liberty.[98] This requires individuals to think independently and take decisions on the basis of optimal outcomes rather than on the basis of other extraneous factors. Second, human relationships are transient in the Anglo-American culture.[99] Individuals do not have any compulsions to be recognized as part of a collective. Third, individuals make decisions based on rationality and are devoid of emotional attachments.[100]

Since the evolution of independent directors is connected with the emergence of a monitoring board (wherein these directors operate as a check on the management), the concept fits well with Anglo-American liberal attitudes. The monitoring role of an independent director requires such person to constantly challenge members of the management such as the CEO. Such challenges do not necessarily question the authority of the CEO or other managers. The focus is usually on the issue rather than the individuals. In crisis situations, a non-performing CEO may have to be confronted or even shown the door. Independent directors have in fact carried out that role even in recent times.[101]

CORNELL INT'L L.J. 321, 347 (2001) (observing "the nearly complete absence of any discussion of varying cultures, or of the role of culture ... [in] comparative study").

94. Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147 (2001).
95. Id. at 149.
96. Id. at 150.
97. *See* Brian Cheffins, *Current Trends in Corporate Governance: Going from London to Milan to Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 11 (2000) (noting that "corporate governance arrangements in any one country are, to a significant extent, a product of the local economic and social environment" and that a "distinctive feature of the British corporate governance system is that the environment in which its public companies operate strongly resembles that which exists in the United States").
98. CHARLES LEE, COWBOYS AND DRAGONS: SHATTERING THE CULTURAL MYTHS TO ADVANCE CHINESE-AMERICAN BUSINESS 59 (2003).
99. *Id.*
100. *Id.* (referring to individuals in the Anglo-American cultures as "cowboys"). Lee further notes: "Cowboys reach decisions with the head. Everything is rational: "I think it is a good decision"". *Id.* at 189.
101. *See, e.g.*, Greg Farrell, *Under Fire, Merrill Lynch CEO O'Neal Retires*, USA TODAY, Oct. 30, 2007, *available at* http://www.usatoday.com/money/companies/management/2007-

Culturally, there is nothing heretic about such conduct. Therefore, at a broad level, it appears that the Anglo-American culture is conducive to independent monitoring by directors over managers, and that perhaps explains why the concept of independent directors originated in those jurisdictions in the first placeInsider systems on the other hand, demonstrate very different cultural values (often alluded to as Asian values. Some of the cultural characteristics in these systems are diametrically opposite to those of the outsider systems.[102] These are: (i) the society values the collective more than the individual; (ii) interpersonal relationships are valued more than the resolution of substantive issues; and (iii) decision-making often gets mired among extraneous issues without a unified focus on the optimal outcome. These issues are discussed below to the extent that they are relevant to the question of board independence.[103]

In China, the cultural traditions have been influenced to a great extent by Confucianism.[104] China follows the collectivist model,[105] which is built on the concept of "'family state', a form of social organisation that is autocratic and hierarchical and not at all democratic".[106] This societal structure suppresses individual beliefs and convictions and requires individuals to follow persons in authority. Harmony is an essential element of interpersonal relationships, and breaking the mould is not at all considered acceptable.[107]

10-30-merrill_N.htm; Ben Livesey, *RBS Cedes to UK, Seeks $34 Billion as CEO Quits*, BLOOMBERG, Oct. 13, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akFotBaDKzRw (last visited Mar. 1, 2011).

102. *See* RICHARD NISBETT, THE GEOGRAPHY OF THOUGHT: HOW ASIANS AND WESTERNERS THINK DIFFERENT—AND WHY (2003) (citing experimental, historical and social evidence to find that East Asian thought tends to be more holistic attending to the entire field in question, while Westerners are more analytic and pay closer attention to the primary issue at hand and use formal logic to explain and predict behaviour). In that sense, while Asian thought is more relational, Western thought is transactional.

103. While some level of generalisation is possible with reference to the features of all jurisdictions that are either emerging economies or form part of the insider system, that ought not to be assumed in the case of cultural factors as they can vary significantly from country to country (or even within a given country). This is because cultural factors take shape on the basis of historical and anthropological factors that are specific to each system. Hence, while there are some common traits among cultural values in the different Asian countries, they are subject to equally diverse factors among these countries. This discussion therefore delves into a detailed application within the two subject countries of China and India.

104. *See* Lay Hong Tan & Jiangyu Wang, *Modelling an Effective Corporate Governance System for China's State Owned Enterprises and Challenges in a Transitional Economy*, 7 J. CORP. L. STUD. 143, 167-68 (2007); YUAN WANG, XIN SHENG ZHANG & ROB GOODFELLOW, BUSINESS CULTURE IN CHINA 19-20 (1998). To simplify matters, Confucianism propounds conventions that can be categorized into hierarchy, collectivism, 'face' protection, respect for tradition or age and egalitarianism. *See* WANG, ZHANG & GOODFELLOW, *id.* at 20.

105. *See* HEIDI DAHLES & HARRY WELS, EDS., CULTURE, ORGANIZATION AND MANAGEMENT IN EAST ASIA: DOING BUSINESS IN CHINA 44 (2002).

106. WANG, ZHANG & GOODFELLOW, *supra* note 104, at 20.

107. *See also* Tan & Wang, *supra* note 104, at 169 (noting that "it would thus be imprudent and even dangerous to openly express differences with someone, for these differences may offend not only that person but his entire network of friends"); WANG, ZHANG & GOODFELLOW, *supra* note 104, at 22 (finding that this requires individuals to act in accordance with expectations of other human beings rather than on the basis of their own beliefs or wishes).

Human relationships in Chinese society are built very carefully and are long-lasting. Two facets of interpersonal behaviour are peculiar to China and require further exploration. They are *guanxi* and *mianzi*. The simple meaning of *guanxi* is relationships,[108] although it is understood to involve personal relationships created through reciprocal favours or creation (and repayment) of personal debts from time to time among individuals.[109] Mutual trust operates between individual relationships in a manner that it is considered unacceptable to offend the other person through actions or conduct.

An extension of *guanxi* is the concept of *mianzi*, which literally means 'face'.[110] *Mianzi* means behaving in a way that avoids embarrassment, particularly to persons higher up in the hierarchy. In return, it also requires the recipient of the favour to have to return it at a later point in time creating obligations between parties. Both *guanxi* and *mianzi* play an important cultural role in the way Chinese business organisations are managed.[111]

These concepts are important not only in family-owned businesses but also in state owned enterprises (SOEs). The dominance of SOEs in Chinese business signifies the acceptance of the relationship between the bureaucracy and other corporate actors.[112] Although the influence of the bureaucracy in business was initiated with a view to preventing the "socially destabilising influence" of business,[113] "government officials involved in commerce used their privileged positions to guarantee business success".[114] This naturally meant the commingling of businesses and the political process. The concepts of *guanxi* and *mianzi* operate even more forcefully in the case of SOEs, as any other conduct is considered subversive to the political system as a whole.[115] Thus, individual opinion is looked down upon and the overall benefit of the collectivity is considered with a view to maintaining harmony.

Finally, Chinese culture does not permit individuals to directly reject or say 'no' to any idea, suggestion or proposal.[116] This is due to the operation of *mianzi*, as "Chinese people believe that directly saying 'no' to a partner or

108. LEE, *supra* note 98, at 150. It is sometimes also interpreted to mean "connections". *See* WANG, ZHANG & GOODFELLOW, *supra* note 104, at 75.
109. *See* Tan & Wang, *supra* note 104, at 169; LEE, *supra* note 98, at 150.
110. Such an interpretation is perhaps inaccurate in the present context, where it ought to be referred either to "loss of face" or, to the contrary, "face saving". *See* DAHLES & WELS, *supra* note 105, at 5; WANG, ZHANG & GOODFELLOW, *supra* note 104, at 23.
111. Referring to individuals in the Chinese culture as "dragons", Lee notes: "Dragons reach decisions with the heart. Everything is intuitive: "I feel good about the decision"". LEE, *supra* note 98, at 189.
112. *See* Chenxia Shi, *What Matters in the Governance of the Board? – A Comparative Perspective*, 17 A.J.C.L. 144, 151 (2004).
113. WANG, ZHANG & GOODFELLOW, *supra* note 104, at 29.
114. *Id.*
115. *See* Tan & Wang, *supra* note 104, at 169.
116. *See* Margaret Wang, *The Independent Directorship System in China*, 17 A.J.C.L. 243, 247 (2004).

associate may engender hurt and therefore damage a valued friendship or network relationship".[117]

It is interesting to note that there are several commonalities in Chinese and Indian culture. Some examples are the prominence of collectivity, the importance of personal or familial relationships and the inability to directly say 'no'. However, compared to China, there is greater recognition of individual freedoms in India, particularly freedom of speech and expression. Thus, Indian society is somewhat more liberal as compared to the Chinese society.[118] Nevertheless, the differences between Chinese and Indian cultures tend to matter more in terms of degree than in substance.

In India, most family businesses are based on collective and personal relationships. The family is the basic social unit, and in the case of Hindu undivided family or joint family the eldest male in the family (also known as the *karta*) possesses principal authority.[119] The family unit traverses the business arena as well. In family owned businesses, which form a significant portion of Indian businesses (including publicly listed companies), the head of the family maintains strict control of the business and exercises significant powers.[120] Authority is normally vested in such person, and it is rare to question the mode of functioning of the patriarch.

As with China, relationships matter in India as well. Business is carried out through personal relationships, which are often created based on factors such as heredity, family, religion and even caste.[121] These relationships last several generations, and are mutually beneficial, owing to which it is difficult for any party to question the actions of the others due to the fear of upsetting the harmony of the relationship. Furthermore, it has been found that the style of Indian management is not direct and goes "round and round in circles, and [takes] forever to formulate policy".[122] Indians also find it difficult to directly reject any offer or proposal.[123]

Applying these cultural factors to the present discussion, it is not surprising that independent directors have not been very effective in the insider systems of China and India. Apart from the general dissonance between the concept of the independent director (performing a monitoring mechanism) and the way in which businesses are managed in these countries, there are two specific

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117. WANG, ZHANG & GOODFELLOW, *supra* note 104, at 38.
118. For a broad understanding of the comparison between the two politico-cultural systems in the context of business and economics, *see* Randall Peerenboom, *Law and Development in China and India: The Advantage and Disadvantages of Front-Loading the Costs of Political Reform* (La Trobe University School of Law Legal Studies, Working Paper No.15, 2008), *available at* http://ssrn.com/abstract=1283209.
119. *See* MONIQUE BOER, INDIA, CULTURE AND MANAGEMENT: THE ART OF DOING BUSINESS 188 (1989).
120. *Id.*
121. S. BALASUBRAMANIAN, THE ART OF BUSINESS LEADERSHIP: INDIAN EXPERIENCES 97 (2007).
122. WILLIAM NOBREGA & ASHISH SINHA, RIDING THE INDIAN TIGER: UNDERSTANDING INDIA—THE WORLD'S FASTEST GROWING MARKET 203 (2008).
123. *Id.*

implications. First, the definition of 'independence' in both these countries fails to take into account cultural factors.[124] Independence is defined with reference to familial and pecuniary ties and does not extend to social ties and other loose forms of bonding practised in China and India, such as through *guanxi* in China and the extended family in India.[125] It is possible for companies to pack their boards with directors who satisfy the formal definition of independence, but are otherwise obligated through social ties to the controlling shareholders or management or both.

Second, both China and, to a lesser extent, India find dissent to be culturally objectionable. Therefore, independent directors, even when they are truly independent of management and controlling shareholders, are unlikely to obviously object to any matter on corporate boards, even if that is a part of their monitoring role. At most, they are only likely to raise questions, but may not take matters to their logical conclusion for fear of disturbing the harmony on boards. Deference to the company patriarch often inhibits independent directors from voicing their concerns in board meetings. They may raise issues with the controlling shareholders or management outside board meetings, but are easily convinced to not press the issue further. These cultural barriers obstruct independent directors from performing their roles satisfactorily towards resolution of the agency problems between majority and minority shareholders.[126] While independent directors are implicitly beholden to management and controlling shareholders due to cultural norms, they share no such relationship with minority shareholders (whose interests they are required to protect).

The transplantation of the independent director concept from the outsider systems that share the Anglo-American liberal culture, into societies such as China and India, which emphasize collective harmony, is bound to be fatal in its effective implementation. These cultural factors have not been taken into account in the process of transplantation. That leads me to a discussion of the last set of factors, namely political, that impose constraints on independent directors in China and India.

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124. Sibao Shen, *China's New Corporate Governance Measures after its Accessions into the WTO*, 17 A.J.C.L. 6, 8 (2004) (noting that "there is a clash between the original international definition of corporate governance and traditional Chinese values. This is one of the root causes of the many imperfections that can be found in relation to corporate governance in China.").

125. It is a different matter that social relationships are unrecognized by rules even in the outsider systems. For example, Professor Brudney critiques the definitions in the U.S. by stating: "No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess". *See* Brudney, *supra* note 44, at 613.

126. Western-style independence cannot coexist with the Asian search for harmony, even on corporate boards.

V. Political Constraints: Rent-seeking by Controlling Shareholders?

It appears that globalisation has caused several countries around the world to embrace Western norms of corporate governance. Professors Hansmann and Kraakman argue that all corporate governance models will converge on the lines of the American model.[127] Since the independent director is a by-product of American corporate governance, it is argued that the concept will be admitted into all countries as a result of global convergence. At a broad level, this philosophy may well deserve some merit. After all, it is true that several countries around the world have embraced the concept of independent directors. However, as the studies discussed in Part B demonstrate, such convergence is confined largely to changes in the rule book and compliance with the letter of the law relating to corporate governance.

It is found that this convergence is a result of economies opening up their markets for investments from countries that are familiar with the Anglo-American model of corporate governance rather than with any particular concern for benefiting their own constituencies such as minority shareholders.[128] In that sense, the changes adopted so far have been largely with a view to signaling comfort to international investors about enhanced corporate governance norms. This has given rise to the situation where concepts such as independent directors have been introduced into these economies, but there still continues to be uncertainty and confusion regarding proper implementation of these concepts.

This situation can be explained using the theories of path dependence, interest group politics and rent-seeking, which have brought out inadequacies in the independent director concept in the insider systems of China and India. Professors Bebchuk and Roe elaborate on the theory of path dependence in corporate governance. They argue that countries' corporate governance norms and structures persist because of two sources of path dependence, namely *structure-driven path dependence* and *rule-driven path dependence*.[129]

As regards structure-driven path dependence, Professors Bebchuk and Roe argue that "existing corporate structures might well have persistence power due to internal rent-seeking, even if they cease to be efficient".[130] Parties who are beneficiaries of corporate control under existing structures have every incentive to maintain *status quo* so that they continue to enjoy the benefits of

127. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001).

128. *See* Clarke, *supra* note 21, at 209; Xi, *supra* note 47, at 35; Tania Mazumdar, *Where the Traditional and Modern Collide: Indian Corporate Governance Law*, 16 Tul. J. Int'l & Comp. L. 243, 253 (2007); Rajiv Gupta, *Reforms Made and Reforms Needed in India's Capital Markets: Issues Facing US Investors*, 1650 PLI/Corp 85 (2008).

129. Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan. L. Rev. 127, 129 (1999).

130. *Id.* at 130.

control. Parties with control will impede even efficient changes if that reduces their level of control.[131] This explains the continued existence of concentrated ownership of companies in the insider systems, particularly in China and India. Although the process of diffusion of shareholding in companies in these countries has commenced, the rate of progress is quite slow. The stickiness of concentrated ownership and the dominance of controlling shareholders are not likely to bring about significant change in the role of independent directors in the insider systems of China and India. The effect of *structure-driven path dependence* will only help in maintaining the current position rather than accommodating change.

The phenomenon of *rule-driven path dependence* has a greater role here. This theory argues that existing corporate structures will determine the relative efficiency of alternative corporate rules.[132] Further, it finds that interest group politics play an important role in rule-driven path dependence.[133] For example, it has been noted that managers continue to play a dominant role in interest group politics in the outsider systems.[134] Similarly, controlling shareholders are bound to play a key role in the insider systems.[135] Controlling shareholders will have a significant influence on rule-making in the insider systems. It is unlikely that they would permit any rule changes that would significantly erode their dominance, even if those changes are in fact efficient.[136] This is particularly so in the case of China, and to a lesser extent India, where the state itself is a controlling shareholder in a number of publicly listed companies, and hence can directly influence decision-making.

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131. *Id.*, noting further:

> As long as those who can block structural transformation do not bear the full costs of persistence, or do not capture the full benefits of an efficient move, inefficient structures that are already in place might persist. To be sure, all potentially efficient changes would take place in a purely Coasian world. However, as we show, the transactions feasible in our imperfectly Coasian world often would not prevent the persistence of some inefficient structures that are already in place.

132. *Id.* at 131. For instance, the existing concentrated shareholding in the insider systems would determine the efficiency of the independent director rule in those systems, while diffused shareholding would do so in the outsider system.

133. Bebchuk and Roe have pinpointed the effect of interest group politics:

> A country's initial pattern of corporate structures influences the power that various interest groups have in the process of producing corporate rules. If the initial pattern provides one group of players with relatively more wealth and power, this group would have a better chance to have corporate rules that it favors down the road. Positional advantages inside firms will be translated into positional advantages in a country's politics. And this effect on corporate rules will reinforce the initial patterns of ownership structure.

134. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

135. Since the ownership structures of companies in the insider systems provide significant powers to controlling shareholders, they will likely play interest group politics to retain their dominant influence in companies.

136. Bebchuk & Roe, *supra* note 129, at 157.

Finally, Professors Bebchuk and Roe find that the effective implementation of rules is as important as promulgating the rules. They state:

> What counts are all elements of a corporate legal system that bear on corporate decisions and the distribution of value: not just general principles, but also all the particular rules implementing them; not just substantive rules, but also procedural rules, judicial practices, institutional and procedural infrastructure, and enforcement capabilities. Because our concern is with the corporate rules system "in action" rather than "on the books," all these elements are quite important.[137]

No doubt, the insider systems have moved towards the Anglo-American model by embracing the independent director concept. However, that movement has been occasioned primarily with a view to providing cosmetic comfort to investors from those systems. Substantive rules and other constraints, as discussed in this article, impede the efficient functioning of independent directors. I argue here that interest group politics has been played in a manner that benefits controlling shareholders. The introduction of the independent director in the insider systems helps controlling shareholders raise equity financing for their companies through public capital markets, thereby enhancing their own wealth in their companies. On the other hand, by ensuring that independent directors remain largely docile in insider systems, controlling shareholders have retained their overall private benefits of control. As I have emphasized, the continued dominance of controlling shareholders in appointing, renewing and removing independent directors and the lack of any specific mandate to independent directors to protect other interests in any meaningful way are just some illustrations of how interest group politics have devised a more ornamental role for independent directors.

Due to path dependence driven corporate governance reforms in the insider systems, it is unlikely that there will be any meaningful change to the position of independent directors in a manner that will eliminate the dominance of controlling shareholders. Interest group politics in this situation gives rise to an interesting contradiction, i.e., controlling shareholders are themselves influencing the process through which their actions are monitored by independent directors. The contradiction cannot have been starker.

CONCLUSION

This article is an exploratory effort to assess the constraints faced by independent directors in China and India. It finds that there are several constraints that operate in these countries that obstruct the effective implementation of the independent director concept that has been transplanted

137. *Id.* at 154.

from the U.S. and the U.K. These constraints, which are embedded in the very structure of China and India, help explain the underlying reasons for the lack of desired success of the independent director concept in those systems.

At the outset, the obvious question that arises is whether the concept of independent directors adds any value to corporate governance systems in countries such as China and India and whether it should be done away with altogether. However, the analysis in this article does not support a radical proposal such as eliminating independent directors. Merely because the concept has not been fully effective, it is not prudent to follow the radical (and perhaps less disquieting) approach of doing away with independent directors.[138] Metaphorically speaking, that would tantamount to "throwing the baby out with the bathwater". If the requirement of mandating independent directors is done away with, that would mean a loss of even the currently available (albeit minimal) monitoring efforts on corporate boards in insider systems. Hence, what is required is a revamp of the structure of the institution and the support systems available to independent directors to carry on their role more effectively.

The constraints discussed in this article point to the need for urgent reform of independent director norms in China and India. *First*, in order to obliterate the significant weakness relating to nomination and appointment of independent directors, several measures may be employed that remove the nomination and appointment process from the purview of the controlling shareholders. These include nomination of independent directors by an independent nomination committee, the use of cumulative voting for appointment of independent directors (so that minority shareholders obtain meaningful participation), the imposition of voting caps on controlling shareholders for resolutions appointing independent directors, the election of independent directors by a "majority of the minority" shareholders, and such similar measures.[139] *Second*, the role of the independent directors in insider systems ought to be clearly identified; they

138. Commentators in insider systems have noted that since it is a "universally acclaimed regulation" [sic], it ought to be retained, and that any other approach would question its introduction in the first place as a misjudged policy choice in these countries. *See* Prithvi Haldea, *The Naked Truth About Independent Directors*, *available at* http://www.directorsdatabase.com/IDs_Myth_PH.pdf. Similar ideas have been expressed with reference to outsider systems as well. *See* Kahan & Rock, *supra* note 77, at 892 (observing that "it is hard to oppose more independent directors"); Rodrigues, *supra* note 75, at 457 (noting even more, that "[t]o oppose the institution of the independent director almost amounts to heresy"). *See also* Cheng Han Tan, *Corporate Governance and Independent Directors*, 15 SING. ACAD. L. J. 355, 390-91 (2003) (advising that "[a]ny jurisdiction that does not stipulate the need for independent directors may find itself unable to attract capital to its securities markets").

139. The issue of nomination and appointment of independent directors has captured the attention of regulators in India. The Ministry of Corporate Affairs, Government of India has issued certain guidelines on corporate governance that may be adopted by Indian companies on a voluntary basis. *See* Voluntary Guidelines, *supra* note 63. These encourage the use of independent nomination committees. However, no reforms have been suggested to the actual process for appointment of such directors.

should include monitoring of controlling shareholders and managers, and the protection of the interests of minority shareholders. This can be achieved by granting specific powers to independent directors such as approval of related-party transactions (that may otherwise adversely impact minority shareholders). *Third*, other relevant considerations include introducing a meaningful definition of "independence" that takes into account relationships that are unique to specific cultures,[140] mandating that independent directors meet without the presence of management or controlling shareholders (so as to overcome the cultural barriers), and prescribing appropriate incentives and disincentives to a more optimal independent director role (to the extent that law should meaningfully intervene). *Finally*, regulators ought to moderate the reliance on independent directors as an institution to enhance corporate governance in an economy; it is only one of several institutions that can perform the task. Not only should regulators manage the over-optimism, but they should also focus on strengthening several other corporate governance institutions such as a stringent financial and accounting regime, whistle blowing mechanisms, code of ethics, just to name a few, that may suitably support the independent director institution.

140. For a detailed discussion on this issue, *see supra* Part E.