CORPORATE ECOLOGY: BEYOND CORPORATE GOVERNANCE DEVELOPMENTS IN INDIAN CORPORATE LAW

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Corporate governance has emerged as a significant component of the regulation of the securities market in particular and the company in general and indeed a significant tool to ensure legal compliance. The last year has seen significant developments with respect to corporate governance in the listing agreements that publicly traded companies have with the stock exchanges (Listing Agreement Amendments). These Listing Agreement Amendments were made pursuant to the *diktat* of the Securities and Exchange Board of India (SEBI), which in turn was implementing the recommendations of the Kumaramangalam Birla Committee (Birla Committee) appointed by SEBI.

As issues of corporate governance have been discussed in some form or the other from the days of the charter companies (the precursor of the modern company) the term itself has come to mean different things. Narrow conceptions restrict corporate governance to the structure and functioning of the board of directors and the rights and responsibilities of the directors of a company vis-à-vis the shareholders. These conceptions are often challenged by those who view the company as more than the shareholders and management – this wider conception refers to the various internal arrangements that exist, questions of control, and the allocation of risk and returns. Given that the title of this publication sees a link between corporate governance and legal compliance, it would perhaps be more appropriate to provide a flavour of the wider conception of corporate governance.

THE BASIC PREMISE

Any analysis of corporate governance, particularly within the Indian context, requires an understanding of the nature of the company. Indian law has traditionally subscribed to the multi-stakeholder conception of the company. The Indian Companies Act, 1956, (the Companies Act)[1] has detailed provisions where governmental and quasi-judicial bodies can ensure that management of companies and indeed shareholders take into consideration the interests of the various stakeholders in the Company. The Supreme Court of India while granting approval to a proposed merger has held that the term “company” given the statutory framework would take into its fold not just the shareholders and employees, but the public interest as well.[2]

[1] The Government of India has introduced a Companies Amendment Bill, 1999 (Amendment Act) incorporating certain corporate governance requirements. The Amendment Act has not yet been passed by the Indian Parliament.

[2] **Hindustan Lever Employees Union** v. **Hindustan Lever Limited**, (1994) 4 Comp LJ 267 (SC).

The multi-stakeholder conception has been under increasing attack over the last few years[3] with different stakeholders seeking to protect their interests. The attack is based on a view
that the shareholders being owners of the company are the primary stakeholders of the company. In the Cadbury Report,[4] the stakeholders of the company are primarily understood to be the shareholders of the company. Prior to the recommendations of the Birla Committee, the Confederation of Indian Industry formulated a Corporate Governance Code, which viewed shareholder interests as being paramount. Corporate governance therefore is seen as being essential in the enhancement of shareholder value.

However, the Birla Committee Report acknowledged the multi-stakeholder conception of the company. The Committee was of the view that the fundamental objective of corporate governance is the enhancement of long term shareholder value while simultaneously protecting the interests of the other stakeholders viz. suppliers, customers, creditors, bankers, employees, the government and the society at large.[5]

THE CHALLENGE OF CORPORATE GOVERNANCE

The Indian legal system has responded to the challenges (identical to those faced in the developed markets of the world) of corporate governance through a variety of statutory and regulatory responses. These challenges arising out of – separation of ownership and control resulting in the vulnerability of small investors who do not have control over the company; the need for developing a sense of management responsibility in corporate decision making vis-à-vis the stakeholders of the company; the need to ensure that stakeholders do not have to face the consequences of corporate failure; and the risks created by the twin concepts of company law i.e. separate legal identity and limited liability of the members of the company, when seen in the context of inadequate funding and poor quality management – are sought to be addressed through a variety of means.

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[3] It may be noted that the multi-stakeholder conception of the company has directly or indirectly been questioned by at least two committees looking into legal reform in India. Firstly, the Birla Committee itself recommended that financial institutions not be permitted to appoint nominee directors - due to a "conflict of interest" concern. Financial institutions hold significant percentage of shareholding in a number of companies they have lent to. Secondly, the Report of the Competition Policy and Law Committee recommended the abolition of the Sick Industrial Companies (Special Provisions) Act, 1985 and the introduction of an effective policy to facilitate exit of employees in the case of sick companies.

[4] **Financial Aspects of Corporate Governance**, (The Cadbury Report), December 1992, London.

[5] The Birla Committee was of the view that shareholder needs to be the fundamental objective of corporate governance since SEBI has a statutory mandate to protect the interests of the investors. What the Committee's response would be if SEBI had a wider mandate is a speculative matter. Indeed, the recognition of shareholder interests as being the fundamental objective (even while taking into consideration the interests of the other stakeholders) would not be acceptable to many proponents of the multi-stakeholder conception on grounds that it does not acknowledge the true balance between stakeholder interests.

- Emphasis on Disclosure Requirements
- Improving the Quality of the Board of Directors (for example the appointment of non-executive directors and independent directors)
- Responsibility of the Board of Directors
- Self Regulation through an Audit Committee of the Board of Directors
- Self Regulation through a Remuneration Committee of the Board of Directors
- Restrictions on Market Control Mechanisms

It would be appropriate to note that the Listing Agreement Amendments need to be implemented by all publicly traded companies not later than March 31, 2001. Some of the changes however require amendments to existing law – and have therefore been classified as non-mandatory.[6]

A. Emphasis on Disclosure Requirements

Disclosure requirements for companies listing on stock exchanges received a fillip only with the Disclosure and Investor Protection Guidelines, 2000, which is a detailed and comprehensive supplement to the provisions of the Companies Act. Mis-statements in an offer document could have civil[7] as well as criminal consequences.[8]

Continuous and ongoing disclosure by publicly traded companies is mandatory through two mechanisms:

- The publication of the Annual Report, the contents of which are determined by the Companies Act and Rules thereunder prescribed by the Central Government. The Annual Report, *inter alia,* contains a detailed report by the board of directors of the company, a detailed report by the statutory auditors of the company, the balance sheet and profit and loss account of the company, and finally particulars with respect to employees earning above a certain amount[9]. Similar information needs to be included for the subsidiaries of the company.[10] Companies are specifically required to disclose the steps taken with respect to conservation of energy, technology absorption and foreign exchange earnings and outgo.[11]

- As a requirement of the listing agreements with the stock exchanges.

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[6] For example, the Birla Committee has recommended the introduction of a postal ballot for shareholders to vote on certain key issues, which affect the company. The Committee has also recommended that accounts of group companies be consolidated. Both these recommendations require statutory amendments.

[7] Section 62 of the Companies Act.

[8] Section 63 of the Companies Act.

[9] See, The Companies (Particulars of Employees) Rules, 1975.

[10] Under Section 4 of the Companies Act, a holding – subsidiary relationship is created through either majority shareholding or majority board control. Given the stress on form rather that issues of factual control and the possibility of complex holding structures, this provision is relatively easy to overcome.

[11] See, The Companies (Disclosure of Particulars in the Report of the Board of Directors) Rules, 1988.

Listing Agreement Amendments now require publicly traded companies to include the following in their Annual Reports, which were not required earlier:

- A detailed Report on Corporate Governance (Report on Corporate Governance).[12]
- This Report also needs to contain a detailed compliance report on the mandatory requirements of the Listing Agreement Amendments.
- A certificate from the statutory auditors of the company regarding the same.
- A Management[13] and Discussion Analysis Report to be included along with the director's report referred to above.[14]

B. Improving the Quality of the Board of Directors

Under the Companies Act, the directors of a company are normally appointed by a majority of shareholders at a general meeting of the company.[15] The maximum number of directorships that an individual can accept is twenty.[16] While the Act itself does not stipulate any significant requirements[17], the listing agreements now require that publicly traded companies comply with the following:

- Not less than fifty percent of the directors of the company should be non-executive director.[18]
- In the case of a company with an executive chairperson, the number of "independent directors"[19] should be half; else the number of "independent directors" can be one-third.

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[12] The Report needs to contain details on the board of directors of the company, the audit committee, the remuneration committee, the shareholders committee, general meetings, means of communication and general information for shareholders.

[13] "Management" is defined by the Listing Agreement Amendments as including the chief executive of the company, the executive directors and the key managers of the company.

[14] This Report needs to include details on industry structure and developments, risks and concerns, segment wise and product wise performance, internal control systems and their adequacy etc.

[15] Section 263 of the Companies Act. It may be noted that there are limited circumstances when directors can be appointed by the board itself, the central government, or even the courts.

[16] Section 275 of the Companies Act. The Amendment Act seeks to bring down the number to fifteen.

[17] It may be noted that Section 274 of the Companies Act contains some general disqualifications like a persons of unsound mind, an undischarged insolvent etc.

[18] "Non-executive directors" would refer to directors who are not in the employment of the company.

- There is a detailed list containing the information that the board of directors should be supplied with. This list includes annual operating plans and budgets, capital budgets, quarterly results, significant impending litigation, fatal or serious accidents, dangerous occurrences, material effluents or pollution problems, material defaults in financial obligations to and from the company, product liability claims, significant labour problems, intellectual property issues, details of mergers and acquisitions, joint ventures and certain investments.

- In addition, an issue of non-compliance of any regulatory or statutory nature needs to be brought to the notice of the board of directors. This requirement has interesting implications. A number of statutes in India cast criminal responsibility on the directors and management for acts of the company. Directors and management can defend themselves if they can establish that they had taken due care or did not have any knowledge. Since all issues of non-compliance would now be brought to the notice of the directors, the efficacy of this defence is substantially reduced – thereby casting a greater responsibility on directors.

- Directors are prohibited from becoming a member of more than ten committees or from acting as Chairperson of more than five committees across all companies in which they are directors.

In the hope that shareholders will exercise a greater control over the appointment of directors, the Listing Agreement Amendments now require companies to provide a bio-data of the directors offering themselves for appointment or re-appointment. The Listing Agreement Amendments have effectively ensured that there are independent non-executive directors on the board - which would help in achieving a better standard of self-regulation and transparency.

It may be noted that pursuant to the Listing Agreement Amendments, all the directors of some Indian companies have resigned to pave way for the appointment of new directors keeping in mind corporate governance requirements. This development augurs well for improving the professional standards of directors, particularly in the context of family controlled and run companies.

C. Responsibility of the Board of Directors

While the board of directors are empowered to exercise all the powers of the company and do all the acts and things that the company is authorised to do[20], the law seeks to ensure that board and management is accountable, inter alia, through the following mechanisms:

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[19] "Independent directors" refers to directors who apart from their remuneration have no material pecuniary relationship with the company, its promoters, its management, or its subsidiaries, which in the opinion of the Board may affect their independence of judgement.

[20] Section 291 of the Companies Act.

- Sensitive corporate transactions need shareholder approval.[21]
- Certain other important corporate decisions can be decided only at meetings of the board of directors.[22]
- Subject to limited exceptions, transactions with companies / firms in which a director or his relative is a member / partner require the consent of the board of directors.[23]
- In certain cases, loans to directors need the prior consent of the Central Government.[24]
- Directors who are interested in a transaction of the company are required to disclose their interest to the board and refrain from participating in discussion or voting on any resolution connected with such transactions.[25]
- SEBI has prescribed detailed regulations prohibiting insider trading[26] and fraudulent and unfair trade practices in the context of the securities market[27]
- As highlighted above, the Annual Report of the company needs to include a Director's Report and a Report on Corporate Governance.
- The Listing Agreement Amendments requires the disclosure of all pecuniary relationship or transactions of the non-executive directors with the company in the Annual Report. Similarly, disclosures on materially significant "related party"[28] transactions need to be disclosed in the Report on Corporate Governance.
- The Listing Agreement Amendments provide that with respect to executive directors, all remuneration details, contract details, and stock options need to be disclosed in the Report on Corporate Governance.

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[21] Section 293 of the Companies Act. Examples include the sale or lease of an undertaking of the company, the extension of the time for payment of a debt due by a director, borrowings in excess of the paid up capital of the company unless the borrowings are loans received from bankers in the ordinary course of business.

[22] Section 292 of the Companies Act. Examples of the key corporate transactions would include the right to make calls, issue debentures and borrow funds.

[23] Section 297 of the Companies Act.

[24] Section 295 of the Companies Act.

[25] Section 299 of the Companies Act.

[26] See, SEBI (Insider Trading) Regulations, 1992. It may be noted that the Birla Committee is in the process of making recommendations on a fresh set of regulations for insider trading.

[27] See, SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Market) Regulations, 1995.

[28] "Related Party" refers to the promoters of the company, its directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of the company at large.

- There are a variety of statutory obligations, including detailed provisions with respect to criminal responsibility, which cast responsibilities on directors.

- The Amendment Act seeks to make a Director's "responsibility statement" mandatory. Directors would be required to certify – that applicable accounting standards had been following in the preparation of the financial statements of the company; the accounting policies have been applied consistently and judgements and estimates are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company; that the directors have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of law and for prevention and detection of fraud and other irregularities.

Directors are also cast with fiduciary responsibilities[29] towards the company, which have a number of facets including:

- Liability for breach of trust: Section 88 of the Indian Trusts Act, 1882 requires that any pecuniary benefit that accrues on account of breach of the fiduciary character needs to be held for the benefit of the person to whom the fiduciary responsibility is owed.

- Duty to act honestly and exercise such degree of still and diligence as would amount to reasonable care, which an ordinary man might be expected to take.

- Duty to disclose any personal interests or potential conflict of interest that may arise.

- Duty not to compete with the company.

D. Self-Regulation through an Audit Committee of the Board of Directors

The self-regulatory approach is seen as being supportive of innovation and enterprise, unlike external regulation. This formed the basis of the recommendations of the Cadbury Committee and would appear to the basis of the recommendations of the Birla Committee. The Indian legal system is rapidly moving towards the establishment of independent regulators and a greater emphasis on self-regulatory structures. In keeping with this movement, the Listing Agreement Amendments have made an audit committee a mandatory requirement for all publicly traded companies:

- The audit committee appointed by the board of directors needs to be independent and qualified.

- The audit committee is to have a minimum of three members, all being non-executive directors with the majority being independent directors (including the Chairman). At least one of these directors should have financial and accounting knowledge.

[29] In this context, reference may be had to the decisions of the Indian Supreme Court in **Nanalal Zhaver** v. **Bombay Life Assurance**, AIR 1950 SC 172 and **Needle Industries India Ltd.** v. **Needle Industries (Newey) India Holding**, AIR 1981 SC 1298.

- Meetings to be held at least thrice a year with one meeting before finalisation of annual accounts.

- Quorum for meetings of the audit committee needs to be one-third or two, whichever is higher. However, a minimum of two independent directors is essential to constitute a quorum.

- The functions of the audit committee include – oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient, and credible; recommending the appointment and removal of the statutory auditor of the company; reviewing with management the financial statements of the company prior to submission to the board of directors; reviewing the internal audit function; review of the findings of the statutory auditor; pre-audit and post-audit discussions with the statutory auditor; review of the company's financial and risk management policies etc.

The Amendment Act has proposed to make audit committees mandatory for public companies (whether listed or unlisted) have a paid up capital in excess of Rupees Five Crores. The proposed amendment sets out the powers and functions of the audit committee.

E. Self-Regulation through a Remuneration Committee of the Board of Directors

The Listing Agreement Amendments have included a "non-mandatory" recommendation that companies establish a remuneration committee of the board of directors, comprising of at least three directors. All of these directors should be non-executive with the Chairperson being independent. The terms of reference of this committee would include determination of the company's policy on remuneration packages for executive directors.

While companies are not required to establish a remuneration committee, the Listing Agreement Amendments make it mandatory for the board to decide on the remuneration packages of non-executive directors. In addition, as highlighted earlier, it is mandatory that all elements of remuneration of all the directors be disclosed in the Report on Corporate Governance.

F. Restrictions on Market Control Mechanisms

Indian law contains a number of statutory and regulatory provisions that restrict market control mechanisms:

- Acquisition of more than five percent of the shares of a publicly traded company, directly or indirectly and with persons acting in concert, requires detailed disclosures to be made by the acquirer to the company and by the company to the stock exchanges.[30]

[30] See, SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

- Acquisition of more than fifteen percent or more of the shares of a publicly traded company, directly or indirectly and with persons acting in concert or a change in control of the company, requires a public offer to be made to the investors of the company for a minimum of twenty percent of the total shareholding of the company.

- Indian law prohibits a variety of restrictive trade practices and unfair trade practices in the conduct of business by a company.[31]

- The Report of the Competition Policy and Law Committee appointed by the Government of India has made recommendations with respect to the regulation of anti-competition practices. It is expected that the Government of India would proceed with the formulation of an appropriate legislation.

BEYOND CORPORATE GOVERNANCE: POSSIBLE TRENDS

Indian companies are looking to the global markets to raise capital - and in the process are finding themselves up against standards of corporate governance not seen in India thus far. The Listing Agreement Amendments have gone a long way in prescribing the mechanisms and procedures (as well as disclosure requirements) needed for effective corporate governance. However corporate governance is not just about procedural requirements - and the time has come for a well thought out amendment to the Companies Act to ensure that Indian corporate law meets global standards on issues like quorum and corporate control within a group context.

Ever since the process of opening the Indian economy to the global economy began in 1991, there have been a number of committees established by the Government of India and SEBI to examine various aspects of Indian corporate law. Perhaps indicative of larger developments and the challenge to the multi-stakeholder conception of the company, the membership of these committees has not always been representative of the various stakeholders. This matter has not been highlighted thus far, perhaps because of the fact that on matters of the economy there appears to be a broad consensus among the main political parties in India. Consequently, Indian corporate law is at the threshold of significant changes over the next few years.

The picture is not entirely rosy however. Examples of the friction between the various stakeholders already exist. Thus far, dominant shareholders, management and creditors have worked together to reduce the bargaining position of employees. The Government of India has committed itself to an ambitious agenda of privatisation of a number of public sector units – raising the shackles of the trade unions. At the same time, dominant shareholders, management and employees are at loggerheads with the right of the financial institutions (the main creditors) to appoint nominee directors, albeit for different reasons. The dominant shareholders and management are opposed to the concept of nominee directors due to a potential "conflict of interest". In addition, their presence is seen as restrictive on the decision-making capacity of the board of directors. Employees however believe that nominee directors have a responsibility to all the stakeholders as financial institutions lend public money – and that nominee directors have not always discharged this responsibility. The Amendment Act had contemplated an ingenious provision wherein small investors would have the right to appoint one director on the board. This effectively meant that

[31] See, The Monopolies and Restrictive Trade Practices Act, 1969.

small investors were seen as a different stakeholder from the controlling shareholders. However, press reports indicate that this provision has since been withdrawn.

Given the well-established traditions of democracy in India, it is possible that in the near future that a furious debate would arise on whether the multi-stakeholder conception of the company is really in conflict with a liberalised economy. The arguments in favour and against shareholder primacy and indeed the multi-stakeholder conception of the company are many and involve a number of theoretical issues. Some of these issues would be:

- Whether shareholders in publicly traded companies are owners of the company.
- What constitutes shareholder value? Does one evaluate the enhancement of shareholder value in terms of the net worth of the company, potential of the company, the record of the company in paying dividend as per the provisions of the Companies Act or the ability of the company to plough back its profits into the business or the price of the share on the stock exchange.
- The methodology or mechanism to overcome conflicts or differences of view between the various stakeholders.
- The role of the dominant shareholders vis-à-vis the company.
- The role of management and the nature of accountability of management.
- Issues of risk and control vis-à-vis the various stakeholders.
- The nature and extent of regulation. For example, employees would be more in favour of external regulation while management and controlling shareholders would prefer self-regulation.
- There is considerable academic writing of recent origins both in India[32] and abroad[33], which has explored the idea that a company operates within the social realm and its goal is the increase of societal wealth as against shareholder wealth.

The role of corporate governance within the constitutional framework of India may assume great proportions in the years to come. To use the parlance of international human rights law, the Indian Constitution recognises a number of first generation human rights[34] and provide a direction to the state with respect to a number of second

[32] See, M. H. Hirani, **The Company Law Related to Social Responsibilities of Company Directors**, (A. P. H. Publishing Corporation, New Delhi, 1997).

[33] See, Margaret M. Blair, **Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century**, (The Brookings Institute, Washington, 1995); J. K. Parkinson, **Corporate Power and Responsibility: Issues in the Theory of Company Law**, (Clarendon Press, Oxford, 1993).

[34] The first generation human rights include the right of life, personal liberty and profession and the right not to be affected by arbitrary state action. See, **Maneka Gandhi** v. **Union of India**, AIR 1978 SC 597.

and third generation human rights.[35] Under the Indian Constitution, the first generation human rights are known as "fundamental rights" and are judicially enforceable while the second and third generation human rights are known as "directive principles of state policy" which are not judicially enforceable, though are to be taken into consideration in the functioning of the state.

Indian constitutional law has seen two significant developments, both spearheaded by the judiciary. Firstly, the content and scope of a number of fundamental rights is being expanded to include principles found in the directive principles of state policy.[36] Secondly, the Supreme Court has laid down (in very few cases) guidelines that need to be complied with and followed by not just the state but also private organisations.[37] If these developments were to enter the realm of corporate law (a possibility that cannot be ignored given the activism shown by the Indian judiciary), the result would be a totally different approach to corporate governance.

As and when the debate on the relevance of the multi-stakeholder conception of the company in a liberalised economy operating within a constitutional framework arrives at a conclusion, corporate governance in India would make significant strides in creating an environment of legal compliance. The pattern of relations between the stakeholders and the company as a whole would give rise to an “ecology” of legal compliance.

[35] The second generation and third generation human rights include aspects of development and environmental protection.

[36] See, **Unnikrishnan** v. **State of Andhra Pradesh**, (1993) 1 SCC 645.

[37] See, **Visakha** v. **State of Rajasthan**, AIR 1997 SC which lays down guidelines on "sexual harassment" which even private employers need to comply with.