
THE EVOLVING REGULATORY LANDSCAPE FOR INDEPENDENT DIRECTORS IN INDIA TO AVERT CORPORATE FRAUDS

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ABSTRACT

Corporate Governance is the key principle to govern and discipline the activities of a company. The corporate governance structure determines transparency and accountability in the functioning of the corporate houses. Corporate governance acts as base, inculcated with various verticals and measures to avert corporate frauds and malpractices. Thus, this paper shall discuss the pivotal role of an Independent director in a company in order to preserve and maintain sanctity of the corporate governance structure of the company. The role of independent director is to strike the right balance between the different fractions of the company and to utilize the optimal maximization of the resource and achieve the targets of the company in coherence with the value of the company and the society. The paper discusses the role of independent director in various organizational structures and recent amendments and their alignment. This paper also highlights certain incidences of malpractices, corporate fraud and role played by the independent directors.

Keywords: Independent Directors, Corporate Governance, Corporate Frauds.

Introduction

The corporate governance structure has gradually reformed in the past few decades, by the attempts of formulating several regimes and rules. One of the most prominent developments in the process of reforms is the constitution of Independent Directors, as an institution. The concept of Independent director initiated in the western nations, United States and United Kingdom in 1950's made sure the institutionalization of Independent Directors in the corporates to eschew acts of self-interest over public interest. India, while undergoing an extensive economic reform in 1991 to ameliorate the business practices and standards, it stepped into the era of globalization. The nation adapted contemporary rules and regulations, in order to even itself with the foreign developed nations. The corporates preferred a standardized structure of corporate governance, as they operated in different regions and domains. The Indian state saw constitution of many committees to provide recommendations to enhance the corporate governance structure. The role of an Independent directed is based on the foundation that they act as watchdog and root for the shareholders¹. The Companies Act, has elaborated provision regarding the institution of Independent Director². The Act mandates public listed companies to have minimum one-third of the total number of members of the board to be appointed as Independent Directors. Whereas the public listed company where the chairman is an executive chairman, that company shall have fifty percent of the directors as independent directors in their board. The Act also mentions the roles and duties of an independent director, their power to protect the rights and interest of the stakeholders, especially minority shareholders, guiding and resolving the conflicts of the company and introspect, analyze and recommend on the performance of the company and its management³. In 1991, the Kumar Mangalam committee recommended the appointment of independent directors in the Board of Directors, with the purpose of keeping a check on the activities of the corporate and enhance the corporate governance standards in India Inc⁴. Independent directors should be appointed to strike the balance between the society at large and corporate houses as an individual, by equally contemplating the economic growth of the companies and social

¹ Brudney, V., 1982. The Independent Director: Heavenly City or Potemkin Village? *Harvard Law Review*, 95(3), p.597.

² Section 149(4) of Companies Act, 2013. 2022. [online] Available at: <<https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>> [Accessed 1 February 2022].

³ Schedule IV of Companies Act, 2013. 2022. [online] Available at: <<https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>> [Accessed 1 February 2022].

⁴ *Kumar Mangalam Birla, Securities and Exchange Board of India (SEBI) 1991* Available at: <https://archive.india.gov.in/business/corporate_governance/kumarmangalam.php> [Accessed 8 February 2022].

interest. The corporate governance code has been updated perpetually. In 2005, a report prepared by J.J. Irani Committee stated that the purpose appointment of Independent Director is to lead the company to the objective and vision of general interest⁵. In 2009, the Naresh Chandra Committee discussed the appointment, re-appointment and removal of the independent director and other Non-executive directors to be disclosed to the shareholders of the company. The earlier Companies Act, 1956 did not specifically mentioned about independent directors and their appointment, the Clause 49 which were inculcated as regulatory SEBI Listing Agreement made it mandatory to appoint Independent directors for listed companies. The recent amendments made are by the virtue of the Uday Kotak Committee established in 2017. The Satyam Scam of 2009 showed the powerless and toothless faces of Independent Directors, which led to mass resignation of independent director, which made the government and other regulatory authorities to rethink on the actual position of Independent directors in the board and the company. The role of an independent directors varies due to his background, but all have a common goal to improve the board process and bring more transparency and accountability in the company⁶. Thus, the position of an independent director and their role are in constant scrutiny and are being strengthen time to time.

Independent Directors in different Ownership structures

The corporate governance framework relies on the ownership structure of the company⁷. The corporate governance models can be classified as two models, outsider model and insider mode. These models of corporate governance are also linked with the ownership structure of the companies. In countries like United States and United Kingdom, the outsider model of corporate governance is applicable, as most of the companies have dispersed shareholding pattern. This establishes a manager-shareholder conflict, among the shareholders and the managers of the company⁸. The corporate governance and the appointment of independent directors, is instituted to protect the rights of these dispersed shareholders, and to eschew any sort of exploitation from the management. It is observed that the Asian countries such as India and China, the companies have a controlling shareholding pattern, as the promoters have

⁵ Dr. Jarnshed J. Irani Chairman Expert Committee on Company Law. 2005. [online] Available at: <<https://ibbi.gov.in/May%202005,%20J.%20J.%20Irani%20Report%20of%20the%20Expert%20Committee%20on%20Company%20Law.pdf>> [Accessed 22 January 2022].

⁶ Nowak, M. and McCabe, M., 2003. Information Costs and the Role of the Independent Corporate Director. *Corporate Governance*, 11(4), pp.300-307.

⁷ Hansmann, H. and Kraakman, R., 2017. Foundations of Corporate Law. *SSRN Electronic Journal*.

⁸ Black, B. and Kraakman, R., 1996. A Self-Enforcing Model of Corporate Law. *Harvard Law Review*, 109(8), p.1911.

magnitude of shares and members from the same family, as part of the members of the board⁹. This creates a majority-minority conflict among the investors. The companies operated by such families, have major stake in the shareholding pattern, this is simultaneously reflected in the decision making of the company¹⁰. The company is structured in a manner where the policy makers are also the majority shareholders. The vision and prospects of the company may get compromised with the ambitions of the promoters. The appointment of independent directors in the board is purpose oriented, they have to be unbiased and shall not get influenced by any other members of the board and act prudently keeping the company, its visions and prospects at the highest priority¹¹. They have to investigate and keep a check on the working of the company, identify any faults and correct them timely, to avoid any future mis happenings. The concern in these controlled firms is that the principal promoters may act opportunistically for self-growth and to accomplish any ulterior motives, disregarding the value maximization targets of the company¹².

The controlled firms have less instances of entrenchment, as seen in dispersed held firms. The controlled firms may have incidents wherein they misuse their power and involve in transactions which may not be in consonance to the welfare of the company and its minority shareholders¹³. the promoters of such controlling firms may lead to have self-financing transactions such as loans or freezeout mergers, wherein they borrow money or make such acquisition for oneself and not for the company. the company may also have related party transactions, wherein they pump the company's money into subsidiaries or known companies, and have stake in those companies as well, for the sole purpose of benefitting themselves¹⁴. The dispersedly held companies have manager-shareholder agency problem, in which the concern lies around the excessive power of the managers, as they have the detailed knowledge of the company, as the board has a superficial knowledge about the workings of the company. the managers are in a position to expropriate the shareholders through several methods such as

⁹ Stavrou, E., Kassinis, G. and Filotheou, A., 2006. Downsizing and Stakeholder Orientation Among the Fortune 500: Does Family Ownership Matter?. *Journal of Business Ethics*, 72(2), pp.149-162.

¹⁰ Cheffins, B., 2003. Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies. *Oxford Journal of Legal Studies*, 23(1), pp.1-23.

¹¹ Gilson, R. and Gordon, J., 2003. Controlling Controlling Shareholders. *University of Pennsylvania Law Review*, 152(2), p.785.

¹² Kinsella, M., 2016. Hostile Takeovers—An Analysis Through Just War Theory. *Journal of Business Ethics*, 146(4), pp.771-786.

¹³ La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., 1999. Corporate Ownership Around the World. *The Journal of Finance*, 54(2), pp.471-517.

¹⁴ Kraakman, R., 1984. Corporate Liability Strategies and the Costs of Legal Controls. *The Yale Law Journal*, 93(5), p.857.

having more power than the board, amending the rules, power to appoint and dismiss other key managers, mismanaging the wealth of the companies and its assets, forging the data in the account books, compensation and remuneration of the executives etc.¹⁵ Thus, it has been observed by learned scholars, academicians and policy makers that controlling firms and dispersedly held firms have similar and sometimes overlapping predicament. Corporate frauds in a dispersedly held firm like WorldCom and Enron, wherein the management misrepresented the financial performance of the company, and gradually increased the executive's remuneration. While corporate frauds in controlled firm such as Satyam, wherein the promoters expropriated the funds of the company, mislead the investors through forging up the financial statements and account books¹⁶. The corporate frauds arising in both the kind of companies through similar modus operandi, addresses the common concerns of corporate governance.

To bridge the gaps in corporate governance structures of both the controlled and dispersedly held firms, academicians and other stalwarts of corporate law suggest incorporation of independent directors in the corporate governance system, as their appointment address the unique corporate governance concerns¹⁷. The independent directors have roles and objectives which may deem fit in all kind of companies irrespective of their ownership structure and agency problems. An independent director monitors the actions and workings of the company, acts as a watchdog on behalf of other public shareholder, and is positioned to scrutinize any wrongdoings of the company and its members of the board¹⁸. The independent directors exercise their power of vigilance and correct any misrepresentation or misappropriation of assets and account books. In a manner they act on behalf of the minority shareholders, to check on any malpractices or self-dealing related party transaction of the company¹⁹. The independent directors enhance the standards of professional in the board room, as they promote the corporate governance practices and make sure of their adherence in the company. The independent directors play an additional role of strategic advisors to the members of the board. They have immense experience and expertise in a niche subject or industry, which can be

¹⁵ Bhagat, S. and Romano, R., 2001. Event Studies and the Law - Part I: Technique and Corporate Litigation. *SSRN Electronic Journal*.

¹⁶ Coffee, J., 2005. A Theory of Corporate Scandals: Why the USA and Europe Differ. *Oxford Review of Economic Policy*, 21(2), pp.198-211.

¹⁷ Jafarli, M., 2020. Relationship problems between independent directors and CEOs in Public Companies. *Young Scientist*, 4(80).

¹⁸ Clarke, D., 2006. Setting the Record Straight: Three Concepts of the Independent Director. *SSRN Electronic Journal*.

¹⁹ DeMott, D., 2007. Guests at the Table? Independent Directors in Family-Influenced Public Companies. *SSRN Electronic Journal*.

utilized in enhancing the economical decision and their social impact and ultimately uplifting the corporate governance standards of the company.

Corporate scams in regard to Independent Director and their roles

The Satyam Scam- Satyam was a leading information technology company, with a reputable image among the others in the market. The company was awarded with Golden Peacock Award for its adherence in corporate governance standards. The Chairman, Mr. Ramalinga Raju colluded with the company's auditor in order to mislead the board, investors, shareholders, regulators and other stakeholders through forgery and misrepresentations of the account books²⁰. The scam was revealed by Mr. Raju through confession made by him, followed by probe against the company by SEBI and other regulatory agencies. A related party transaction was the commencing point of the fraud, wherein the cash and bank statements were overstated and debts were understated. The promoters of this company Maytas, were also the members of the board in Satyam, and investment were made considerable sum of money ₹ 7000. Strict actions were taken against the board of directors of Satyam and World Bank banned the operations of the company for a period of 8 years. Four independent directors of Satyam resigned from their post, as they failed to perform their duties diligently. The Satyam fiasco raised serious question on the regulatory authorities such as SEBI, CII and NASSCOM, and they recommended policy amendments to be made under the ambits of shareholders rights, audit committee and other such methods of corporate governance and concluded their recommendation that at least one independent director shall be part of the committees, strengthening the institutional role of independent directors.

IL & FS Scam- Infrastructure Leasing and Financial Services, a company providing financial support to the companies investing in infrastructural projects and development. The company was involved in circuitous and selective transactions through its subsidiaries and entities where they were invested in. These investments were made in distressed companies, leading to piling up the bad debts of the company. These companies had a record of delayed repayments on the existing loans. On the records of IL & FS, the account books of these distressed companies were window-dressed and were highly rated by the IL & FS group²¹. The top management of IL & FS being well aware about the NPA of theses borrowers, still preferred to continue

²⁰ Grover, N., 2013. The Satyam Scam: A Corporate Governance Perspective. *SSRN Electronic Journal*.

²¹ Gupta, A., 2019. Infrastructure Financing at Crossroads: The Case of Infrastructure Leasing and Financial Services Ltd. (India). *International Journal of Business and Globalisation*, 1(1), p.1.

granting loan to these distressed companies, including few listed public companies. These working and transactions of the company resulted in ultimately losses to IL & FS group. The probe revealed that the members of the board, including independent directors were availing hospitality and other favors from these defaulting borrowers in order to carry on the flow of money and not classifying them as NPA (Non- Performing Assets).

The members of the board of directors, auditors and the independent directors, all being part of several statutory committees did not wish to exercise their power and act diligently and prudently, showing their faith to the company and its stakeholders, rather they chose to profit themselves on the verge of losses, forgery and misrepresentation of account books of the company. These individuals lack the integrity to make fair and just disclosure about the happening and transactions of IL & FS, and rather collided with the officers and management of defaulting companies.

Jet Airways- Till 2018 Jet Airways was the second largest passenger airline operating in Indian market. In the month of April, 2018 close to the ending of the financial year 2018-2019, the company ran out of funds to run the routine business operations. The company had debts of ₹ 8500 crores. The company also had to pay arrears worth ₹ 25000 crores to its 15,000 employees. The company failed to clear its debts and couldn't keep its balance sheet debt free, under the Chairmanship of Mr. Naresh Goyal, he and his family members hold the majority stake in the company. the company was a promoter driven company, working to fulfil the fancy lifestyle of the promoter and his family, the policies of the company were not oriented towards fulfilling the goals and target of the company, but were affluently spend on the Chairman's family. The company also received an offer from the Tata group, which would have covered many of their losses and would have paid the salaries of a considerable number of employees²². Jet Airways rejected the offer, which surprised the other members of the board, investors, shareholders and other stakeholders. The company's actions and directives were to satisfy and benefit the promoters and not the company. the company lacked the corporate governance structure and the regulators such as auditors and independent directors failed to comply their duty. Mr. Ranjan Mathai and Mr. Vikram Singh, the independent directors of the company resigned from the company, as they didn't act diligently.

²² Fernandes, K., 2022. *Biggest Corporate Governance Failures in India - The CSR Journal*. [online] The CSR Journal. Available at: <<https://thecsrjournal.in/corporate-governance-failures-india/>> [Accessed 8 February 2022].

Tata- Mistry conflict- Cyrus Mistry was the member of the board of Directors of Tata Trusts since 2006. Later he was made the Chairman of the Tata Group, as when Ratan Tata stepped down. The Tata family holds the majority stake in the shareholding pattern of the company, this created an opportunity to dominate the decisions of the board. Cyrus Mistry alleged that he was unable to perform freely and was facing impediments managing his corporate affairs and decisions. He stated that the Nominee Directors have also colluded with the Tata family and have cornered him by disapproving his decisions in the board meetings²³. Additionally, he mentioned in his allegations that Ratan Tata was acting as a Shadow Director against his corporate actions and restricting his freedom to exercise his duties.

The promoters and the members of the board had their own interest and vested interest in certain projects, and were not concerned with the overall development and objectives of the company. Cyrus Mistry further alleged that Tata family also curbed the independence of the Independent Directors. Nusli Wadia, an independent director of the company who favored Cyrus Mistry and supported his legitimate concerns was later suppressed and dismissed from his position of Independent Director. Such dismissal of an independent directors raised a question of on the workings of the Tata Group as this impacted their corporate governance structure and diluted the institutional role of independent director.

Recent amendments enhancing the role of Independent Directors

Approval of Shareholders- Earlier an independent director could be removed by a simple majority in his first term and by a special resolution in his second term. This created a position of dominance for the promoters, having majority shares of the company. This appointment, removal and re-appointment directors was changed from March, 2021 by Securities Exchange Board of India. Now, any appointment, re-appointment and removal of an independent director can only happen through special resolution. Additionally, SEBI reduced the period for such appointment of directors including independent director to three months or the next general meeting whichever is earlier or a less period. This was inculcated for quick approval of shareholders and balancing the rights and interest of the minority shareholders.

Role of Independent Directors in Nomination and Remuneration Committee- Earlier SEBI (LODR) Regulations, stated mandatory establishment of Nomination and Recruitment

²³ Pandey, A., 2020. Tata Sons and the Mystery of Mistry. *Vikalpa: The Journal for Decision Makers*, 45(3), pp.183-185.

committee in listed companies, with composition of minimum three directors, where all these directors should be non-executive director and at least $\frac{1}{2}$ of those directors should be Independent Directors. the recent modification made in the composition of Nomination and Remuneration Committee is that the $\frac{2}{3}^{\text{rd}}$ of the members of the committee shall be Independent Directors of the company. this would enhance the role of independent directors in the process of appointments and remunerations of directors of the board²⁴. The committee also has to critically evaluate the candidate and his skills, and their optimal use in the progress of the company and balancing the composition of directors in the board.

Resignation of Independent Directors- Earlier SEBI (LODR) Regulations stated the directions for an Independent Director to resign shall disclose his resignation to the stock exchange market, his reasons of resignation and confirmation regarding no material reason for resignation from the company as Independent Director. Now the SEBI has modified the resignation process of an independent director where he has to further mention his past and present membership to various board of directors, and also introduced modified cooling period provision where if the independent director wants to rejoin the company or its holding, associate and subsidiary company as a whole-time or executive director membership to the board.

Cooling-Off period for Independent Directors- Earlier, the existing provision under SEBI (LODR) Regulations, specified a period of 3 years for person who is a former employee, played a key managerial personnel role, or his relative has been positioned at such post in the company or its holding, associate and subsidiary company. The cooling period was 2 years when there was a material pecuniary relationship²⁵. The recent amendments made where 3 years is the cooling period for appointment as an independent director, for the former employees, Key managerial personnel and their relatives. Whereas, cooling off is been waived off for the related personnel and relatives of the employees of a listed company or its holding, associate and subsidiary company.

Insurance of Directors and Officers- The SEBI (LODR) Regulations mandated the top 500

²⁴ *Recent amendments 2021- The role of Independent Directors*. [online] Available at: <<https://www.sconline.com/blog/post/2019/07/12/independent-directors-role-responsibilities-effectiveness/>> [Accessed 2 February 2022].

²⁵ Garg, P., 2021. *SEBI's recent amendments relating to Independent Directors: Should Nominee Directors be next?* [online] Bar and Bench - Indian Legal news. Available at: <<https://www.barandbench.com/columns/sebi-amendments-independent-directors-nominee-directors-be-next>> [Accessed 4 February 2022].

listed companies to evaluate the quantum and risk, and accordingly undertake the insurance of the independent directors under the supervision and directions from the board. In the recent amendment made SEBI had extended this provision for the independent directors of top 1000 listed companies.

Change in Composition of Audit Committee- The SEBI (LODR) Regulations provides provision for the establishment and composition of the Audit Committee, wherein $\frac{2}{3}$ rd of the members of the Audit Committee shall be Independent Directors and the listed companies shall obtain prior approval from the Audit Committee to have a related party transaction. The recent modification, keeping intact the existing provision has now further added that $\frac{1}{3}$ rd of the members of the committee appointed shall be Non-Executive Directors who are unrelated to the Promoters, Nominee Directors and any other Director. This has minimized the influence of the Promoter and the Management team over the Audit Committee.

Conclusion

It is explicit that the institution of Independent Directors has unceasingly enhanced the corporate governance standards. The amendments made with respect to Independent Directors strengthen their role and enlarge their significance in the corporate governance structure. The modified corporate governance structure has overhauled the one followed earlier. It is to be observed that how the companies adapt the amended corporate governance structure as majority of the companies in India Inc are promoter driven and thus, promoter hold the majority shares of the company. The Indian market consists of investors wherein they invest on the name, reputation and entrepreneurship skills of promoter, as done traditionally. They ignore the fundamentals of the company, but it is always recommended to have a look and perpetually supervise the financial statements and other fundamental books of the company to eschew any irregularities with the investment. The board shall abide the corporate governance regime and shall not follow any other alien process. The role of independent director is to strike the right balance between the different fractions of the company and to utilize the optimal maximization of the resource and achieve the targets of the company in coherence with the value of the company and the society. The recent amendment aligns with objective of strengthening the corporate governance regime in India. The board shall make sure that the independence of independent director is not limited to regulations and rules, but shall be visible as groundwork and in complete spirit. The corporate governance structure and the enhanced role of independent director shall make the companies more accountable, self-disciplined and responsible.

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