Corporate Governance—Evolution And Challenges In the New Companies Act

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# List of Abbreviations

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<th>Abbreviation</th>
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<td>Birla Committee</td>
<td>Kumar Mangalam Committee on Corporate Governance</td>
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<td>CII</td>
<td>Confederation of Indian Industries</td>
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<td>Indian Depositary Receipts</td>
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I. Introduction

At independence, with four functioning capital markets with a clearly defined market micro-structure and a banking system with a well-developed appraisal and recovery norms, India had one of the best institutional structures for corporate governance among the former colonies. It also inherited, with all its blemishes, the British common law system, arguably the best legal system for protecting investor rights. The Companies Act, 1956, styled after British corporate laws, has stood as a major edifice of corporate governance in this country since its inceptions.

The winds of liberalization in the early 1990’s, however, brought very significant changes to the Indian financial sector. The SEBI was constituted formally in 1992 for the development of capital markets and protection of investors. In 1994, the erstwhile office of controller of capital issues was abolished. A disclosure-based equity capital market replaced the then prevailing merit-based capital market. In 1996, the CII released the Code for Desirable Corporate Governance, developed by a committee chaired by Rahul Bajaj. The Committee submitted the Code in 1998.

Following on the CII endeavor, SEBI constituted two committees on corporate governance—the Birla Committee and the Narayana Murthy Committee; the former to promote and raise the standards of corporate governance and more specifically to, inter alia, suggest suitable amendments to the listing agreement executed between the stock exchanges and companies to raise the standard of corporate governance in listed companies. Accordingly, the Birla Committee focused on board-level reforms including proposals for equal representation of executive and non-executive directors on the board, an audit committee and a remuneration committee. The Birla Committee also made several proposals for ensuring transparency and disclosure to the company’s shareholders including consolidated accounts for subsidiaries, disclosure of related party transactions and proposing a “Management and Discussion Analysis” section in the annual report that discusses industry outlook, financial and operational performance et al. The Listing Agreement was amended to include clause 49 incorporating the recommendations of the Birla Committee Report.
The Birla Committee was followed by another committee on corporate governance chaired by NR Narayana Murthy. The Narayana Murthy Committee was set up to further refine the corporate governance measures put in place by the Birla Committee and submitted its Report in 2003. Saliently, the Narayana Murthy Committee recommended that the concept of nominee directors be abolished, and all the directors should be fiduciaries of the company and that stock options granted to the directors should vest an year after their retirement; that whistle blowers be given direct access to the audit committee and that the audit committee have the powers to approve related party transactions. It further recommended that CEOs certify their knowledge of financial statements and appropriate disclosures to the auditors and the audit committee. ¹

Notwithstanding the slew of measures bolstering corporate governance that the regulators adopted, India Inc. witnessed an unprecedented corporate accounting scandal at Satyam Computers, a Hyderabad based I-T company within only about a half a decade of incorporating the new corporate governance code in clause 49 of the Listing Agreement. In the wake of the Satyam scam, it was felt that India required a comprehensive change to its corporate regulation including reforms in the flagship Companies Act of 1956. A committee headed by Dr. Jamshed Irani, director of Tata Sons Limited was appointed to review the extant corporate law in 2008 and propose a wholesale reform of the law—after all, the then existing Companies Act of 1956 had been on the books for more than five decades till then and appeared out of sync to deal with realities of modern business. The J.J.Irani Committee (as it came to be called) submitted its report (“Report”) in 2012. The Companies Act of 2013 emerged largely from the proposals made in the Report. It is interesting and important to note the major differences brought about in the Companies Act 2013 from the much amended version of the 1956 Act that it replaced in the area of corporate governance. The next section summarizes these key changes in a table. The following section attempts to expound somewhat upon the implications of these changes. The fourth and final section conclude.

II. **The Companies Act, 2013**

The table below tabulates the several reforms introduced by the new companies act in the area of corporate governance, classifying the same either as addition, deletion or modification, to

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¹ Chakrabarti, R. 2005. ‘Corporate Governance In India—Evolution and Challenges’
or from the previous law. The table divides the reforms into several topical heads ranging from auditors, the board of directors, M and A, tribunals and shareholder rights.

[Insert Table Here]

III. A Critique of the Corporate Governance Reforms Under the Companies Act, 2013

This section discusses a few of the changes tabulated above in light of comparable legislation in other countries.

A. Directors: Saliently, the new act defines the concept of “Independent Director”. Previously, clause 49 of the Listing Agreement defined the concept; the definition under the new companies act is stricter than the definition in clause 49. However, the fraud at Satyam Computers teaches us that directorial independence is likely to be compromised by social ties between the promoter/management and the independent director concerned. It is difficult to define all the proxies of independence exhaustively. In this regard, it may be helpful to take a leaf out of jurisprudence emanating from Delaware that distinguishes “independence” from “disinterest” and determines whether a particular director is disinterested, on a case by case basis. In other words, ex post determination (instead of ex ante prescription) of independence, may ensure genuine independence among independent directors.

The new act has incorporated a “limitation of liability” provision for the non-executive directors. Accordingly, a non-executive director will be exempt from liability for any action or omission under the act, unless the action/omission occurred with her knowledge, is attributable to the board process, the board acted with the director’s connivance or the director is negligent. The exemption is a welcome addition; non-executive directors lend their time and expertise to companies without being involved in day-to-day operations of the company. They have to therefore rely on their executive counterparts for information about the affairs of the company. The information asymmetry makes them inefficient bearers of the risk of liability. However, it appears that the protection available under the said provision should also have been extended to actions/omissions of the company, under acts other than the companies act. Anecdotal evidence
suggests that non-executive directors have been prosecuted in the past in cases of cheque bouncing and environmental disasters, without having knowledge of any violation. The absence of protection from prosecution under these laws may inhibit supply of quality expertise to companies on the one hand, and add to the cost of hiring non-executive directors (through enhanced D and O insurance premium, for example) on the other.

The new act also explicitly defines duties of all directors. It obligates the directors to take a stakeholder approach in their decision-making and consider the interests of community, employees, environment along with shareholder in good faith. This explicit mandate marks a shift from a shareholder-centric anglo-saxon model of corporate law to the stakeholder-centric model of corporate law (that some continental economies like Germany) have adopted. The Indian experiment is peculiar in the sense that the stakeholder approach to corporate decision making is nonetheless situated in a unitary board structure that is answerable to the shareholders (members). Germany, for instance, has a two-tier board structure, to account for the stakeholder approach. Furthermore, the new act has stopped short of according explicit procedural rights to either of the stakeholders to enable enforcement of these directorial duties.

Finally, the new act also mandates that boards of certain prescribed companies retain at least one woman director on their roster. Anecdotal evidence after the new act entered into force indicates that some companies are appointing women from the promoter group to comply with the mandate.² A research by Prime Database, a repository for directors, indicates that of the 78 appointments made since the new act (and the Listing Agreement amendments) entered into force and June 30 2014, of which, 25% of the appointments have been from the promoter group itself.

B. Related Party Transactions: The new act mandates that all companies take approval from the board, audit committee as also shareholders (through special resolution) for defined related party transactions over prescribed thresholds. It also prescribes that all related parties

recuse themselves from voting on such resolutions. In other words, the act prescribes a “majority of a minority” approval for related party transactions.

The thresholds for “qualifying related party transactions” (for seeking shareholder approval) are defined as certain percentage of the company’s turnover or net worth. As such, smaller companies are likely to require complying with these provisions more than companies with larger balance sheets. Furthermore, the provisions as drafted apply to all companies, public and private. It appears that there is a business case for exempting private companies from the ambit of these provisions given the unity of ownership and control in the private company structure. Accordingly, the risk of promoter group funneling corporate assets through such transactions is lower in these types of companies.

Finally, the new act has defined the transactions that would constitute “related party transactions” exhaustively. Recent anecdotal evidence however suggests that the defined set of transactions is not comprehensive enough; for instance, Cairn India lent INR 7500 Crores to its parent, Vedanta plc at an extremely low interest rate in July this year. It could do the same without adhering to any of the compliances prescribed in the aforementioned provisions because loan transaction is not a “qualifying” related party transaction within the meaning of law as it stands. (However, LIC in more precision may not necessarily solve the issue since laws will always remain incomplete at the penumbra, and may therefore be “gamed” again.

C. Executive Remuneration: The new act, strikingly, provides that independent directors may not be paid in stock options. It permits them to be paid in profit-linked commissions apart from sitting fees. The proscription on stock options is a departure from the policy hitherto advised or adopted. Both the Narayan Murthy Committee and the clause 49 (as it then stood), were affirmative about compensating the independent directors in stock options. 3

Borrowing from the Dodd-Frank Act, the new Act also mandates disclosure of ratio of directorial compensation and median employee-pay. The provision relies on shame sanctions for

excessive executive compensation and wastage of corporate assets. It may be pointed out however that horizontal agency costs rather than vertical agency costs are a peculiar feature of capitalist systems with concentrated promoter shareholding. In such settings, there is a risk that promoter-shareholder tunnels corporate assets to promoter-owned/controlled vehicles through related party transactions and the like. Excessive compensation is more prominent feature of well developed capitalist systems where the decoupling between ownership and control is sharper and executives impose vertical agency costs on shareholders at large including through excess compensation.  

D. Auditors: Auditor law in the new act incorporates the teachings of accounting fraud at Satyam Computer Services in 2008. PwC failed to monitor and detect fraudulent revenue recognition policies followed by the promoter-management even though the firm audited the accounts for nearly a decade. This had raised concerns about auditor-complicity in the accounting fraud. Arthur Anderson, the erstwhile auditors to Enron Corporation (“Enron”) was similarly impugned for the accounting fraud and the subsequent collapse of Enron. The new act mandates rotation of auditor firms after two consecutive terms of five years each, to mitigate the risk that auditor-independence is compromised on account of either pecuniary consideration or social ties. It provides a “look-back” period of five years before the audit firm can be re-appointed.

E. Mergers and Acquisitions: The new act permits an Indian company to be merged into a foreign company. Hitherto, there was no provision for an Indian company to merge into a foreign company, although it could acquire and merge a foreign company into it. Further, it enables the foreign company to use IDRs as a transaction currency in such a merger. In other words, the Indian shareholders of the merged company may be paid in IDRs as consideration of the merger. Both these measures ought to be welcomed; permitting an Indian company to merge into a foreign company allows the Indian entrepreneurs to exit their business and gain better value for their investments because of a wider universe of potential buyers to choose from. Since the IDRs are derivatives instruments deriving their value from shares of the foreign company and denominated in INR, Indian shareholders of the merged Indian entity are not exposed to any

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4 See supra note 1, pp. 10-11 (writing in similar vein).
currency risk. Finally, IDR are non-dilutive for the shareholders of the foreign surviving company and as such, their shareholding in the foreign company remains identical pre and post transaction.

The new act permits the so-called “shot-gun mergers”—mergers between two or small companies and merger between a parent and its wholly owned subsidiary without any approval from the NCLT 5 thus reducing compliance requirements for transactions where all interests are privately held.

Finally, the new act prescribes a higher threshold for dissenting shareholders' creditors to challenge an arrangement or compromise before the competent tribunal. It prescribes that members shall hold not less than 10% of the outstanding share capital of the company to have any “locus” for objecting the transaction. Likewise, creditors holding not less than 5% of outstanding debt may also challenge the transaction. The higher thresholds prescribed for objecting to an arrangement mitigates the risk that hold-outs without having adequate “skin in the game” obstruct a transaction beneficial to all the shareholders concerned.

F. Class Action Rights: The new act strikes a significant blow for the cause of shareholders by empowering them with class action rights. Accordingly, not less than 100 members (if the company has share capital) and not less than 20% of members (if the company does not have share capital) may file an application at the National Company Law Tribunal (“NCLT”) for a host of reliefs including preventing the company from acting ultra vires its constituent documents, from breaching its constituent documents, preventing the company from acting in violation of a resolution and claiming damages/compensation from directors, auditors and consultants for any breach of duty on the latter’s part to the company, if they are of the opinion that the affairs of the company are being conducted in a manner prejudicial to the company or its members. The new act also symmetrically empowers depositors of a company.

The substantive trigger for a class action suit is the opinion that “affairs of the company are being conducted in a manner prejudicial to the company or members”; this language borrows

5 Approval from the Registrar of Companies, Official Liquidator, shareholders holding not less than 90% of the outstanding equity shares and 90% in value of the bond holders is required.
from Section 241 of the new act that empowers members to move the NCLT on account of oppression. Section 241 is similar to Section 397 of the Companies Act, 1956. Jurisprudence related to Section 397 teaches us that for cause to arise under the erstwhile section 397, the majority shareholders shall have acted wrongfully towards the minority shareholders qua shareholders, for a continuous period, leading up to the application.\(^6\)

It appears that this threshold would apply to class action litigation given the similarity in language and will therefore impose a higher burden of proof on the class of shareholders moving the tribunal. The deterrence sought to be achieved by the procedural remedy is likely to be muted given the higher burden of proof imposed by the language. However, inclusion of class action remedy mitigates the “collective action dilemma” that would occur in the absence of such provision, where no member moves the judicial authority to enforce their collective rights owing to, concentrated costs and diffuse benefits of such recourse.

G. **Tribunals and Authorities:** The new act also establishes a new statutory framework to replace the High Court and the Company Law Board under the previous regime. It has constituted the NCLT and its appellate authority that will perform the tasks and exercise the powers the High Court and the Company Law Board exercised in the previous regime. The new regulatory apparatus is empowered under the new law to adjudicate issues arising out of oppression and mismanagement, approve schemes of merger and other arrangements between shareholders/ creditors et al. Sections 407 through 434 of the new act deal with the NCLT and the appellate authority. The NCLT shall have a President, Judicial and Technical Members. The President shall have been a judge of the High Court for five years; the Judicial Members shall have either been, advocate having experience of not less than a decade, a judge of the district court for not less than half a decade or a judge of a high court of not less than half a decade. The members of the Tribunal (and the technical members of the appellate tribunal) are to be chosen by a committee consisting of 3 bureaucrats and 2 Judges. The Madras Bar Association has filed a writ petition in the Supreme Court alleging that the provisions of the new act related to the NCLT are ultra vires the directions of the Supreme Court regarding design of such tribunals.\(^7\)

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\(^6\) S.P. Jain v. Kalinga Tubes AIR 1965 SC 1535  
\(^7\) Union of India v. R. Gandhi [2010] 6 S.C.R.
The Serious Fraud Investigation Office and the NFRA are the other investigative/regulatory established under the new act. The NFRA, established pursuant to Section 132 of the new act, shall make recommendations to the central government on the formulation of and laying down of accounting and auditing policies and standards. It is further empowered to monitor and enforce compliance with the accounting standards, oversee the quality of service provided by auditors and accountants etc. The Central government has the discretion of consulting with and examining the recommendations made by the NFRA, before prescribing the standards recommended by the Institute of Chartered Accountants of India.

The SFIO will have the competence to investigate frauds relating to the company. The establishment of SFIO gives the central government the option of entrusting investigation into the affairs of a company, to the SFIO. The SFIO will comprise of experts including from the field of banking, corporate affairs, taxation, forensic audit and as such, is empowered to investigate complex cases of fraud, capacity whereof, is not otherwise available to regular enforcement authorities.

IV. Conclusion

The new Companies Act is a major step towards updating what could be called the keystone of corporate governance and investor protection in India. It reflects and regularizes several developments that have gradually emerged in the country and the world of financial markets and corporate governance and necessitated the modernization. Like all other laws before it and since, it has its critics and will certainly undergo inevitable changes and revisions, but its enactment does epitomize a significant step in corporate governance in the country.