

NOTES & COMMENTS

MARKET AND THE BOARDROOM – THE INDIAN EXPERIENCE

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The rules of the game of investment in the stock markets have more to it than what meets the eye. The real position and scope of powers enjoyed by a shareholder vis-à-vis the management of the company is nowhere strictly defined. However the developed markets have incorporated rules governing the relationship between a shareholder and the management of the company. Thus, a huge gap seems to exist between the required results that have been obtained by incorporation of such rules in Indian scenario and the one envisaged by the framers.

In the Anglo Saxon system, the management has only one objective, namely to act in the financial interests of the shareholders. The management comprises of individual directors and the shareholders are not a part of the decision making process of the company.

In India, the problem of corporate governance though is much different from its European and American counterparts. There seems to be an inherent problem regarding the conflict of interests between the dominant and minority shareholder. This is coupled with the different corporate structures that characterize the Indian market. The role of institutional investor and financial institutions in ensuring a balance between the powers of the dominant and the minority shareholder seem to be negligible. Even the statutory provisions leave enough space for manipulation, which are misused mainly by the family businesses.

This article aims at analyzing this problem faced by the Indian markets and provide a India Specific model so as not only to protect the interest of the minority shareholder but also ensure a better exercise of corporate governance by the companies.

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I. INTRODUCTION

As economies moved away from agrarian modes of production to industrial modes of production, the major actors in the economy became an organisation known as the Corporation. Professors Adolf Berle & Gardiner Means, in their seminal work on corporate governance and law, *The Modern Corporation and Private Property* outlined the fundamental problems plaguing the structure of corporate ownership.¹ In a modern corporation, wherein there exists separation of ownership and control², the shareholders of a corporation own it, but owing to cumbersome management procedures the responsibilities of the day to day management of the corporation are delegated to a board of directors. Though the board of directors are supposed to ensure wealth maximisation for the shareholders and act in the interest of the shareholders, this is not always the case. Boards often act only in self interest to maximise their personal wealth or for their job security. Examples of such conduct which resulted in corporate governance related failures such as in Enron, Worldcom & Parmalat. This is essentially the agency cost involving delegating responsibilities to the board as an agent of the shareholders.³ Therefore the shareholders to safeguard the interests of the company are supposed to act as checks on the Board. Therein lies the significance of the voting rights of the shareholders and other transparency measures envisaged by corporate governance systems.

Corporate governance systems play a central role in economic performance because they provide mechanisms affecting the returns on investment by suppliers of external finance to firms. Corporate governance systems differ significantly, even among economies. The debate surrounding the basic allocation of power between boards and shareholders in publicly traded companies thus resulting in low levels of governance has been put to hold on the very logic that the mechanism by which securities are priced “ensures that the price reflects the terms of governance and operation” offered by the firm.⁴ If those governance terms are unfavourable, investors will discount the price they are willing to pay for that firm’s securities. As a result, the firm’s cost of capital rises, leaving it, inters alia, more vulnerable to bankruptcy or hostile takeover. Corporate managers therefore have strong incentives to offer investors attractive governance arrangements, either via the corporation’s own organic documents or by incorporating in a state offering such arrangements off the rack.⁵

¹ See generally ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* (1932).

² *Id.* at 9. Berle & Means’ models are based on a modern corporation where there is separation of ownership & control.

³ *Id.*; See generally RONALD COASE, *NATURE OF THE FIRM* (1937)

⁴ See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law*, 30 J. ECON. LIT. 2169-2170 (1992)

⁵ Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251-292 (1977) (arguing that managers are more likely to charter in “states which offer the optimal yield to both shareholders and management”).

The nascent debate on corporate governance in India has tended to draw heavily on the large Anglo-American literature on the subject. However the corporate governance problems in India are more specific. Though the issues still lie in shareholder rights, while the governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the shareholders, the problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector or the family business) is that of disciplining the dominant shareholder or the promoters of a company and protecting the minority shareholders' interests.

The Anglo American Model of Governance, which is followed by the United States. A central and well-settled principle of U.S. corporate law is that the board must initiate all major corporate decisions. Shareholders may not initiate any such decisions. The only way in which shareholders can attempt to introduce a new corporate decision is by replacing incumbent directors with a new team that is expected to make such a change.⁶ Thus Professor Bebchuk opines that to ensure a greater accountability on the part of the company to the shareholders ensuring a higher level of corporate governance and thus a greater stability to the economy. But Economists Bengt Holmstrom and Steven Kaplan point out that "Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional."⁷ Likewise, Professors Richard Castanias and Constance Helfat have argued that even in the extreme case of corporate takeovers, the incentives for superior senior managers to act efficiently prevent the presumed conflict between shareholder and managerial interests.⁸ The principal-agent problem is nonexistent or even trivial, but only that it is not panglossian to conclude that managers' interests generally are aligned with those of shareholders. Accordingly, it is not panglossian to believe that managers have significant incentives to offer investors attractive corporate governance terms.⁹

The German and the Japanese models are much different to the Anglo American model of corporate governance. The German system of corporate governance is often thought to be effective at addressing problems arising in large firms. In addition to the usual emphasis on the role of German banks, it is increasingly recognized that the German system also involves a high concentration of the ownership of large firms. Although banks may influence corporate

⁶ Lucian Arye Bebchuk, *The Case For Increasing Shareholder Power*, 118 HARV. L. REV. 833-914 (2005)

⁷ Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, European Corporate Governance Inst. Finance Working Paper No. 23/2003, 2003) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441100 (last visited Sep. 4, 2007).

⁸ Richard P. Castanias & Constance E. Helfat, *Managerial and Windfall Rents in the Market for Corporate Control*, 18 J. ECON. BEHAVIOR & ORG. 153-184 (1992)

⁹ Stephen M. Bainbridge, *Director Primacy & Shareholder Disempowerment*, 119 HARV. L. REV. 1746-47 (2007)

governance via their control of proxy votes, positions on supervisory boards, and provision of loan finance, in practice they do not play a role in the governance of large German firms, which is distinct from that of other types of large shareholders.

In India, the primary regulatory body for the capital markets and hence for public companies listed on stock exchanges is the Securities Exchange Board of India. The Preamble of the Securities and Exchange Board of India Act describes the basic functions of the Securities and Exchange Board of India as “...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto”.¹⁰

As it is evident from the main objective behind setting up such a regulatory body in India was to strike a balance between the powers that lie with the investor and the company, but gradually the character has changed. Before analyzing the role of a regulatory body in a developing country like India, there is a need to understand the forces that operate in the emerging markets and the need of corporate governance in the same.

But it is to be noted that the problem existing in India is quite endemic. Here the problem does not lie so much with the power disparity between the board and the shareholder, since majority of companies in India are family owned and managed.¹¹ Therefore the problem lies between the conflict of interests amongst the dominant shareholder and the minority shareholder. The problem of the dominant shareholder arises in three large categories of Indian companies. First are the public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%). Second are the multi national companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder. Third are the Indian business groups where the promoters (together with their friends and relatives) are the dominant shareholders with large minority stakes, government owned financial institutions hold a comparable stake, and the balance is held by the general public. The governance problems posed by the dominant shareholders in these three categories of companies are slightly different.¹²

This article would aim at addressing the problem of weak corporate governance due to the existence of a greater power in the hands of the dominant shareholders and the possible solutions to the problems through the perspectives of institutional investors and the Takeover Code.

¹⁰ Securities & Exchange Board of India Act, 1992 - Preamble

¹¹ The Tata, Birla, Ambani, Bajaj families own and manage their enterprises which consist of some of the largest companies in India.

¹² Jayantha Verma, *Corporate Governance in India: Disciplining the Dominant Shareholder*, 9 J. THE INDIAN INSTITUTE OF MANAGEMENT, BANGALORE 5-18 (1997)

Part I of the paper would deal with the specificity of the problem of corporate governance exiting with regards to the private enterprises or family businesses. Part II would analyse the evolution of the takeover code in India and the development of a regulatory scheme *vis-a-vis* the promoter groups. Part III, would deal with the role of institutional investors both private and government owned to regulate the market behaviour and present a system of checks and balances towards ensuring a better corporate governance system. This article concludes by answering the question of whether the present model of corporate governance which is being followed by India is sufficient to meet the problems and the consequent solutions which can be applied by the regulators.

II. CORPORATE GOVERNANCE & THE FAMILY BUSINESS

In India most large corporate houses are owned and managed by old business families. Family businesses and corporate groups are common in many countries which range from *Keiretsus* in Japan and *Chaebols* in Korea. The widely discussed problem in contemporary corporate governance jurisprudence is that of accountability that management of the company owes towards its shareholders. Since a majority of the companies are family owned, and are the management of the company, the only conflict of interests that arises is between that of the controlling and the non-controlling shareholders. Firms in developing countries, especially in India, do not follow the widely dispersed ownership pattern found in US and UK.

In spite of their substantial variation in economic conditions and politico-legal backgrounds, most Asian countries are marked with concentrated stock ownership and a preponderance of family-controlled businesses while state-controlled enterprises form an important segment of the corporate sector in many of these countries. Corporate governance issues have been of critical importance in Asian countries particularly since the Asian crisis which is believed to have been partly caused by lack of transparency and poor corporate governance in East Asian countries.¹³ Research has established the evidence of pyramiding and family control of businesses in Asian countries, particularly East Asia, though this feature is prevalent in India as well. Even in 2002, the average shareholding of promoters in all Indian companies was as high as 48.1%.¹⁴

The Cadbury Commission¹⁵ envisaged a situation where there would be a major dispersal and concentration of shareholdings which would dramatically

¹³ See S. Claessens & J.P.H. Fan, *Corporate Governance in Asia: A Survey*, (UNIVERSITY OF AMSTERDAM WORKING PAPER, 2003)

¹⁴ Topalova, Petia, *Overview of the Indian Corporate Sector: 1989-2002*, (IMF WORKING PAPER No. 04/64 2004)

¹⁵ A committee chaired by Adrian Cadbury which produced the first Code of Best Practice on corporate governance, in 1992, available at, <http://www.finance-glossary.com/terms/Cadbury-Committee.htm?id=2177&ginPtrCode=00000&PopupMode=false>

alter the balance of power from family held companies, due to the need for financial capital to sustain pace at which businesses were deemed to grow. This intended dispersal has not been replicated in India, in fact the windfall of international financial capital since the liberalization of the economy has paradoxically consolidated family holdings in companies.¹⁶ Family controlled or owned businesses are attractive to many investors, their internal structures and their operations often create challenges in terms of Corporate governance.

Inter-locking and “pyramiding”¹⁷ of corporate control within these groups make it difficult for outsiders to track the business realities of individual companies in these behemoths. In addition, managerial control of these businesses are often in the hands of a small group of people, commonly a family, who either own the majority stake, or maintain control through the aid of other block holders like financial institutions. Their own interests, even when they are the majority shareholders, need not coincide with those of the other minority shareholders. This often leads to expropriation of minority shareholder value through actions like “tunneling” of corporate gains or funds to other corporate entities within the group.¹⁸

Poor development of external financial markets also contributes to these ownership patterns. The effect of this concentrated ownership by management in Asian countries is not straightforward. Similar to the effects for US companies¹⁹, in several East Asian countries, firm value rises with largest owner’s stake but declines as the excess of the largest owner’s management control over his equity stake increases.²⁰ In Taiwan, family run companies with lower control by the family perform better than those with higher control.²¹

¹⁶ E.g., by 2004 the aggregate share of ‘promoter’ holdings in the listed company sector stood at roughly 55%, substantially higher than pre-liberalisation levels.

¹⁷ A method of increasing a position size by using unrealized profits from successful trades to increase margin.

¹⁸ Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 *STAN. L. REV.* 863-906 (1991)

¹⁹ Managerial ownership of corporate equity, however, has interesting implications for firm value. As managerial ownership (as a percentage of total shares) keeps on rising, firm value is seen to increase for a while (till ownership reaches about 5% for Fortune 500 companies), then falling for a while (when the ownership is in the 5%-25% range, again for Fortune 500 companies) till it begins to rise again. The rationale for the decline in the intermediate range is that in that range, managers own enough to ensure that they keep their jobs come what may and can also find ways to make more money through uses of corporate funds that are sub-optimal for shareholders. See generally R. Morck, A. Shleifer, and R. Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, *J. FIN. ECON.* 20, 293-315 (1988).

²⁰ Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 *J. FIN.* 2741-2771(2002)

²¹ Y.H. Yeh, T.S. Lee & T. Woidtke, *Family Control and Corporate governance: Evidence from Taiwan*, 2 *INT’L REV. FIN.* 21-48(2001)

Recent research has also investigated the nature and extent of “tunneling”²² of funds within business groups in India.²³ During the 90’s Indian business groups evidently tunneled considerable amount of funds up the ownership pyramid thereby depriving the minority shareholders of companies at lower levels of the pyramid of their rightful gains. Empirical analyses of the effects of ownership by other (non-family) groups in Asia are relatively scarce. The state is an important party in some countries in Asia, notably India and China. The corporate governance mechanism and efficiency in state controlled companies are generally deemed to inferior. Several studies show that accounting performance is lower for state-owned enterprises in China. The non-linear effects of entrenchment are also present with state ownership.²⁴

Institutional investors fulfill an important certification role in emerging markets, but there is little evidence of their effectiveness in corporate governance in India and similarly placed emerging markets like Brazil and China. Equity ownership by institutional investors like mutual funds has limited impact of performance in India.²⁵ Ownership by other groups like directors, foreigners and lending institutions, on the other hand, appear to improve performance. In post-liberalization India, foreign ownership helps performance only if the foreigners constitute the majority shareholders.²⁶

III. USING TAKEOVER TO CONTROL MANAGEMENT-THE STATUTORY CONTROL

In the Anglo Saxon corporate structure, the inability of the Board of Directors in micro-monitoring the activities of management is sometimes compensated by the financial markets, as real monitoring is expected to come from them. The underlying premise is that shareholders dissatisfied with a particular management would simply dispose of their shares in the company. As this would drive down the share price, the company would become a takeover target. This premise runs on the assumption that if and when the acquisition actually happens, the acquiring company would change the existing management.

²² An illegal business practice in which a majority shareholder or high-level company insider directs company assets or future business to themselves for personal gain. Actions such as excessive executive compensation, dilutive share measures, asset sales and personal loan guarantees can all be considered tunneling. The common thread is the loss to the minority shareholders, whose ownership is lessened or otherwise devalued through inappropriate actions that harm the overall value of the business.

²³ M. Bertrand, P. Mehta & S. Mullainathan, *Ferretting out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121-148 (2002)

²⁴ G.L.H. Tian, *State Shareholding and the Value of Chinese Firms*, (LONDON BUSINESS SCHOOL WORKING PAPER, 2001)

²⁵ J. Sarkarand & S. Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*, 1 INT’L REV. FIN. 161-194(2000)

²⁶ P.K.Chhibber & S.K. Majumdar, *Foreign Ownership and Profitability: Property Rights, Control, and the Performance of Firms in Indian Industry*, 42 J. L. ECON. 209-238 (1999)

Thus it is the fear of a takeover rather than shareholder action that is supposed to keep the management honest and on its toes. This mechanism, however, presupposes the existence of a deep and liquid stock market with considerable informational efficiency as well as a legal and financial system conducive to M&A activity. More often than not, these features do not exist in developing countries like India. In all markets outside the US and UK, takeover regulations emerged as part of the pressure exerted by foreign institutional investors for convergence on global standards of accounting and corporate governance. Convergence of corporate governance standards was an essential part of the agenda chalked out by finance capital for the less well integrated capital markets of Continental Europe and Asia.²⁷ If ‘convergence’ or the globalisation of the capital markets really were to culminate in a globally integrated market for corporate control, its undermining of the dense networks of family and large block-holder capitalism would not just replace one set of capitalists with another but dismantle the whole culture of clandestinely that surrounds the operation of business in most markets in the world today.²⁸

As mentioned above corporate governance essentially deals with effective safeguarding of the investors’ and creditors’ rights. Various areas of management that is contrary to the interests of the shareholders, are excessive executive compensation, transfer pricing (that is transacting with privately owned companies at other than-market rates to siphon of funds), managements resistance of replacement by superior management and sub optimal use of free cash flows. Ensuring that a professional management team does a competent job with the shareholders money is one of the most important aspects of ensuring good corporate governance.

There is a great deal of clandestinely about the true extent of promoter holdings in Indian companies, despite the rapid extension of the depositories. This is because lack of transparency is a prevalent part of the way control is structured to “ensure control over the largest possible amount of outside capital with the smallest possible amount of one’s own capital”.²⁹ In India investment companies and trusts have been a crucial part of this “structuring” of control and have never been subject to proper regulation. To avoid this kind of opacity, SEBI has been debating the issue of a more reliable format for disclosure of promoter shareholdings. Among other things, the new format replaces the term “promoter holdings” with “holdings of the controlling group”.

This will, at one stroke, bring into the open the total stake that is, in effect, under the control of the promoter group, and will impact promoters who control companies through nominal shareholdings in their own name but significant

²⁷ William Underhill & Andreas Austmann, *Defence tactics*, in TAKEOVERS IN ENGLISH AND GERMAN LAW (Jennifer Payne ed., 2002)

²⁸ See generally FABRIZIO BARCA AND MARCO BECHT, *THE CONTROL OF CORPORATE EUROPE* (2001)

²⁹ Johnson, S., P. Boone, A. Breach & E. Friedman *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141-186 (2000)

stakes through trusts and other legal entities. Indeed, the essential purpose of the investment companies is to “mask the way a company is controlled by a promoter”.³⁰

The existing Takeover Code of 1994³¹ was considered to be inadequate to deal with the complexity of Indian corporate structure. Hence, a committee chaired by Justice P.N. Bhagwati was appointed in November 1995 to review the Takeover Code. The committee’s report of 1996 formed the basis of a revised Takeover Code adopted by SEBI in February 1997.³² However, it was observed that the code did not serve the interests of the minority shareholders. The code in effect helped boost the promoters chances of increasing stock holdings, in fact the ex Chief Justice, Bhagwati stated that Indian companies do not have adequate defence mechanisms to cope with hostile takeover bids, especially when these are made by overseas players³³ and hence the interest of the promoters should be upheld. He pointed out that in the absence of a facility for buyback of equity, Indian companies will not be in a position to thwart hostile takeovers.³⁴ Bhagwati argued that in India entrepreneurs have built up their industries over a period of time but still hold a small stake, and thus ‘they should be given an opportunity to consolidate their holdings’.³⁵ Justice Bhagwati, had taken it upon himself to state publicly³⁶, on repeated occasions, that the code was in fact designed to shore up existing businesses against the threat of hostile takeovers.

If the main objective of using take over as a tool to keep the management in check has to work in India, it has to essentially take into account the rights of the minority shareholders, hence it is imperative that the takeover regulations should prevent majority holders to get more control through takeover.

Current regulations, by making disclosures of substantial acquisitions mandatory, have sought to ensure that the equity of a firm does not covertly change hands between the acquirer and the promoters. Moreover, the right of the existing management to withhold transfer of shares under Section 22A of the Securities Contract (Regulation) Act, 1956, dealing with free transferability and registration of listed securities of companies has been withdrawn in the recently introduced Depository Regulations Act, 1996. However, under Sections 250 and 409 of the Companies Act, target companies can shelter against raiders if the proposed transfer prejudicially affects the interests of the company. The main

³⁰ Pandya & Rajawat, *Lifting The Veil On The World Of Investment Companies*, ECONOMIC TIMES, Dec. 11, 2004.

³¹ Securities & Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1994.

³² Securities & Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

³³ ECONOMIC TIMES, Jan. 8, 1997.

³⁴ *Id.*

³⁵ ECONOMIC TIMES, Aug. 29, 1998.

³⁶ *See, e.g.* ECONOMIC TIMES, January 1, 1997 (Justice Bhagwati cited with reference to the note of dissent by the merchant banker Nimesh Kampani)

objective of the regulations governing takeovers is to provide greater transparency in the acquisition of shares and the takeover of ownership and control of companies through a system based on disclosure of information.

It is also of importance that there should be no absence of correct information on the arrangements of the promoters for the management control, because otherwise the market for corporate control cannot function in an efficient and transparent manner. Currently, considerable debate has been going on in this area after some corporate raiders became active. One of the important points being debated is, whether the promoter groups should also be allowed to have a level playing field with the raiders by stepping up the creeping acquisition limit to 15%.

The debate is negated, without the presence of information about promoters of companies listed on the stock markets. Even if the promoters under attack from acquirers, resort to other ways of strengthening their shareholdings, it is very difficult to know whether they had been abiding by the existing guidelines. As the promoters get to know whenever anyone acquires more than 5 % of the shares, even the shareholders have a right to know about all the dealings of the promoters in the shares of the company.

Instead of discovering that the management of the company one owns has covertly changed hands, resulting in huge gains for the promoter, a shareholder could now expect to be informed each time, and at what price a firm's equity changed hands. Moreover, if the shareholder had less faith in the new owners, he could sell the shares without incurring a loss, since SEBI regulations stipulate that a buyer must make a public offer to buy shares at the same price at which the acquisition is made. The current regulations on takeovers in India seem to have taken a liberal view towards takeovers. TOs are thought to play an important role in building corporate synergy, in raising shareholder value and in keeping companies on their toes.

A number of reports on corporate governance, claim that TOs are internationally experienced to aid the growth of industry and business by serving three purposes³⁷ - creating economies of scale and scope, imposing a credible threat on management to perform for the shareholders and enhancing shareholder value in a short and medium term. It has therefore advocated for relaxation of restrictions on the financing of acquisitions.³⁸ The Report of the Working Group

³⁷ A number of reports and codes on the subject of CG have already been published internationally – notable among them are the Report of the Cadbury Committee, the Report of the Greenbury Committee, the Combined Code of the London Stock Exchange, the OECD Code on Corporate Governance and the Blue Riband Committee on Corporate Governance in the US.

³⁸ Accordingly the Confederation of Indian Industries (CII) recommended that the government must allow greater funding (till April 1997, banks had imposed a credit limit of Rs. 10 lakhs against share collateral) to the corporate sector against the security of shares and other papers: see CII, *Desirable Corporate Governance in India – A Code* (1997), http://www.ciionline.org/_vti_bin/shtml.dll/busserv/corporate/cgform.htm (last visited Sep. 4, 2007).

on the Companies Act³⁹ argues that a key feature of corporate democracy is that all shareholders, who own a given class of equity, must be treated alike. Moreover, as a part of corporate democracy, any shareholder has full freedom to sell, purchase, transfer and acquire shares and that enhancing shareholder value through consolidation and growth of companies would bring out the latent dynamism of Indian firms⁴⁰

Without full buy-out provisions, the residual shareholders face one of two options, both of which are inimical to this aspect of shareholder democracy. First, they may hold out for a higher offer, which is palpably unfair vis-a-vis the other shareholders who sold their stake. Or, second (and more likely if the company gets de-listed), these shareholders may get squeezed out by the buyer to accept a lower price, which is unfair to them. Therefore, in the interest of shareholders and companies, the Group recommends that in the event of any person, group or body corporate acquiring 95% of the shares of a public listed company - either through a TO or otherwise and the company getting de-listed, residual shareholders should sell their shares to the 95 owner at a price based upon the SEBI guidelines⁴¹

The Indian family-controlled business houses have been under pressure to clean up their balance sheets and rationalize their businesses, including the crossholdings⁴² that have traditionally acted as their takeover defence, and there has been a great deal of restructuring in the past decade. However the sheer capability of the system to survive through a period that has seen a substantial increase in levels of competition is due less to any intrinsic strengths or capabilities it may have than to the role played by regulation in structuring the rules of competition.

Regulation itself has proved to be a means of accelerating the rationalisation of family capital. for example, the term “promoter” has now been expanded to include all persons or entities in control of a firm, directly or indirectly, including spouses, parents, brothers, sisters, children, etc. Thus entities that come under the new definition of promoters can avail themselves of the benefit of *not having to make an open offer when making inter-se transfers of shares*.⁴³ This is

³⁹ Report of the Working Group on Companies Act (The Working Group on Companies Act was constituted in August 1996 at the behest of Mr. P. Chidambaram, the then Union Finance Minister, to rewrite the Companies Act and present it for public debate by early 1997).

⁴⁰ Report of Working Group on Companies Act, 1956 (1977) at 2, 11.

⁴¹ *Supra* note at 9.

⁴² For example, of the 46.67% generally said to be owned by the Ambanis in Reliance Industries, the country's largest private sector enterprise, over 34% was controlled through at least 14 investment companies and another 7.5% through the Petroleum Trust. It had to be specially clarified that this 7.5% stake was not part of the promoters' holding, as stated (by the company, presumably) on the BSE website www.bseinida.com.

⁴³ See BUSINESS STANDARD, Jan. 25, 2005.

a good example of the nuances of regulative practice and the way they can be used to speed up consolidation within family businesses, that is, actively shape the nature of business.

Such blatant favouritism towards the promoters is a sad reflection on the way regulatory proceedings are conducted in India. Far from legitimising the contestability of control, India's takeover regulation has been the single most important enabling factor in the consolidation of promoter stakes against any possible takeover threat. Hence it is amply clear that takeover as a tool for ensuring corporate governance is not suited to the Indian experience.

IV. INSTITUTIONAL INVESTORS –THE REGULATOR AND DIRECTOR

Despite the option of takeover in absence of good corporate governance, it is always beneficial for the company to have an effective internal control system for efficient corporate governance. Like in Japan and Germany, in India also Financial Institutions have a strategic role to play in the internal control of Indian firms. They in most cases are both large stakeholders as well as creditors of the companies. However it has been observed over a period of time that the Financial Institutions (hereinafter FIs) nominees in board meetings have a very passive participation. Notwithstanding the general perception of passivity of institutional shareholders that has proved to be detrimental to minority shareholders, there is an emerging trend of a more proactive policy stance on the part of the FIs on corporate governance issues.⁴⁴ Certain stands have been taken by the FIs in recent years that indicate towards more proactive governance on their part ⁴⁵

Under the most pervasive 20th century visions of the shareholder, a monitoring role for shareholders would be paradoxical, if not absurd. Features of the corporate landscape regarded as inevitably fostering passivity were widely dispersed shareholdings, (resulting in collective action difficulties)⁴⁶, free-rider problems⁴⁷, centralized and strategically superior managerial power, the availability

⁴⁴ Attention to the passivity problem of the Indian FIs have been drawn by several committees, including the Bhagwati Committee on TOs, the Kumar Mangalam Committee of CG, both sponsored by the SEBI and also by the CII Committee on CG. Moreover, the Working Group, has, in 1997 recommended some change in the Companies Act, 1956, in favour of executive incentive and compensation. This, if effective, could have the prospect of signaling the beginning of a new era in Indian CG.

⁴⁵ *Supra* note 25 at 165. *See generally infra* note 50.

⁴⁶ According to collective action theory, individual shareholders only initiate or oppose management where the ultimate benefits outweigh the costs of action. Since the ultimate benefits will be shared pro rata with other shareholders (enabling these to free-ride), the precondition of benefits outweighing costs is rarely satisfied. *See generally*, Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-63 (1991)

⁴⁷ *See* B.S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

of the Wall Street Walk⁴⁸, and the superior efficiency of the market for corporate control as a disciplinary mechanism.⁴⁹ In the past, institutional investors were regarded as, if anything, more apathetic than widely dispersed natural shareholders, and treated as “short-term profligates”.⁵⁰

The dominant assumptions about the role and conduct of shareholders have, however, been seriously questioned in the last decade.⁵¹ Institutional investors are taking greater interest in voting today. Certain U.S. institutional investors are now required to cast their proxy votes on domestic shares and many are following suit as a matter of course on their international equity holdings.⁵²

FIs have been asked by the Finance Ministry to take ‘full responsibility for Corporate Governance in companies where they have substantial stakes. The objective is to boost investor confidence and pep up the capital market.’⁵³ The government has issued a five-point directive to FIs directing them to make among other things adequate disclosures while implementing internationally accepted accounting standards, ensuring regular board meetings with proper recording and dissemination of proceedings and asking for a greater participation on part of the FIs.

FIs have implemented new norms for the appointment of nominee directors, which have drastically cut down the total number of such directors on company boards. According to the new criteria for nomination, FIs are required to place their nominees only in companies where their combined exposure is above Rs. 50 crore or their shareholding is above 26% or in the event of companies showing signs of problems such as default on loans. They are also setting up of audit subcommittees comprising ‘adequate’ number of non-executive independent directors of the company board in each and every large and medium firm with a

⁴⁸ If a large shareholder is aware that a firm’s management does not act in the best interest of shareholders, it may be rational for the shareholder to follow the so-called “Wall Street Rule” or “Wall Street Walk,” which leads the shareholder to sell his shares (i.e., “vote with his feet”) rather than attempt to be active.

⁴⁹ *Id.*

⁵⁰ *Supra* note 18 at 900.

⁵¹ See e.g., B.S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (challenging the inevitability of the received vision of shareholders).

⁵² See generally, Stapledon, *Should Institutional Shareholders Be Required to Exercise their Voting Rights?*, 17 COMPANY AND SECURITIES L.J. 332 (1999).

⁵³ N. Balasubramaniam, *Towards Excellence in Board Performance*, IIMB MGMT. REV., Jan.-Mar. 1997, at 67-84

view to bringing in substantial financial discipline on the part of the management and checking against executive malpractice. This is expected to strengthen internal control structures and safeguard shareholder interests⁵⁴.

The participation of the FIs in the governance of corporations is gradually increasing in India with liberalization, for example the Unit Trust of India had asked leading companies, in which it has a sizable stake, to make presentations outlining their plans and expected performance after the declaration of their half yearly results. This exercise in corporate governance was performed to give confidence to unit holders.⁵⁵ The government FIs, which are both shareholders and lenders, seem to be realizing their responsibility of earning higher rates of return on their investments and this has started to be the criterion for them to intervene or not to intervene in board-room decisions. ICICI is reported to be the first FI to enforce its own brand of Corporate Governance through its nominee directors who are on the boards of various companies⁵⁶

Among the directors, in principle, the institutional nominees appointed by the FIs, not only have the fiduciary responsibility to the institution they belong but also are morally responsible to the ordinary shareholders who often look up to these institutions to protect their interests. In 1996, ICICI had asked all the directors nominated by it to file status reports on the happenings at various board meetings. It may be taken as a signal to the corporate sector that the FIs through monitoring the performance of nominee directors are becoming active rather than hitherto passive shareholders in companies.

V. CONCLUSION: THE SOLUTION

The way to solve the problem of corporate governance in India, would be to create a more flexible capital market. The past few years have witnessed a silent revolution in Indian corporate governance where managements have woken up to the power of minority shareholders. In response to this power, the more progressive companies are voluntarily accepting tougher accounting standards and more stringent disclosure norms than are mandated by law and have adopted greater levels of governance.

⁵⁴ For example FIs have successfully opposed a move by the ACC to make preferential issue to the Tata group that will enhance the latter's stake, citing as justification the need to protect the rights of minority shareholders of ACC.

⁵⁵ Several big companies like Reliance have made presentations to the UTI, Life Insurance Corporation of India (LIC) and the General Insurance Corporation (GIC). See Nandita Dasgupta, *Mergers and Takeovers in India in the Post Liberalization Regime – Proposals and Policies*, <http://www.uticm.com/cmcpdfs/2000/nandita-dasgupta.pdf> (last visited Sep. 4, 2007)

⁵⁶ *Id.*

Thus it can be safely concluded that Indian problem of corporate governance can be easily be solved by following an amalgamation of the Anglo-American model and a regulator based model. The regulator has to enhance the disclosure of information which is predicament for the minority shareholders and market to act against errant management. Reforms in bankruptcy laws and more stringent measures that promote an efficient market for corporate control would create an effective threat to some classes of dominant shareholders have to be taken up by SEBI, this would be a better utilization of the Takeover Code to promote corporate governance rather than acting as a tool in the hands of the family businesses.

A viable option at this juncture, where Indian market still is showing signs of volatility, would be to concentrate on the greater role of the institutional investor. It is suggested that the this change has to be brought through a greater investment on the part of the Venture Capital Funds (VCF) or other Private Equity Investors. The Investor would in substance perform the same model as suggested by us for the FIs above. Once the Investor holds a minimum of 26% equity shares in the company, it would be in a position to act as a check on the management, as the per some of the general terms in Shareholders Agreements concluded between the Venture Capital or other Private Equity Investors, there are significant restrictions placed on the powers of the Board. This is the VCFs would have the incentive to greater transparency within the board, as it would otherwise result in fall of share prices, which would hamper their own financial interests.

The regulator's role on the other hand would be to ensure the credibility of the independent non-executive director. It has been observed that these non executive directors are essentially close acquaintances of the family business and thus not serving the designated purpose. We recommend appointment of a non-partisan non executive director whose sole purpose would be to oversee compliance with the SEBI Code of Corporate Governance.

The traditional option of taking over a company, due to bad corporate governance has always remained an option, but as shown in this paper it has either not been used effectively or been used to the detriment of the minority shareholders. Thus, it can be safely concluded that India today needs a more active action by the Institutional investors and that has to be coupled with stringent measures on the part of the SEBI in order to promote a better transparency in the market.