

## Commissioned Article

# Some Inherent Challenges to Good Corporate Governance

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*Are corporations, in general, amenable to good governance? Are there inherent incompatibilities between good governance and the corporate format of organizations? How can these be addressed satisfactorily without over-regulation that might impair entrepreneurial potential? These are some of the nagging issues being explored in this paper. The author recapitulates the conventional principal – agent paradigm in corporations and flags some of the more important issues that militate against good governance. The paper then deals with the current governance frameworks and identifies some of the countervailing measures that best-practice prescriptions advocate. It then explores a few out-of-the-box measures that might serve as potential enablers of better governance and discusses both their justification and impact.*

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## Principals & Agents in Corporate Governance

By its structural design, a corporation involves separation of ownership (by all or most shareholders) from executive management (including by controlling shareholders) of its business and operations. By virtue of its size and increasing complexities, the modern corporation requires significantly large risk capital and managerial expertise; this entails a departure from the ‘owners manage and managers own’ paradigm that was appropriate in an earlier business world of smaller size and relatively less demanding competencies. This transition brought in its wake the phenomenon of agents (or hired help with requisite managerial skills and technical knowledge) being asked to manage the affairs of the corporation on behalf of the owner-principals (Berle & Means 1932), the shareholders who had pooled together their resources to raise the required risk capital for the organization. Given the usually non-congruent individual aspirations and ambitions of these two sets of players, namely maximization of shareholder

wealth and protection of the corporation's wealth creating assets on the one hand and the personal enrichment objectives of the executives managing the corporation, the design of the corporate format inherently and almost always unavoidably encourages conflicts of interest between these principals and agents; the goal of good corporate governance often is to contain and mitigate the severity of the implications of such conflicts, a task that is entrusted to the corporation's board of directors elected by the shareholders to protect and promote their interests from any undue expropriation by executive management controlling operations.

In practice, the distinction between agents and principals is not, as a general rule, so precisely demarcated; thus, in countries like the United States and (to a lesser degree) the United Kingdom, a large majority of corporations have a vastly diversified ownership pattern with individual shareholdings scarcely exceeding the 2% mark; in virtually all other countries (India included) concentrated or dominant ownership is the predominant feature, where the operational control of corporations rests with some of the shareholders, often referred to as promoters or dominant shareholders (La Porta et al 1999). This brings in to play a situation of the principal-agent paradigm being further compounded by what many scholars have referred to as the principal-principal problem, one where the interests of absentee shareholders (those who have nothing to do with operational

control) need to be protected and promoted from the potential excesses both of the executive and the controlling shareholders. Yet another variant occurs when a corporation has a block shareholder not in operational control: in this event, again, the absentee shareholders' interest may need protection against possible collusion between such block holders and the operational controllers, whether they are controlling shareholders or hired executives. In essence, therefore, a prime objective of good governance remains protection of absentee shareholders' interests, uniformly in all ownership patterns; the mechanisms to achieve this objective may vary but the intent remains the same.

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### **Shareholders & Other Stakeholders**

In this discussion so far, shareholders have been assumed as the principals in the corporate form of business organization. There are very strong arguments in support of this proposition based on what is termed as the *residual claimant* theory in legal scholarship. Briefly, this theory postulates that shareholders as the risk-bearing entrepreneurs contributing the equity capital of the company have the discretionary authority for allocating resources to end-uses (essentially through the objects set out in the charter documents such as the memorandum of

association and through subsequent approvals at general meetings of members), elect directors on the company's board to guide and control executive management in running the operations of the company, are the last in the pecking order of distribution of surpluses in the event of winding up after meeting all other claims on the company, and thus qualify as residual claimants in the corporate hierarchy entitled to have the company and its board of directors exclusively accountable to them (Easterbrook & Fischel 1991).

While shareholder primacy on this basis is largely acknowledged and accepted around the world, there have also been substantial criticism and rejection of this concept both in scholarly literature and in practice. The idea of shareholders being the exclusive residual claimants has been challenged, with the claims of other stakeholders being advanced (Blair 1995). Stakeholders themselves have been described as those who are able to influence, or are affected by, the decisions of a company: usually, these are the employees, customers, vendors, lenders, the State, and the community in which the company operates, besides of course the shareholders who provide the risk capital. While many of the European countries subscribe in varying degrees to the relevance of such stakeholders in governance, many others including India recognize their importance without compromising shareholder primacy.

In any case, the underlying issue is the protection of the interests either

exclusively of the shareholders or collectively of all the stakeholders from potential excesses and expropriation by the controlling shareholders and executive management.

### A Framework for Good Governance

Given the objective of shareholder wealth maximization and protection of absentee shareholders (with due regard to other stakeholder interests), the instruments of good governance that would ensure its efficient and effective achievement need to be put in place. Historically, this task has been entrusted to a company's board of directors, theoretically elected by the shareholders in general meeting but in practice hand-picked and proposed by the controlling shareholders or incumbent boards for general shareholder approval and election. Once duly constituted, the board becomes the supreme authority presiding over the destinies of the corporation subject only to the laws of the land and shareholder concurrence in certain prescribed matters. By and large this position holds in almost all countries, although some scholarly debate has been raging for some time on whether shareholders should reclaim for themselves some more potent power to

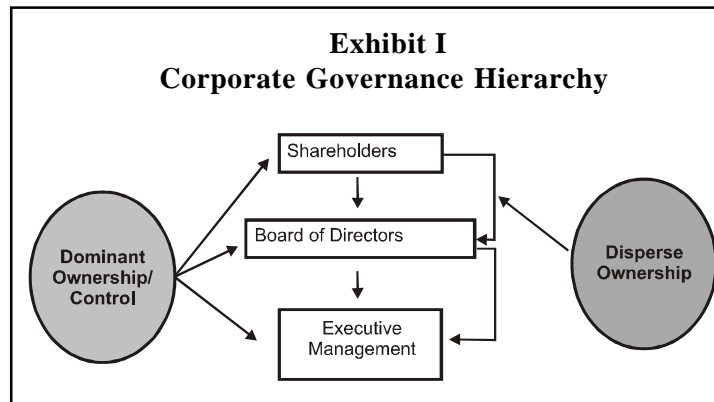
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dictate terms to the board on certain key matters (Bebchuk 2005, 2006, Bainbridge 2005, Strine 2006) especially in the US context. Indian law, it may be noted with some satisfaction, allows greater power to shareholders in such matters although in practice this is negated by dominant ownership practices and institutional shareholder apathy. Both executive and non-executive directors take on *fiduciary* obligations to promote and protect the interests of the company and its shareholders; in essence, they are trustees who are charged with this responsibility of acting in the best interests of the company and its shareholders. As the Cadbury Report in the United Kingdom pointed out more than a decade ago, the board is at the centre stage of corporate governance (Cadbury 1993); legislation and regulation in numerous jurisdictions accordingly charge company boards with the responsibility of overseeing the affairs of their companies so as to create shareholder value and ensure equitable distribution of created value on the one hand and on the other, periodically reporting informatively and transparently back to the shareholders on the company's performance including providing audited financials.

**The board is at the centre stage of corporate governance**

### Boards as Primary Instruments of Governance

The governance hierarchy in corporations (Exhibit I) is deceptively simple: shareholders as ultimate principals elect and appoint a board of directors to oversee and guide the affairs of their company; the board puts in place the top executive management including the CEO (often also called the Managing Director) and supervises its performance in delivering results in tune with laid



down plans; the board reports to the shareholders periodically on the performance and seeks their approval on major initiatives (such as acquisitions, borrowings, auditor appointments, etc) as required by law and the company charter provisions. This process, especially board and executive appointments, tends to be largely influenced by the ownership pattern of the company, whether it is diversified or concentrated, and whether some of the directors also occupy executive positions in the company. In the case of concentrated ownership situations, it is

usual to have controlling shareholders in executive and board positions; in such circumstances, they actually wear two caps, one as senior executives in the corporation and the other as directors with all the attendant responsibilities, though often in practice the role clarity gets blurred. This is one of the major reasons why functional directors subordinate to the CEO in the executive hierarchy are less than effective in their directorial roles at board meetings, as many of them feel obliged to toe the 'party line' as handed down from the top. It is also a fact of life that CEOs and Managing Directors relish the thought of their executive subordinates disagreeing or challenging what they propose for board approval; it is for this reason that appointment of functional or operational executives is often dysfunctional from a board perspective and generally not a preferred option from the company's viewpoint.

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The stewardship role of the board was well enumerated in a Canadian document, appropriately titled "Where were the Directors?" that set the standards of good governance in publicly traded corporations in that country (TSE 1994). These were ensuring an adequate strategic planning process, appointment of top management including the CEO,

articulating a suitable communications policy, ensuring appropriate risk management processes, internal controls and management information systems. To these must be added a sixth component of postulating and ensuring an appropriate value system within the framework of which corporate objectives must be set and met. These elements of board responsibility are as valid today as they were when originally written.

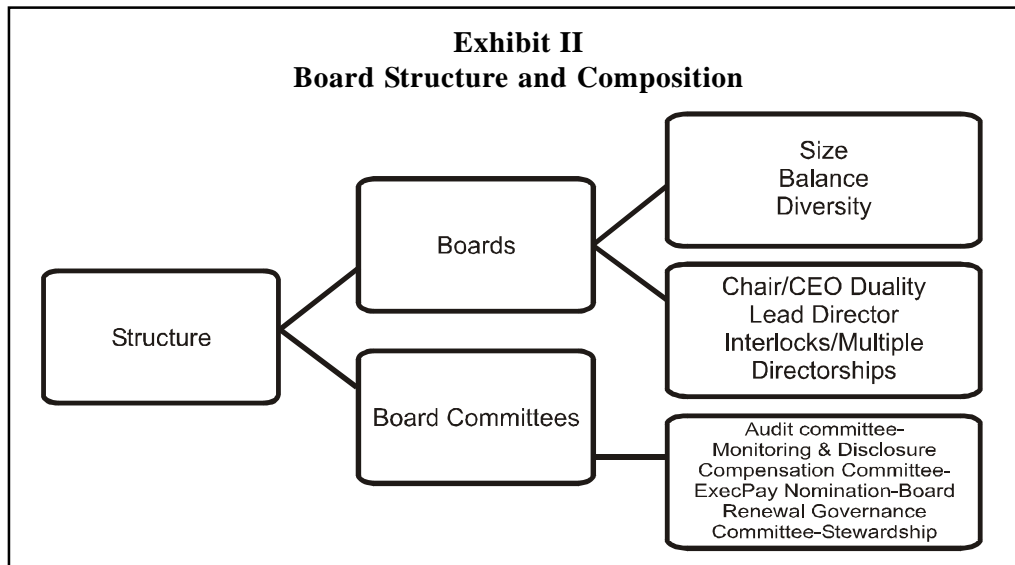
From a different perspective, board and director roles can be seen in a three dimensional frame consisting of contributing, counselling and controlling. Individual directors on boards with specific domain expertise can contribute to a company's strategy-making and other managerial dimensions such as risk and control processes, ethical practices, human resource initiatives, accounting and auditing issues, and so on. Virtually all directors could offer mentoring and counselling advice based on their own experience and exposure. Controlling dimension of the board is key to equitable distribution of created wealth to the shareholders and requires a measure of forensic and probing skills to prevent tunnelling and expropriation in the wealth creation and distribution pipeline. Closely related, controlling also involves exploring

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accounting and reporting practices for their appropriateness as much as for their acceptability and also validating audit independence. This latter aspect may require some accounting and financial expertise which is the reason why such skills are preferred for membership of audit committees of the board which largely deal with such issues.

It is important to recognize that the board is a collective body with individual directors contributing to its effectiveness and success. It is neither practicable nor necessary that each director on the board should have

competencies in equal measure in all three dimensions of board role; rather, the board should work as a team, as an orchestra with different members contributing their expertise so that the effectiveness of the board as a whole is greater than the sum of individual directors' competencies. This is also the underlying reason why considerable time and attention are required to be devoted to get the right balance in board structures in terms of diversity, size, competencies, and so on. Exhibit II represents graphically some of these important aspects relating to board structures and composition.



While no rigid one-size-fits-all prescription would ever be meaningful (not the least because of the great diversity among corporations in terms of their complexity, domain, and so on), a functionally effective and efficient board would have the right mix of executive and non-aligned members, with diversity

in terms of gender, ethnicity, skill sets, age and experience, and so on. Board independence and objectivity are key to good governance; these are sought to be achieved through a majority of non-aligned directors with little or no economic dependence on the company or its executive management and

controlling shareholders that may actually, or even perceived to, have the potential to impair independent and objective judgement on matters coming up for decision. Board independence is also enhanced by separating the roles of the chairman of the board and the chief executive, so that board supervision and appraisal could be objective and board processes and discussions could be overseen by a person independent of executive responsibility for the operations of the company. Board interlocks where directors sit on each others' boards in executive and non-aligned roles and multiple directorships where directors sit on several boards thus gaining wider exposure and insights are mechanisms that can enhance board effectiveness even while increasing potential for inappropriate use of privileged information and network contacts; somewhat analogous to good and bad cholesterol, they have to be nurtured with great dexterity and caution.

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Director independence is a topic that has been widely debated and its elements have even been mandated, but it is necessary to appreciate that independence is a state of the mind and reflective of the strength of character of the individual, neither of which is strictly amenable to detailed codification. Certain normative principles however

may be helpful as a guide for assessing a director's independence status (NFCG 2006).

These are some of the best practices and legislative or regulatory requirements that have been evolved over a period of time in different countries in the quest for reasonably effective mechanisms that would protect the interests of absentee shareholders. Are they enough? Can there be some radically innovative approaches that would offer further safeguards without curbing entrepreneurial aggression and the traditional self-interest-driven *invisible hand* that are so necessary to survive and prosper in an acutely competitive globalised business environment?

### **Towards A More Robust Corporate Governance Regime**

While the objectives of good governance, namely creation, protection and equitable distribution of shareholder value, have long been recognized, their full achievement in practice has been dogged by challenges emanating from various sources like dominant shareholders, autocratic executive managements, ineffective independent auditors, inefficient enforcement mechanisms, and so on. Standing out prominently among these challenges is the potential for controlling shareholder dominance often abetted, unwittingly or otherwise, by inefficient board surveillance over the executive. Two themes are picked up here for consideration:

- First, how to countervail material related party transactions being unjustly processed for board approval?
- Second, how controlling shareholders could be pre-empted from steamrolling at general meetings key decisions that may leave absentee shareholders negatively impacted?

In other words, we look at the possibilities of containing the ill effects of dominance by controlling shareholders and executive managements both at the level of board meetings and members' meetings.

#### **Enhancing Board Objectivity & Effectiveness**

Board objectivity and independence are sought to be enhanced by inducting a large proportion of non-executive directors who would also qualify as non-aligned with, and independent of, the company, its controlling shareholders and/or executive management. Many leading corporations in the United States and the United Kingdom, two countries where diversified ownership structures are most prevalent, have embraced the practice of having no more than one or two executive directors including the chief executive on their boards, all the rest being non-aligned. Countries with predominantly concentrated ownership structures, as is the case in India, tend to have more executive and non-independent representation on their boards and bring in non-aligned directors

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only when, and even then only to the extent, mandated. There are several companies including in the state-owned-or-controlled sector that have failed to induct such non-aligned directors even after regulatory mandates, often citing paucity of suitable independent directors.

Board objectivity can be measured by a simple index of the proportion of non-aligned directors in the overall board, with a theoretical maximum index of 100 where the board is entirely non-aligned; illustratively, if one half of the board is non-aligned, the board independence index will be 50. This computation can be further refined to take in to account specified key indicators of independence such as relationship with other directors, time since tenure as an executive director or chairman (where applicable), deviation from industry median of non-executive director compensation (higher the positive deviation lower the level of independence), relationships with controlling shareholders or executive management in terms of other executive or non-executive directorships in entities controlled or substantially owned by them (greater the level of relationships lower the level of independence), level of donations or endowments received by

entities where the director is engaged in executive or directorial position from the company or other entities controlled or substantially owned-influenced by the controlling shareholders or executive management (higher the level of such relationships lower the level of independence), and so on. The independence score of each board member thus computed can then be aggregated to reflect the level of board independence of the company. A word of caution however is necessary in relying upon such metrics: they can at best be useful indicators but cannot be conclusive; they can only show the theoretical independence of the board; actual independence would depend upon how objectively the directors in practice exercise their judgement. Instances abound where individuals with a theoretically low score turn out to be fiercely independent and objective in practice and where regrettably those with an impressively higher independence score may turn out to be ineffective in reality

In assessing the effectiveness of the board, directors' dependence upon executive management for timely and meaningful information on which to base their decisions and monitor their adherence needs to be recognised. Effectiveness can be substantially enhanced if the non-aligned directors could keep themselves abreast of developments at a macro level germane to the business of the company and also allocate adequate preparation time for each meeting of the board and its committees. Research support is

currently unavailable to non-aligned directors unless they engage such help on their own; this deficiency is a serious lacuna which often militates against greater effectiveness since such directors are left to their own devices to enlighten themselves on the company's affairs or just depend upon what information executive managements provide.

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The number and duration of board and committee meetings and the advance circulation of agenda papers are key determinants of board effectiveness. Often, companies schedule committee and board meetings in quick succession on the same day as a matter of convenience but this may prove dysfunctional if sufficient time is not available for due deliberation and discussion. The board and committee chairs will have to assess the time requirements depending upon the agenda (which itself should be set and cleared by them in consultation with executive management) and schedule meeting durations accordingly. Prior preparation by directors would also save considerably the required contact time at meetings which then can be devoted to discussions.

Routine and mundane as these matters may appear their contribution towards making boards more effective cannot be overemphasized. And even

more critical to non-aligned directors' effectiveness are issues like how such directors could be empowered to discharge their surveillance roles generally, and how the potential abuses of unscrupulous executive managements and controlling shareholders may be contained, to a discussion of which we now turn.

### **Empowering Board Independence**

Enhancing board independence and effectiveness is by itself unlikely, in all but a few exceptional cases, to be adequate to upgrade governance standards without, concomitantly, also empowering the non-aligned directors' role and positioning. The present legislative and regulatory dispensations in India and indeed in most countries do not adequately provide for such empowerment. Doubtless there are some provisions that partly address this problem: for example audit committees in the United States listed companies to comprise only independent directors. Indian company law mandates audit committee recommendations on all financial and accounting matters to be binding upon the board with a provision that where the board disagrees, it can reject such recommendations with the only requirement that grounds for such actions should be explained. Where board independence is imposed by regulation rather than invited through genuine conviction, as is generally the case in India in a majority of companies, it is not unusual to have important matters routed through and approved by boards without many of the independent

directors being present and participating.

Two recommendations deserve serious consideration in placing the independent component of the board at the centre stage of board effectiveness:

**The present quorum requirements for board and committee meetings do not mandate the presence of any of the non-aligned directors.**

- The present quorum requirements for board and committee meetings do not mandate the presence of any of the non-aligned directors. Theoretically, it is possible to have a valid board meeting only with executive directors and approve important decisions, notwithstanding the presence of independent directors on the board. For non-aligned directors' surveillance role to be effective, it is important that board meetings necessarily have them or at least a majority of them to be present at the meeting. There is thus a strong case for mandating such a requirement.
- Equally, it is important to mandate that certain key decisions on specified topics be approved by the board only if a majority of independent directors of the company (not of just those present) affirmatively vote in support. This provision will ensure independent directors' voice is heard and their votes count. Under the present

dispensation where at the minimum (and it is fair to assume a vast majority of listed companies will prefer just about meeting the mandatory requirement) only a third or at best a half of the board is required to be independent and it is possible for the executive directors to validly approve a proposal even if some or all the independent directors are against it. The recommended provision will ensure that independent non-aligned directors' views are taken into account and thus board independence is given a chance to assert itself effectively and meaningfully.

Several arguments would of course be advanced against these recommendations especially since they would effectively circumscribe the freedom that controlling shareholders and executive managements are currently accustomed to in having their way with their boards. For example:

- *All directors are created equal, with similar fiduciary obligations and liabilities. Conferring on some of them special powers even to veto a majority of other members of the board amounts to downgrading other directors' importance and value to the company, and is patently unfair.*

This is apparently a strong argument for equality of voting strength. However, equity demands that unequals be treated unequally: directors in executive capacities are

performing the role of 'agents' in the governance hierarchy and to that extent their personal agenda can potentially be incongruent with the principals' agenda in terms of wealth creation for, and distribution to the latter. Since a key responsibility of the board is oversight and monitoring of the executive management, it is not unfair to ensure that the non-aligned directors who have been specifically inducted on to the boards with a view to carry out such unbiased and independent evaluations and monitoring in the interests of shareholders are in fact present and participating, and that a meeting without their full (or at least a majority of their) presence is disempowered to take critical decisions.

- *Vesting such special authority in some directors to the exclusion of others will be dysfunctional and hence untenable.*

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This need not be the case if the respective roles are clarified and understood. Vesting some special powers to some directors on boards is not an uncommon practice if mutually agreed or mandated. Classic examples are of joint venture company boards where it is not unusual to reserve special powers to

partners in respect of certain topics as mutually agreed. Similar is the case where the affirmative concurrence of some directors, for example nominees of financial institutions or (as in the recent case of Satyam Computers) the government on specified matters. These are done with specific objectives of surveillance and are known to have worked well without any undue difficulties in the functioning of the board. The special objective sought to be achieved by this recommendation is to ensure board decisions are taken with due presence and concurrence of non-aligned directors who have been brought on board with the clear mandate to provide objectivity and fairness in decisions affecting the company and especially absentee shareholders; once this role is understood and appreciated, smooth board operations should be possible.

- *Non-aligned directors are busy people with many irons in the fire and it is not always possible to have them present at every meeting.*

This argument in fact begs the question on director responsibility to attend as many meetings as possible; having non-aligned directors only for check-list-compliance purposes without having their availability at meetings defeats the purpose of having them on board. Both the individuals and companies should satisfy themselves before joining or induction, that reasonable time

availability was feasible barring unforeseen circumstances. This is also the reason for requiring a minimum only a majority of the independent directors on the board. Also, with advances in communication technologies, it may be possible for more such directors to participate through video conferencing facilities. The key focus should be on how best to get a majority of non-aligned directors to participate in meetings, not on how to carry on regardless of their presence and participation.

- *These provisions would create a power centre within the board and there is no guarantee that such concentration of authority would not be subjected to abuse.*

This is a valid point since power in any form is often an invitation to potential abuse. After all, non-aligned directors are not all angels and they are equally subject to human failings. Keeping this vulnerability in view, the recommendation is for approvals by a majority of independent directors and not by all such directors. It is highly improbable that independent directors would all get together to unreasonably withhold consent to matters that are in the overall interests of the company. As a further measure of prudence and deterrence against such abuse of authority, it may be appropriate to set up a quasi-judicial, autonomous National Corporate Governance

**It may be appropriate to set up a quasi-judicial, autonomous National Corporate Governance Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors and other people of eminence.**

Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors and other people of eminence to look at complaints of any such abuse of power by non-aligned directors; if abuse is proved, the guilty should be handed down the most stringent penalties including disgorgement of any personal gains with salutary penalties and debarment from directorship of any corporate entity where other people's money and resources are involved. To ensure the accused non-aligned directors also have a fair dispensation of justice, they should have a right of appeal to the highest court against the decisions of the NCGA. With these systemic checks and balances, it should be possible to allay fears of any abuse of these salutary provisions.

### **Restoring Democratic Values in Corporate Governance**

The corporate format of business organization is, from a sociological perspective, a community of people who come together with the common purpose of carrying on a commercial venture with profit motivation; and by definition all

the contributors to the capital of the company cannot be actively involved in day to day operations which must be left to the promoting shareholders and/or hired executives. There is thus an inescapable situation where a large proportion of the shareholding community has to settle for someone else being entrusted with the job of putting their contributed resources to good and fruitful use on their behalf and in their interest. Voltaire, the noted French philosopher, insightfully described why people agree to become citizens of civic and political communities even though such a decision may bring about some elements of sacrifice of individual freedom and subjection to the group discipline: the principal motivation, he reasoned, was the assurance of security and peaceful existence in pursuit of individual economic and other goals which may not be possible without such structural agglomeration into communities and nation states. Similar is the rationalization for absentee shareholders investing in corporations: they may be well aware that they may not receive the full benefits that ought to flow to them as a result of successful business operations but this sacrifice they are willing to make because they by themselves with their limited resources and expertise may not be able to initiate and sustain such business ventures. Like political citizens, shareholders in their limited corporate communities do have the right to vote on principal issues like approving corporate objectives and resource allocations, electing their directors, approving independent auditors, and so

on. But the critical difference between political citizenship and corporate shareholders is that while in the former every citizen has a single vote based on adult suffrage, the latter tends to weight the shareholders' voting rights on the basis of their financial contribution to the capital of the company. Unlike political democracy, the corporate scene is one plutocracy with each shareholder having votes in proportion to the slice of the company capital held.

And yet it has not always been so (Dunlavy 2004). The earliest corporations, the British East India Company among them, worked on the principle of one vote per shareholder irrespective of his or her financial contribution to the company's capital. Over the decades, this situation has changed leading to the evolution of proportionate voting rights, and worse still, disproportionately differential voting rights as well. The result of this development is the modern day dominant shareholders who by virtue of their voting rights are able to have a stronger say in key corporate decisions that require approval by members in general meeting. With corporations being allowed to hold shares in other corporations, itself a much latter day development, the saga of corporate groups began to unfold, with three broad categories of dominant controlling shareholder groups emerging: the family or domestic groups, the multinational groups, and the state-owned enterprises group. By definition these groups each had the potential to enjoy private benefits of control at the expense of

absentee shareholders. Their voting strength based on shareholdings helped them to pilot approvals at the shareholders' meetings, assisted in large measure by the inability or indifference of small shareholders to incur the costs of monitoring their companies and attending their meetings, and the incapacity of institutional block shareholders (barring some conspicuous exceptions), especially when under state ownership or influence, to fulfil their assigned roles effectively.

While there can be no serious advocacy for return to pure democracy and the consequential one vote-one shareholder principle (if only because in commercial corporations it might be meaningful to allocate voting powers according to the risks borne by individual shareholders reflected by their proportion of shareholding), there would appear to be a strong case for reining in the rights of shareholders who stand to benefit to the exclusion of other shareholders through certain material proposals brought up for approval at the members' meetings. In fact the OECD Principles of Corporate Governance (OECD 2004) specifically recommend that in such circumstances, the shareholders negatively impacted (namely those who may stand to lose by such approvals) alone should vote on the resolutions. This is a salutary and excellent principle to adopt. In fact, such a recommendation was made by a government appointed Committee on Corporate Excellence in 2000 which was never implemented (DCA 2000). Representations made to the Naresh

Chandra Committee in 2002 went unheeded; the Irani Committee on Corporate Law Reforms (Irani 2005) was more receptive, recognizing it as a good governance practice to be adopted by companies, but stopped short of recommending legislation on the ground that would be difficult to implement. The proposal is path-breaking in its impact and would radically improve the standards of corporate governance in the country, bringing to an end many ills of the corporate world.

### The Concept of Interested Shareholders

**Any party interested in a resolution that offers advantages or removes disadvantages to that party to the exclusion of other shareholders in the same class or category should not exercise its votes on such a resolution.**

The recommendation in brief is predicated on the principle that any party interested in a resolution that offers advantages or removes disadvantages to that party to the exclusion of other shareholders in the same class or category should not exercise its votes on such a resolution, which should be allowed to be approved or rejected by those shareholders who are negatively impacted by the consequences of such a resolution. *Prima facie*, no one can seriously object to this principle since it is so well grounded in equity. Its ramifications however will be significant and will largely eliminate many inequitable decisions that are passed

through the sheer voting strength of the benefiting shareholder.

Some of the situations where this salutary provision would minimize abuse of voting authority can be enumerated.

- Preferential share issues to the dominant or controlling shareholders, both in terms of size and price. Many companies with dominant controlling shareholders, among them several multinationals, have adopted this route to increase their shareholding to majority or super-majority status, often at prices that are not truly reflective of the worth of the shares. Of course SEBI has a pricing mechanism in place for this purpose but in a relatively shallow secondary capital market, it is not impossible for the prices to be managed, given some timely planning. With the interested shareholder regulation in place, it will be open to the other shareholders of the companies to extract appropriate valuations from the controlling shareholders.
- Buyback of shares where the controlling shareholders do not offer their holdings is a convenient mechanism to enhance shareholding proportions using company's financial resources that belong to *all* shareholders. With the interested shareholders regulation in place, it will be the other shareholders who decide what is in their interest both in terms of the suitability of the proposal and the pricing.

- Mergers and acquisitions of group companies can be considered, with this principle in place, objectively by the other shareholders without being steamrolled by the interested dominant shareholders or by their hand-picked boards. This will offer an opportunity for evaluating the strategic value of the proposal as well as the consideration being paid for the acquisition.
- Executive remuneration of controlling shareholders' representatives in the company in directorial or other senior level positions. With the interested shareholder regulation in place, other shareholders may have an opportunity to evaluate what levels of compensation are appropriate to the representatives of the controlling families or groups.
- Appointment of independent statutory auditors. Since it is the controlling shareholders through their representative in top management who are responsible, in their executive capacity, for the accounting and reporting of financials, it will not be unfair to exclude them from voting on the appointment of independent auditors whose job is to review and critique the financials and provide assurance to the absentee shareholders. This will also put paid to the practice of group auditors and thereby distance the controlling shareholders from the appointment and remuneration of such independent auditors.

Two points need special mention: First, to be successful and fully functional, institutional block holders, who have the capacity to monitor and evaluate corporate proposals unlike small individual shareholders, should take an active part in guiding proper assessment of proposals and vote appropriately to ensure proper and equitable governance. Second, no rational shareholder will unreasonably withhold approval of a fair proposal in the interests of the company and all its shareholders just to spite the incumbent management. There is therefore no reason to fear the efficient working of the corporate sector will grind to a halt when this proposed recommendation is auctioned.

Despite this, several objections would of course be raised against this recommendation essentially because it takes away a potent weapon in the hands of the dominant shareholder. Some of these are addressed below:

- *All shareholders have equal rights in a corporate organization. It is not fair to deny controlling shareholders their voting rights in any matter coming up before the general meetings of members, especially since shareholders have no fiduciary obligations to other shareholders and are not pre-empted from furthering their interests as shareholders*

The recommendation does not seek to abridge or deny controlling shareholders' voting rights across the

board but only in certain instances where they or their representatives are the beneficiaries, or where they stand to benefit to the exclusion of other absentee shareholders. This is based on principles of equity where an interested party is not expected to exercise his right but leave to the other concerned members of the group to decide on the fairness or otherwise of the proposal. This recommendation does not apply to resolutions where all shareholders are equally impacted, favourably or unfavourably.

- *Controlling shareholders are the promoters and entrepreneurs and are entitled to run the corporation as they think best; what is good for them should be good for other shareholders as well.*

While recognizing the entrepreneurial drive of the promoters in the formation of the company and efficient running of its operations, it should be appreciated that when other peoples' monies are invited and accepted, the promoters have a responsibility to be not only fair in practice but also in perception (very much like Caesar's wife having to be above reproach!). They need therefore to be transparent in their dealings with the company and carry conviction to the other absentee shareholders on the fairness of interested party transactions. Given the fact that private benefits of control are a reality, the maxim "what is good for the dominant shareholders will also be good for

the absentee shareholders" may not always be the case. In any event, it is up to the controlling shareholders to convince the others that it is so, and they should not use their voting muscle to carry such resolutions.

**The maxim "what is good for the dominant shareholders will also be good for the absentee shareholders" may not always be the case.**

- *Have such provisions been made anywhere else in the world?*

Several countries have legislation or regulation that is similar to this recommendation. Illustratively, in the United Kingdom and Australia, certain share buyback proposals have to be approved by shareholders negatively impacted. In South Africa, the Johannesburg Stock Exchange rules seek to ascertain whether such resolutions have received majority backing not reckoning interested parties' votes. More importantly, if India is convinced on the fairness of this recommendation in the interests of better corporate governance, should it not go ahead and set an example to the rest of the world rather than always looking to adopt best practices only from other countries?

Exhibit III provides a summary of these and some other recommendations that would spell a step change in raising the bar on corporate governance standards in the country.

**Exhibit III**

**Protecting Absentee Shareholder Interests  
Some Key Governance Issues & Suggested Control Measures**

Issue	Objective	Current Requirements	Suggested Initiatives
Private benefits of control, tunnelling, diversion of company funds and resources	Contain if not totally eliminate expropriation of shareholder wealth	Related Party transactions (such as purchases, sales, leases, loans, guarantees) to be disclosed to, and approved by board or committee; interested directors not to participate or vote	To be approved by affirmative majority of all non-aligned directors; certain specified key decisions to be approved by majority of all negatively impacted shareholders
		Mergers, acquisitions, divestitures, unrelated diversifications, equity investments etc to be approved by board, and in some cases by shareholders in general meetings	To be approved by affirmative majority of all non-aligned directors, and subject to approval by majority of all the negatively impacted shareholders
		Setting up of other entities in the same or similar material business segments by controlling shareholders subject to partner concurrence in case of joint ventures	To be approved by affirmative majority of all non-aligned directors, and subject to approval by majority of all negatively impacted shareholders
Reputational agents' credibility and competence	Ensuring independence of auditors and their unbiased loyalty to shareholders and others	Appointment of auditors to be recommended by board /committee and approved by members present and voting at general meetings	To be approved by affirmative majority of all non-aligned directors, and subject to approval by majority of all shareholders other than those in operational control
		Auditors' remuneration approved by board subject to approval by majority of members present and voting at general meetings; often, remuneration left to the discretion of the board which effectively translates in to controlling shareholders or managements	To be approved by affirmative majority of all non-aligned directors, and subject to approval by majority of all shareholders other than those in operational control
Auditor relationships with shareholders	Ensuring holistic view of such relationships and potential independence	Generally assessments on stand-alone basis for each corporate entity, though professional self-regulation attempts a group view	Non-aligned directors and non-controlling shareholders to assess auditor independence taking into account relationships with all entities including charitable trusts, cooperative societies, partnerships and other vehicles controlled by controlling shareholders or managements, with complete disclosure of entities and total fees received by the auditors to shareholders in annual reports

Timely and Communications with shareholders	Demonstrable accountability and feedback to principals on the state of affairs at the company	Boards largely in the background with the CEO as the public face for communication with the outside world. Directors' report largely drafted by executive management and investor relations advisers with very little oversight by other directors though issued over their signatures	transparent Boards (or a special committee of non-aligned directors) to devote more time in fine tuning their reports for clarity and transparency; Board Chairs or Lead Directors to co-host analysts briefings and media interviews. In case of emergencies, Board Chairs/ Lead Directors along with the CEO to communicate to the shareholders and others.
Executive Compensation	Recruiting, retaining, rewarding, and replacing the CEO and the first line reports, compensating at right levels to attract and retain talent, and avoiding conspicuously disproportionate compensation packages to top management	Board recommends and shareholders approve top management compensation at the board level, subject to government approvals in certain circumstances	A compensation committee of the board to recommend for board and shareholder approvals compensation packages for the CEO and all the top management first line reports, with due explanation of their appropriateness and the processes adopted in finalizing the recommendations. Compensation committees to comprise of only non-aligned directors and the committee report to refer to any dissent with justifications for their rejection by committee majority. Board approval only by a majority of all non-aligned directors, and shareholder approval only by majority of all non-interested shareholders
Potential for abuse of power and trust by non-aligned directors	Contain and if possible eliminate such abuse of power and trust by non-aligned directors	No specific provisions or recommendations dealing exclusively with non-aligned directors (possibly be cause non-aligned directors have not currently been vested with such super-ordinary powers of independent and objective surveillance)	The State (or the Regulator) to create an autonomous National Authority (on the lines of ombudsmen) to whom shareholders and/or executive managements may complain; the authority with the help of a panel of non-interested persons of eminence and experience to adjudicate on the complaints; any non-aligned director(s) found guilty of abuse of authority and trust to be debarred from future directorships and termination of existing board memberships; the impugned decisions may be reversed or referred back for fresh consideration by the reconstituted non-aligned members of the board . Decisions of such an authority should be open to challenge in the Supreme Court or a specially constituted judicial tribunal for speedy disposal.

### **Voting Rights in Well-Governed Corporations**

Once these recommendations are accepted and implemented, India can claim to have set new standards in protecting the interests of absentee shareholders. While retaining the equality of voting rights among

shareholders in the same class, absentee shareholders will have the exclusive right to decide on proposals that would leave them negatively impacted. It does not follow that all such resolutions will be rejected. On the contrary, all of them if shown to be fair and in the interests of the company and therefore all its shareholders including especially the absentee shareholders, they will most likely be approved with significant majorities. Institutional investors have a predominant role to play in evaluating and guiding other shareholders on the merits of

such resolutions. And it would be the role of non-aligned directors on the board to provide their counsel after due deliberation among themselves recommending approval or rejection of such resolutions. All in all, a regime of due diligence would be set in place in respect of related party proposals and hopefully Satyam-like situations would largely be pre-empted in future.

The voting rights model in such a situation will comprise a large proportion of matters where all the shareholders, dominant as well as absentee, would vote equally on resolution. Most of these would require

**Exhibit IV**  
**Circumscribing Controlling Shareholders’  
Dominance over Key Corporate Decisions**  
**A Suggested Voting Rights Model**  
(Slicing not to scale)



a simple majority but some would require a super-majority of 75% plus as currently required. The third segment would comprise interested party resolutions where only the absentee shareholders will have the right to vote. Exhibit IV depicts a stylized graphic (not to scale) of the likely voting profile when this recommendation is implemented.

Similar will be the case in terms of voting rights at board meetings. Already, legislative provisions exist, fully justified by equity and *fiduciary* obligations, mandating interested directors not to participate or vote on agenda items where they are interested

parties, giving rise to potential conflicts of interest. The recommendations offered here will further strengthen this position in that the majority concurrence of non-aligned directors would minimize the potential for damaging the interests of absentee shareholders, unwittingly or otherwise.

What is there in these recommendations for corporations and its shareholders? Why should the dominant shareholders submit to such constraints on their freedom? Would this not drive away foreign direct investment to geographies apparently more investor friendly?

Governance is an important risk factor in corporations that impacts market pricing of a company's shares. International experience suggests that good governance practices that minimize the potential for expropriation of shareholder wealth by executive management and controlling shareholders tend to reassure absentee shareholders and thus minimize their risk perception that in turn leads to better market prices. Shareholder returns thus improve with better corporate governance. Besides, corporate reputations, such an essential element in attracting not only financial but also human and other resources, are enhanced leading to lower costs and hence better bottom lines. There is thus everything to gain by improving governance standards. Foreign investment tends to flow in to countries that provide a good corporate governance regime that is reassuring; the recommendations made here in fact are

**Shareholder returns thus improve with better corporate governance.**

steps in furthering good governance and, far from driving away foreign investment, are likely to attract more such investment. The only firms and controlling shareholders that would feel aggrieved by these recommendations and consider exiting are those that believe in indulging in unfair practices at the cost of absentee shareholders. If in fact they do decide to move on, it may be the best thing that could have happened to the country which can then be free from such misguided corporate players whose large scale presence can only be detrimental to the country's image and reputation as a safe, transparent, and therefore desirable investment destination.

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