Part 2

Law of Corporate Governance in India

I Introduction

1. Importance of Corporate Governance

The concept of corporate governance has its origin to the *agency problems* in a company, i.e., the issues concerning with the relationship between corporate management and shareholders with an aim to put their relationship in proper perspective. These issues have extensive ramifications, with consequences for both the efficiency of companies and for the overall efficiencies and growth of economies. They have become increasingly significant because of the process of globalization-increasing international trade, competition, cross border capital flows and international finance. With the development of international financial markets, the issues of corporate governance have become less domestic and more global.

From the corporate perspective, a governance system is a framework of laws, regulatory institutions and reporting requirements that conditions the way the corporate sector is managed. The governance issue, therefore, is to ensure that management's interests are aligned with those of shareholders. This focus on shareholder is justified by recognizing that other suppliers of capital (both human and financial) have mechanisms through which they can protect their interests after having committed their capital.[1]

Furthermore, the modern corporations are large organizations requiring a huge capital investment. The large amounts of capital required could only be raised by pooling the savings of a multitude of investors, who must rely on a competent group of persons to manage their investments and run the companies. Thus, the set of legal rules, incentives, and behaviors that support and underlie that reliance by investors on Board of Directors constitute the system of corporate governance.[2]

A starting question may be that why a company would wish to rely on external finance at all. The answer is that it is cheaper to finance through the stock market. Stock market equity reduces the corporate cost of capital by opening up the potential supply of capital. A lower cost of capital for the company (or a nation's economy) increases profitability, economic growth, and international competitiveness. The shareholders are the bearers of the residual risk of the firm, enabling others to contract with it on more definite terms. As such, it leaves the shareholder potentially quite vulnerable to managers who may act incompetently or in their own interest.

If the position of shareholders cannot be well protected by contract, then how can it be made secure? There are two principal mechanisms through which it can be done. One is through legal principles of fiduciary relationship that require managers (agents) to act in the best interests of shareholders (principals). The other is corporate governance, i.e., a set of provisions that enable the shareholders by exercising voting power to compel those in operating control of the firm to respect their interests. The fiduciary rules can address conflicts of interest; the issues of managerial competence fall in the domain of corporate governance.[3]

The corporate governance, in fact, is an issue mainly for minority shareholders in companies that are controlled by the managers and where there are no significant shareholders, they can easily work together. In such a situation, the shareholders can still exert control through the board to protect their interests, but they may face formidable difficulties in acting together and actually doing so. Thus, in practical sense, corporate governance is important as a means of reducing the "agency costs" imposed by managers, acting in their own interests to the detriment of shareholders.

The phrase corporate governance is often applied narrowly to the issues related to the structure and functioning of board of directors or the rights and prerogatives of shareholders in boardroom decision-making. The much broader view of corporate governance refers to the whole set of legal, cultural, socials and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, what constraints and requirements are imposed on those who manage corporations, whose interests managers must serve, and what influence and recourse the various constituents have. Corporate governance thus extends for beyond the confines of corporate law. It also include boardroom practices, corporate finance, securities and bankruptcy law, laws governing the behavior of financial institutions, contract law, and labour relation practices. Corporate governance is sine-qua-non for vibrant growth of corporates today.

2. Different Systems of Corporate Governance

Governance systems differ across countries. Monitoring of managers and the monitoring entities vary largely on the ownership structure of the equity and corporations, the role of the banking system in the economy, business circumstances, the efficient functioning of the capital markets and the level of the product market and capital market competition, both domestic and international. The corporate governance system also incorporates the financial system since the latter has a role to play in conditioning behaviour of the corporate sector.

Any financial system has two primary goals: to channel resources to their most productive uses and to ensure that an adequate return flows to the financier. The latter is, of course, crucial to the former. Without a guarantee of an adequate return, funds will not be made available for investment. There are two basic corporate finance and governance systems. One is the Anglo-Saxon *arm's-length* or *market based* or *outsider controlled* system with widely dispersed shareholders and vigorous corporate control (or takeover) market. The other is Japanese and German *bank based* or *relation-based* or *insider controlled* system with large bank and inter-corporate holdings.[4]

The market-based system has reliance on capital markets and the market for corporate control along with the focus on shareholders as the prime stakeholders. Another distinguishing characteristic of this system is the presence of widely held companies. Banks play relatively minor role in governance functions. Alternatively, reliance on banking relationship, inter-corporate holdings and concentrated holdings of equity is the basis of relationship-based corporate governance system. Relationship-based system ensure a return to the financier by granting her some form of power (implicit or explicit ownership) over the firm being financed. In contrast with this, in the Anglo-Saxon system, the financier is protected by explicit contracts. In such a system, contracts and market become more important medium in determining the terms of transactions.[5] Another important distinction between these two systems is their different degree of reliance on legal enforcement. Relationship-based system can survive in environment where laws are poorly drafted or contracts not enforced- as relationship is largely self-governing and the parties intent on maintaining their reputations, honor the spirit of agreements in order to ensure a steady flow of future business within the same network of firms. By contrast, the prompt and unbiased enforcement of contracts by courts is a pre-condition for the viability of a market-based system. For this reason, the market-based system is found largely in countries with a common-law tradition, including India.

One more distinction between the two systems is the relative importance of transparency. Market-based system requires transparency as a guarantee of protection. By contrast, relationship-based system is designed to preserve opacity or secrecy, which has the effect of protecting relationships from the threat of competition. However, an important ingredient in both the corporate governance systems is monitoring of managerial activity by various elements of the system. Monitoring can be undertaken either by the board of directors, individual shareholders, concentrated holders of shares such as mutual funds and pension funds, bondholders, banks or workers. Monitoring is facilitated by the presence of information on the firm and this can be generated pursuant to loan agreements or general shareholder information. While 'hands-on' monitoring function is provided by board of directors or banks, monitoring is also reinforced at annual meetings through shareholder proposals and proxy voting. Financial institutions can play a crucial role in monitoring the companies.

Solutions to Corporate governance problem under Market-based System: Markets provide monitoring arrangements, incentives and disciplinary techniques to achieve strong managerial performance. On the incentive side, the principles on which management compensation is based are presented in the annual report along with the salaries, bonuses and contingent compensation of senior management. By using compensation tied to share price, for example, management is expected to make decisions that lead to higher share prices. Share price performance provides an indication of management success.

Board of directors is legally and practically charged with directing and managing the business of the corporation on behalf of the owners. Some aspects are delegated to management. In meeting its obligations, the board must be vigilant in overseeing management' actions with the ultimate goal of shareholder wealth maximization. Their general responsibilities, beyond management oversight, are to adopt corporate strategy, to appoint and monitor senior management, to communicate with shareholders and other stakeholders, and to ensure that internal control systems and management information systems are in place and function effectively. The access to up-to-date information is crucial for the board to do an effective job. In addition to the monitoring activities of shareholders and board of directors, markets provide a monitoring and, in some situations, a disciplinary function. The markets considered are of securities (capital market), corporate control, managers and the product market**.**

1. *Capital Market:* Transactions in equity are undertaken in the securities market. In deep and liquid markets, the share price is an estimate of the value of the equity of the company under incumbent management and the impact of any entrenchment devices the management has introduced. The capital market monitors the company in the sense that the security price provides a signal of management's success.

2. *Market for Corporate Control:* The market for corporate control is very important to solve the principal-agent problem. Poor performance leads to a low share price. A potential acquirer believing that it can improve the performance of the company either by removing management, altering operations or generating economies of scale will either make a friendly bid for the equity of the company or, if incumbent management is not inclined to the transaction, make a hostile bid. In some situations there is an auction in which there are a number of bidders. Securities regulation is designed to facilitate an auction. The bids are usually facilitated by the existence of one or more institutional investors who tender their shares to the bid and make it successful. Thus, the market for corporate control operates as a disciplinary mechanism for poorly performing managers or as a monitoring mechanism, whose existence leads incumbent management to decisions to maximize the wealth of company's shareholders. The market for corporate control works only in a widely held company or in which share blocks are held by institutional investors who have no interest in supporting incumbent management, unless they are providing competitive returns.

3. *Market for Managers:* The market for managers is an informal one but can be very effective in monitoring and disciplining managers. Management, in order to maintain its marketability, operates the firm to achieve strong returns. A poorly performing manager will have difficulty finding a new job. It provides the incentive for the managers to operate in the interests of the firm. Managers, unless entrenched and insulated from losing their positions, should be interested in their marketability, which is related to their managerial performance and reputation. As managers are generally professional, their reputations are crucial for future employment at other corporations.

4. *Product Market:* The final market is the product market. If a company operates poorly relative to its competitors, it will find itself in a financial distress and in the extreme, bankrupt. This will result in a restructuring of the operations and asset holdings and in some cases the replacement of management. Government policies concerning domestic and international competition in product markets are very important in the effective functioning of the product market.

Other Solutions: The market-based corporate governance system provides solution to principal-agent problem also by some other internal and external techniques. On the internal side, there are number of ways to improve managerial behaviour. The first is the use of compensation contracts related to the performance of the company. These contracts include stock options or similar contracts to pay-off to managers when the company's share price increases above some threshold value. These contracts are costly to shareholders but with an improved alignment of interests, the expected benefits exceed costs. However, board oversight and internal controls are essential to control excess in this direction. The second technique is monitoring by an effective board of directors. Measures to ensure an effective board include director's legal liability, the use of truly independent directors, and equity ownership by board members. The third method is monitoring by shareholders whose holdings are large enough to over come the free-rider problem. These shareholder groups need to have sufficient votes to pose a credible threat to management or have sufficient influence to lead other shareholders to question management's behaviour and agitate for change. Corporate managements are usually very distressed by activist shareholders.

However, the market-based system has some problems. For example, with the introduction of management entrenchment devices such as poison pills, altered board structures or increase in debt component in capital structures, all solutions to the principal-agent problem are blunted. However, this system provides flexibility and a number of approaches to address the issue.

3. Impact of Legal Traditions and the Rule of Law on Corporate Governance[6]

As evident, despite its universal importance and a considerable international exchange of ideas and institutions, corporate governance system differs, even among advanced market economies. The most important cause of international diversity among corporate governance systems is the existence of several distinctive legal traditions across countries. These traditions shape the specific rights and protections that investors enjoy in their interactions with the companies. In addition, the extent to which contracts are legally enforced- called the rule of law – also influences how effective corporate governance is in a particular country.

Different Legal Traditions:

The two most important broad legal traditions are *civil law* and *common law*. Other traditions - such as *Jewish law*, *Canon law*, *Hindu law* and *Muslim law* – are religious and quasi-legal and are not relevant for investor protection and corporate governance. The common-law tradition is found in the United States, Canada, United Kingdom, other English-speaking countries and countries whose modern development was heavily influenced by the English-speaking world. India follows the common-law tradition. In the common-law legal tradition, precedents from judicial decisions, rather than contributions of legal scholars, shape the law. The civil-law tradition is found in continental Europe and other countries that are heavily influenced by continental Europeans. The civil, or "Romano-Germanic", legal tradition is much older than the common law. Civil law uses statutes and comprehensive codes as the primary means of organizing its legal principles. It relies on legal scholars to interpret the code and draft new interpretations and rules than building on judicial precedents alone. The civil-law tradition can be further sub-divided into Scandinavian civil-law tradition, German civil-law tradition, and the French civil-law tradition.

Legal traditions matter for corporate governance and corporate performance because they are systematically related to patterns in the type of legal rights and protections available to creditors and other investors. These rights and protections, in turn, affect the types of financing available to the companies.

1. *Creditor Rights*: Creditor rights are more complex than shareholder rights in two respects. First, there are typically multiple classes of creditors including secured and unsecured creditors. Secondly, in case of financial distress, creditors must choose between two quite distinct strategies. They can either liquidate the company or, alternatively, attempt to reorganize and resuscitate it – means risking total loss in the future. Reorganization may be difficult and contentious, especially if incumbent management retains control rights while the reorganization proceeds.

2. *Shareholder Rights*: Company laws of a country largely determine the nature of shareholder rights. It may provide for six different types of shareholder rights and in addition other measures that affect dividend pay-outs and the conduct of annual meetings. If present, each of the following six shareholder rights provides an important investor guarantee:

1. One share-one vote;

2. Proxy voting by mail;

3. Shares are not blocked before a general meeting;

4. Cumulative voting or proportional representation (to allow minority interests to gain representation on the board);

5. An oppressed minority mechanism (allowing either judicial redress or a mandatory buy-out of shareholders who are opposed to fundamental changes in company bylaws);

6. Pre-emptive rights to purchase new equity issues.

In addition to these six, the law may provide for two other measures of shareholder rights:

1. Percentage of share capital needed to call an extra-ordinary shareholder meeting (a lower number signifies better shareholder right).

2. The percentage of net income that by law must be paid out as a dividend.

The common law countries provide the strongest legal protection of both creditor and shareholder rights. However, under this system, the effective corporate governance requires not just a strong legal framework of investor protections, but also a strong culture of rule of law.[7]

Rule of Law

Legal rights of shareholders and creditors to receive certain cash flows and to participate in various corporate decision-making activities, though necessary but are not sufficient conditions for effective corporate governance. A climate of respect for the rule of law is also needed. Thus, a core set of shareholder and creditor rights and an established tradition of legal enforcement of these rights are complementary features of an effective system of corporate governance. The following five enforcements variables define the rule of a law in a country, in addition to the quality of accounting standards:

1. The efficiency of the judicial system

2. An assessment of the law and order tradition

3. An index of government corruption

4. The risk of expropriation

5. The risk of reputation of a contract by the government

II. LEGAL REFORM OF CORPORATE GOVERNANCE IN INDIA

1. Corporate Governance: Problem in India

In India, the majority of companies, even the listed ones, are family controlled. The controlling shareholder is involved in management either directly or indirectly. The financial institutions, which hold shares for portfolio purposes, may provide a monitoring but not operational role, so they are not considered controlling shareholders. This concentrated ownership generates serious problems for minority shareholders and has a depressing effect on the economic growth. There are potential costs of minority shareholders in companies in which there is a controlling shareholder. The presence of a controlling position gives management an entrenched position. If decisions are made that do not benefit all shareholders and thus depress share price, the market for corporate control and the market for managers cannot operate to discipline poor managerial performance. If one goes by the principal-agent concept, the misalignment of interests of