ISSN: 0976-0369 VOL.4 NO.1 YEAR 2021

JOURNAL ON GOVERNANCE

[Volume 4, Issue 1]

Special Edition on Corporate Law and Governance

Theme: "Winds of Change in the Corporate Governance Regime: Looking Towards a New Horizon"

ARTICLES

- Debkanya Naskar, *Regulating Proxy Advisory Firms in India.*
- Himani Shah, *Independent Directors: Watchdogs of the Company?*
- Aman Raj Singh Bajwa and Anushka Agrahar Murugkar, *Bursting the Bubble of Corporate Governance: Attempting to Understand the Lacunae in Special Courts.*
- Parnika Sharma, *Reconfiguring Stakeholder-Oriented Directors' Duties as under Section 166(2) of the Indian Companies Act 2013: The Bedrock of Corporate Governance.*
- Jayadeep Manchikalapudi and Anomitra Debnath, *Making the legal case for ESG Investing.*
- Naman Devpura and Varnik Yadav, *Mergers and Acquisitions Transactions: Impact of Shareholder Activism on Corporate Governance.*

A NATIONAL LAW UNIVERSITY PUBLICATION

VOLUME 4 ISSUE 1

Journal on Governance

PATRON

PROF. (DR.) POONAM PRADHAN SAXENA, VICE CHANCELLOR

CHIEF EDITOR

DR. MANOJ KUMAR SINGH

ASSOCIATE PROF., NATIONAL LAW UNIVERSITY, JODHPUR

STUDENT EDITORIAL BOARD

EDITORS-IN-CHIEF

NIHARIKA JAISWAL SURAJ SONOWAL

EXECUTIVE EDITOR

AYUSH KHANDELWAL

MANAGING EDITOR

ASHUTOSH ARVIND KUMAR

SENIOR CONTENT EDITORS

GEORGE CYRIAC KRISHAN SINGHAL SHUBHAOJHA

ASSOCIATE EDITORS

RISHABH KUMAR AYUSHI SUMAN CHAARU GUPTA

SHREYA RAJASEKARAN VEDAANT AGARWAL

COPY EDITORS

SAURAV THAMPAN DIVYA SHARMA NANDINI KAUSHIK

OJASAV CHITRANSHI RISHABH PERIWAL

VOLUME 4 ISSUE 1

Journal on Governance

TABLE OF CONTENTS

Regulating Proxy Advisory Firms In India

Debkanya Naskar 1

Independent Directors: Watchdogs Of The Company?

Himani Shah 32

Bursting The Bubble Of Corporate Governance: Attempting To Understand The Lacunae In Special Courts

Aman Raj Singh Bajwa and *Anushka Agrahar Murugkar* 72

Reconfiguring Stakeholder-Oriented Directors' Duties As Under Section 166(2) Of The Indian Companies Act 2013: The Bedrock Of Corporate Governance

Parnika Sharma 88

Making The Legal Case For Esg Investing

Jayadeep Manchikalapudi and *Anomitra Debnath* 122

Mergers And Acquisitions Transactions: Impact Of Shareholder Activism On Corporate Governance

Naman Devpura and *Varnik Yadav* 153

REGULATING PROXY ADVISORY FIRMS IN INDIA

Debkanya Naskar[*]

ABSTRACT

The advent of proxy advisors, a decade ago, had barely created any ripples in the Indian corporate waters. Proving otherwise to their critics, proxy advisors have managed to cement their place in the Indian corporate governance agenda through their aggressive push for better governance standards. The growth of proxy advisors denotes a paradigm shift in the approach of making management answerable to minority shareholders. However, given the nature of the task, strife with management and the existence of conflicting interests is inherent. In 2020, SEBI issued circulars directing the development of proxy advisors, who were earlier governed under the broader framework for research analysts. This article analyses the potential impact of the circulars on various stakeholders. The author argues that the circulars have adopted a light-touch approach and has left room for market forces to standardise business practices overtime, instead of being overtly prescriptive. The question whether the safeguards and mechanisms provided under the circulars will be effective in addressing the friction between proxy advisors and management will depend on how the circulars are implemented going forward.

[*] The author is a Master of Laws (LL.M.) candidate at New York University, specializing in Corporations. She is a graduate of the National University of Juridical Sciences, Kolkata and has worked with Cyril AmarchandMangaldas, Mumbai and Institutional Investor Advisory Services, Mumbai in the past.

I. INTRODUCTION

The last decade has witnessed proxy advisory firms (PAFs) finding their foothold in the Indian corporate governance agenda.[1] Providing voting recommendations on shareholders' voting items of listed companies is one of their key functions, and institutional investors are their primary clients.[2] Apart from voting advisory, certain PAFs also offer a heterogeneous mix of corporate governance-related consultancy and advisory services in addition to advocating towards better governance standards.[3] The Securities and Exchange Board of India (SEBI) has been proactive in directing development of the PAF industry practices.[4] Recently, SEBI issued circulars on '*Procedural Guidance for Proxy Advisors*' and '*Grievance Resolution between listed entities and proxy advisers*', which are proposed to become applicable from January 1, 2021, apart from certain key

---

[1] Nisha Poddar, *Big Deal: India is witnessing a new era of shareholder activism, says Cyril Shroff of Cyril Amarchand Mangaldas*, CNBCTV18 (Nov. 11, 2020, 5.40 P.M.), https://www.cnbctv18.com/economy/big-deal-india-is-witnessing-a-new-era-of-shareholder-activism-says-cyril-shroff-of-cyril-amarchand-mangaldas-4042621.htm [hereinafter Nisha Poddar].

[2] Working Group on Issues of Proxy Advisors, *Working Group's Report on Issues Concerning Proxy Advisors*, SECURITIES AND EXCHANGE BOARD OF INDIA, 27 (2019), https://www.sebi.gov.in/reports/reports/jul-2019/report-of-working-group-on-issues-concerning-proxy-advisors-seeking-public-comments_43710.html[hereinafter 2019 Report].

[3] Priya Garg, *Ripple, If Not The Waves Effect: Analysing The Way(S) In Which Proxy Advisory Firms Can Affect Corporate Governance In India, In The 'Long Run'*, 5 NAT'L L.U. DELHI STUD. L. J. 111 (2018), 112 (2018), https://nludelhi.ac.in/download/publication/2018/NLUD%20SLD-Vol.5(2018).pdf. [hereinafter Priya Garg]

[4] *Consultation Paper on Proposed Regulation of Research Analysts*, SECURITIES AND EXCHANGE BOARD OF INDIA, 5, 7 (2013), https://www.sebi.gov.in/sebi_data/attachdocs/1385713647782.pdf.

procedural formalities which are applicable from February 1, 2021.[5] The article will collectively refer to the circular and the modifications issued thereto as 'Circulars'.[6]

The goal of this article is to analyse the terms of the Circulars and their potential impact on various stakeholders. However, before delving into the analysis of the Circulars in Section IV, to put things into context, Section II of the article will elaborate on the performance of PAFs in India in the past decade; and Section III will trace the evolution of the existing regulatory framework governing PAFs and the factors which lead to SEBI issuing the Circulars.

---

[5] *Procedural Guidelines for Proxy Advisors*, (Aug. 3, 2020), SEBI/HO/IMD/DF1/CIR/P/2020/147, https://www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors_47250.html(hereinafter Procedural Guidelines Circular); *Grievance Resolution between listed entities and proxy advisers*, (Aug. 4, 2020), SEBI/HO/CFD/CMD1/CIR/P/2020/119, https://www.sebi.gov.in/legal/circulars/aug-2020/grievance-resolution-between-listed-entities-and-proxy-advisers_47252.html (hereinafter Grievance Resolution Circular). *'Procedural Guidelines for Proxy Advisors' – Extension of implementation timeline*, (Aug. 27, 2020), SEBI/HO/IMD/DF1/CIR/P/2020/157, https://www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors-extension-of-implementation-timeline_47412.html (hereinafter Procedural Guidelines Extension Timeline); *'Grievance Resolution between listed entities and proxy advisers' – Extension of timeline for implementation*, (Aug. 27, 2020), SEBI/HO/CFD/CMD1/CIR/P/2020/159, https://www.sebi.gov.in/legal/circulars/aug-2020/-grievance-resolution-between-listed-entities-and-proxy-advisers-extension-of-timeline-for-implementation_47424.html (hereinafter Grievance Resolution Extension Timeline). *'Procedural Guidelines for Proxy Advisors*, (Dec. 31, 2020), SEBI/HO/IMD/DF1/CIR/P/2020/256, https://www.sebi.gov.in/legal/circulars/dec-2020/procedural-guidelines-for-proxy-advisors_48633.html(hereinafter Modification Circular).

[6] Procedural Guidelines Circular, Grievance Resolution Circular, Procedural Guidelines Extension Timeline, Grievance Resolution Extension Timeline and Modification Circular are collectively referred to as Circulars.

For the purpose of this article, the author is assuming that encouraging growth of PAFs as corporate governance intermediaries will lead to implementing better corporate governance standards.[7] Further, the author is also assuming that increasing institutional ownership and their role in the burgeoning Indian capital markets as active participants of corporate decision-making is encouraged.[8] Given that there is sufficient literature[9] justifying the basis for these assumptions, the article will not be addressing them, except in relation to evaluating PAF performance in Section II of this article.

II. SETTING THE CONTEXT: PERFORMANCE REPORT 2010-2020

The first domestic PAF was set up in 2010.[10] Currently, there are three home-grown[11] and several global PAFs (out of which two

---

[7] *See* Umakanth Varottil, *The Advent of Shareholder Activism in India*, 602 (2012), 1(6) J. OF GOVERNANCE; Michael Cappucci, *The proxy war against proxy advisors*, 16(3) N.Y.U. J. L. & BUS. 579, 580-632 (2020) [hereinafter Cappucci]; Cyril Shroff, *Corporate Governance & Shareholder Activism*, INDIA CORPORATE LAW (Apr. 16, 2016), https://corporate.cyrilamarchandblogs.com/2016/04/corporate-governance-shareholder-activism/#more-1867[hereinafter Cyril Shroff].

[8] *See* Umakanth Varottil, *Shareholder Stewardship in India: The Desiderata*, NUS LAW WORKING PAPER SERIES 2020/005, (2020),http://law.nus.edu.sg/wps/ [hereinafter Umakanth Varottil]; P. Krishna Prasanna & Anish S Menon, *Corporate Governance and stock market liquidity in India*, I NT'L J. BEHAVIOURAL ACCNT'G. & FIN., (2011), https://ssrn.com/abstract=1735808; Manjit Kaur Sidhu, *Corporate Governance and Stock Market Liquidity*, 5(3) J. Com. & ACCNT'G R., (2016).

[9] *Id.*

[10] *See* S. Subramanian, *Proxy Advisory Industry in India*, 13(2) CORPORATE OWNERSHIP & CONTROL, 371-378 (2016), https://www.virtusinterpress.org/IMG/pdf/10-22495_cocv13i2cLp5.pdf;

have significant presence in India and one of them is registered with SEBI)[12], which are active in India. While offering voting advisory is a common thread, the business model followed and the service offered by them are not homogenous.[13]

After the initial skepticism,[14] the stakeholders have gradually started acknowledging the influence of PAFs.[15] Over the span of the last decade, the sphere of coverage of PAFs has expanded.[16] Further, given the nature of their engagement, PAFs often find themself in a unique position where their recommendations have the potential to influence the dispersed institutional investors' vote. Additionally, earlier, given the minority stake held by most institutional investors, they preferred to follow the equivalent to the 'Wall Street Rule',[17] where they either voted with the management or abstained from voting.[18] However, as has been demonstrated in

---

[11] *See* INGOVERN, http://www.ingovern.com/ (Nov. 11, 2020); INSTITUTIONAL INVESTOR ADVISORY SERVICES (IIAS), https://www.iiasadvisory.com/ (Nov. 11, 2020); and STAKEHOLDERS EMPOWERMENT SERVICES (SES), https://www.sesgovernance.com (Nov. 11, 2020).

[12] 2019 Report, *supra* note 2.

[13] 2019 Report, *supra* note 2.

[14] N. Sundaresha Subramanian & Sudipto Dey, *Proxy firms lead change in governance framework*, BUSINESS STANDARD (Ju. 9, 2015),https://www.business-standard.com/article/markets/proxy-firms-lead-change-in-governance-framework-115070900757_1.html [hereinafter N. Sundaresha Subramanian & Sudipto Dey].

[15] Nisha Poddar, *supra* note 1.

[16] For example, IiAS claims to have covered more than 800 companies and issued more than 47,000 recommendations, https://www.iiasadvisory.com/ (Nov. 11, 2020).

[17] Cappucci, *supra* note 7.

[18] Institutional Investor Advisory Services, *Institutional Investors: Growing heft*, INSTITUTIONAL EYE, (Feb 17, 2020) https://docs.wixstatic.com/ugd/91c61f_374047565b594007a83e9dae9d832aee.pdf.

recent literature,[19] India is witnessing a gradual shift in institutional investors' involvement: i.e. from opting from a 'Wall Street Walk'[20] approach to actively participating in decision making.[21] The enhanced role of institutional investors can be argued to have contributed to the relevance of PAFs' recommendations.

Without delving into granular details, some of the factors which have led to this shift towards institutional investors playing a greater role include, *inter alia*, the following:

(i) Increase of institutional ownership from about 22% to about 35% in the last 12 years;[22]

(ii) Stewardship obligation being imposed on fund managers *(SEBI introduced a consolidated stewardship code in India effective from 2020,[23] however Insurance Regulatory and Development*

[19] Umakanth Varottil, *supra* note 8.
[20] Institutional Investor Advisory Services, *India's progress on the Corporate Governance agenda: An* overview, INSTITUTIONAL EYE, (Nov. 11, 2020), https://mcusercontent.com/ad513546cf36ede008c1097c7/files/4c2cdc3d-d866-4a5b-ba52-86e919f5dc84/ICGN_IndiaTalkingPoints_HetalDalal_11Nov2020.pdf [hereinafter Institutional Investor Advisory Services].
[21] Cyril Shroff & Amita Katragadda, *India Corporate Governance Laws and Regulations 2020*, ICLG (Nov. 11, 2020, 5.45 P.M.), https://iclg.com/practice-areas/corporate-governance-laws-and-regulations/india.
[22] Institutional Investor Advisory Services, *supra* note 20.
[23] *Stewardship Code for all Mutual Funds and all categories of AIFs, in relation to their investment in listed equities*, (Dec. 24, 2019), CIR/CFD/CMD1/ 168 /2019, https://www.sebi.gov.in/legal/circulars/dec-2019/stewardship-code-for-all-mutual-funds-and-all-categories-of-aifs-in-relation-to-their-investment-in-listed-equities_45451.html; *Extension of deadline for implementation of the circular on Stewardship Code for all Mutual Funds and all categories of AIFs due to the CoVID-19 pandemic*, (Mar. 30, 2020), SEBI/HO/CFD/CMD1/CIR/P/2020/55, https://www.sebi.gov.in/legal/circulars/mar-2020/extension-of-deadline-for-

Authority of India,[24] *Pension Fund Regulatory and Development Authority*[25] *and SEBI (for mutual funds)*[26] *had issued guidelines in line with stewardship and fiduciary obligations in 2017, 2018 and 2010, respectively)*;

(iii) Ease of access to corporate information and voting facilities;[27] and

(iv) A requirement of majority of minority approval for certain items which have notable impact on corporate governance.[28]

These factors noted above, among other things, can be argued to have cumulatively led to institutional investors, and consequently their advisors, PAFs, acquiring a significant role in Indian corporate decision-making.

---

implementation-of-the-circular-on-stewardship-code-for-all-mutual-funds-and-all-categories-of-aifs-due-to-the-covid-19-pandemic_46451.html.

[24] *See Guidelines on Stewardship Code for Insurers in India,* (Mar. 22, 2017), Ref. No: IRDA/F&A/GDL/CMP/059/03/2017, https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo3096&flag=1; *Revised Guidelines on Stewardship Code for Insurers in India*, (Feb. 7, 2020), Ref. No:IRDAI/F&A/GDL/CPM/045/02/2020,https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo4045&flag=1.

[25] *See Common Stewardship Code*, (May 4, 2018), PFRDA/2018/01/PF/01, https://www.pfrda.org.in/writereaddata/links/circular-%20common%20stewardship%20code%2004-05-186ec9a3b4-566b-4881-b879-c5bf0b9e448a.pdf.

[26] *See Circular for Mutual Funds*, SEBI/IMD/CIR No 18/198647/2010 (15 March 2010), https://www.sebi.gov.in/legal/circulars/mar-2010/circular-for-mutual-funds_2019.html.

[27] Priya Garg, *supra* note 3.

[28] Sachin P. Mampatta, *Small Guys Can Punch above Their Weight*, BUSINESS STANDARD (Jul. 29, 2014), http://www.business-standard.com/article/markets/small-guys-can-punch-above-theirweight-114082901000_1.html.

Given the nature of the role played by PAFs, their success stories are not evident.[29] One probable rationale could be that given the stewardship obligation of fund managers, glorifying or advertising their excessive reliance on PAFs may raise allegations of 'lazy stewardship'.[30] Therefore, while ample evidences of institutional investors defeating resolutions are available in the public domain,[31] empirical evidence[32] of instances where such a decision was influenced by PAF recommendation is not easily available in India. This has made it difficult to analyse the areas of governance where PAFs hold a significant say.

Nevertheless, on the basis of some of the notable reported instances, it can be deduced, although at the risks of generalising and confusing coincidence with co-relation, that PAFs may have impacted the following areas of governance in India in the last decade:

(i) Related party transactions (including payment of royalty)

---

[29] 2019 Report, *supra* note 2.
[30] *Outsourcing corporate governance – Are proxy advisors measuring up to expectations?*, NSE-ECGI ROUNDATBLE ON LONG TERM IMPACT OF INSTITUTIONAL OWNERSHIP ON GOVERNANCE AND SUSTAINABLE INVESTMENT (Nov. 13, 2017), https://archives.nseindia.com/products/resources/download/NSE_ECGI_Mumbai_roundtable_report_2017.pdf.
[31] Pawan Burugula, Rajesh Mascarenhas & Prashant Mahesh, *Vocal FIIs give company managements a tough time*, THE ECONOMIC TIMES (Aug. 26, 2020), https://economictimes.indiatimes.com/markets/stocks/news/vocal-fiis-stall-appointment-of-underperforming-directors/articleshow/77753995.cms.
[32] 2019 Report, *supra* note 2.

Examples: (i) Nestle India Limited's initial proposal to seek approval for payment of royalty in perpetuity was revised to a fixed time frame after PAFs and investors expressed reservations (2019);[33] *(ii) Raymond Limited's proposal in relation to sale of immovable property to a related party was defeated (2017);*[34] *and (iii) United Spirits Limited – Diagio' proposal to ratify related party transactions with entities associated with then Chairman Vijay Mallya was questioned (2014).*[35]

(ii) Director (including independent director) appointments and re-appointments

Examples: (i) Lakshmi Vilas Bank (2020);[36] *(ii) HDFC Limited (2018);*[37] *(iii) Infosys Limited (2017);*[38] *(iv) Raymond Limited (2017);*[39] *and (v) IDFC Limited (2017).*[40]

---

[33] Institutional Investor Advisory Services, *Royalty payments: Too early to take your eyes off* INSTITUTIONAL EYE, (Feb. 20, 2020), https://docs.wixstatic.com/ugd/6e1ce5_1feca2706ded4c64b8095ddc19834143.pdf.

[34] *LIC reduces stake in Raymond by 2.01%*, BLOOMBERG QUINT(Sept. 6, 2017), https://www.bloombergquint.com/markets/2017/09/06/lic-reduces-stake-in-raymond-by-201.

[35] N. Sundaresha Subramanian & Jayshree P. Upadhyay, *United Spirits' private deals come into question*, BUSINESS STANDARD (Nov. 3, 2014), https://www.business-standard.com/article/companies/united-spirits-private-deals-come-into-question-114112200823_1.html.

[36] Atmadip Ray, *Lakshmi Vilas Bank directors lacked accountability: Advisory firm*, THE ECONOMIC TIMES (Sept. 27, 2020), https://economictimes.indiatimes.com/markets/stocks/news/lakshmi-vilas-bank-directors-lacked-accountability-advisory-firm/articleshow/78345414.cms.

[37] *Foreign proxy advisory firms need domestic regulation: Uday Kotak*, THE ECONOMIC TIMES (Aug. 7, 2018), https://economictimes.indiatimes.com/news/company/corporate-trends/foreign-proxy-advisory-firms-need-domestic-regulation-uday-kotak/articleshow/65300546.cms.

(iii) Executive remuneration

Examples: (i) Apollo Tyres Limited (2018);[41] *(ii) ITC Limited (2017);*[42] *(iii) Tata Motors Limited (2014-2015);*[43] *and (iv) HCC Limited (2014-2015).*[44]

(iv) Transactions impacting long term interest of the company/minority shareholder's interest

Examples: (i) Payment of non-compete fees to Max Financial in relation to the HDFC Life and Max Financial merger (2016);[45] *(ii) Crompton Greaves Limited restructuring (2014-2015);*[46] *(iii) Maruti-Suzuki's proposal for procuring parts from related party, instead of captive manufacture*

---

[38] Anand Adhikari, *The lone wolf*, BUSINESS TODAY (Feb. 25, 2018), https://www.businesstoday.in/magazine/the-hub/the-lone-wolf/story/269874.html [hereinafter Anand Adhikari].
[39] *Id.*
[40] *Id.*
[41] *Victory for minority shareholders in Apollo Tyres: Kanwars to take a 30% salary cut*, FINANCIAL EXPRESS (Nov. 14, 2018), https://www.financialexpress.com/industry/victory-for-minority-shareholders-in-apollo-tyres-kanwars-to-take-a-30-cut-in-salary/1381109/.
[42] Anand Adhikari, *supra* note 38.
[43] N. Sundaresha Subramanian & Sudipto Dey, *supra* note 14.
[44] *HCC recovers chairman's 'excess' salary*, BUSINESS STANDARD (May 1, 2015), https://www.business-standard.com/article/companies/hcc-recovers-chairman-s-excess-salary-115043000791_1.html.
[45] Anand Adhikari, *supra* note 38.
[46] Rajesh Mascarenhas, *Minority shareholders increasingly having a say in key decisions of companies*, THE ECONOMIC TIMES (Feb. 26, 2015), https://economictimes.indiatimes.com/markets/stocks/news/minority-shareholders-increasingly-having-a-say-in-key-decisions-of-companies/articleshow/46377944.cms?from=mdr.

(2014-2015);[47] *(iv) Azko-Nobel's restructuring (2012);*[48] *and (v) Sesa-Sterlite restructuring (2012).*[49]

It is pertinent to note that PAFs have not been spared the ire of Indian management and have faced severe backlash, often from the impugned management. For example, ITC Limited filed a Rs. 1000 crore defamation suit against Institutional Investor Advisory Services for statements made against the company and its management in 2017.[50] In 2018, Mr. Uday Kotak, a veteran banker and Chairman of the Committee of Corporate Governance, SEBI,[51] highlighted the need for regulation of foreign PAFs in India, after such PAFs, applying standards more stringent than applicable laws, voted against the appointment of another veteran banker Mr. Deepak Parekh on the board of HDFC Ltd.[52]

---

[47] Cyril Shroff, *supra* note 7.

[48] N. Sundaresha Subramanian & Sudipto Dey, *supra* note 14.

[49] *Shareholder activism in India*, INGOVERN, http://www.ingovern.com/2015/02/shareholder-activism-in-india/.

[50] ITC Ltd. v. Institutional Investor Advisory Services, High Court of Calcutta, GA No.4075 of 2017; *See also,* Sundaresh Subramanian, *Should SEBI Save Analysts From Their Subjects?*, BUSINESS STANDARD (Sept. 12, 2017), https://www.pressreader.com/india/business-standard/20170912/281981787749511.

[51] *Report of the Committee on Corporate Governance* (Oct. 5, 2017), https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html.

[52] Sajeet Manghat, *Uday Kotak Wants India To Regulate International Proxy Advisers*, BLOOMBERG QUINT (Aug. 6, 2018), https://www.bloombergquint.com/business/uday-kotak-wants-india-to-regulate-international-proxy-advisers [hereinafter Sajeet Manghat].

III. SETTING THE CONTEXT: EVOLUTION OF REGULATIONS GOVERNING PAFS IN INDIA

PAFs are primarily regulated by SEBI under the SEBI (Research Analysts) Regulations, 2014 (RA Regulations).[53] Their conduct may also bring them under the purview of other securities market regulations like regulations against insider trading, prevention of fraudulent and unfair trade practices etc. For the purpose of this article, the author will only focus on the evolution of the RA Regulations and the subsequent Circulars issued thereunder.

In the backdrop of the then persisting global financial crisis of 2008, role of research analysts, particularly sell-side analysts and credit rating agencies, was brought to scrutiny.[54] With the objective of setting international standards for financial market intermediaries, an action plan to implement the 'Common Principles for Reform of Financial Markets' was proposed at the Washington G20 Summit in

---

[53] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, https://www.sebi.gov.in/sebi_data/commondocs/RESEARCHANALYSTS-regulations_p.pdf (Nov. 11, 2020) (hereinafter RA Regulations); *See also*, *Frequently Asked Questions – SEBI (Research Analysts) Regulations, 2014,* https://www.sebi.gov.in/sebi_data/faqfiles/jan-2017/1485860192812.pdf (Nov. 11, 2020).

[54] *Plan of Actions for Compliance To Eight New IOSCO Objectives and Principles of Securities Regulation*, SEBI Board Meeting Agenda (Jul. 28, 2011), https://www.sebi.gov.in/sebi_data/meetingfiles/1313055313828-a.pdf (hereinafter IOSCO POA); *See also,* SEBI Board Meeting Decision (Jul. 28, 2011), https://www.sebi.gov.in/sebi_data/meetingfiles/1323341185009-d.pdf.

2008,[55] which called for a review of the functioning of such intermediaries. International Organization of Securities Commissions (IOSCO), in collaboration with Basel Committee on Banking Supervision and the International Association of Insurance Supervisors, was tasked with the said responsibility and their recommendations were reported in 'Differentiated Nature and Scope of Financial Regulation'.[56] This report, among other things, recommended that the core principles of the global securities market, codified under the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles), be reviewed to ensure addressal of systemic risks.[57] Accordingly, one of the key agendas was the scrutiny of the role of entities that offer investors analytical or evaluative services, and the strengthening of a mechanism to address the inherent conflict of interest.[58] It is pertinent to note that PAFs were not specifically a subject matter of the discussions; rather the focus was on the conduct of sell-side analysts, whose risk of being conflicted was concluded to be significant. The revised IOSCO Principles was approved at the IOSCO 2010 Annual

---

[55] *Declaration Summit on Financial Markets and The World Economy*, G-20 2 (Nov. 15, 2008), https://g20.org/en/g20/Documents/2008-Washington-Declaration%20of%20the%20Summit%20on%20Financial%20Markets%20and%20the%20World%20Economy.pdf.

[56] International Organization of Securities Commissions, Basel Committee on Banking Supervision & International Association of Insurance Supervisors, *Review of the Differentiated Nature and Scope of Financial Regulation Key Issues and Recommendations* (Jan. 2010), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD315.pdf [hereinafter 2010 Report]; IOSCO POA, *supra* note 54..

[57] 2010 Report, *supra* note 56.

[58] IOSCO POA, *supra* note 54.

Conference.[59] Principle 23 which stated that "*other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them*"[60] was introduced, which thereafter became the genesis of regulations applicable to research analysts, including PAFs.

SEBI undertook a self-assessment exercise to ensure compliance with the new IOSCO Principles.[61] On the basis of such exercise, it concluded that there was a regulatory gap when it came to regulation of research analysts and the same should be put in place.[62] The same conclusion was arrived at the November 5, 2012 meeting of the International Advisory Board of SEBI as well.[63] Again, the primary concern at this stage continued to be issues in relation to conflict of interest of analysts like sell-side analysts; and PAFs were not a matter of concern. This is likely because in 2011-2012, with domestic PAFs having set up shop only in 2010, considering regulating PAFs would have been premature.

---

59 Media Release OICU-IOSCO, *Global securities regulators adopt new principles and increase focus on systemic risk*, IOSCO/MR/10/2010 (Jun. 10, 2020), https://www.iosco.org/news/pdf/IOSCONEWS188.pdf.

60 OICU-IOSCO, *Objective and Principles of Securities Regulations*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf (Nov. 11, 2020).

61 IOSCO POA, *supra* note 54.

62 IOSCO POA, *supra* note 54.

63 Press Release, International Advisory Board of SEBI PR No.: 93/201293/2012 (Nov. 5, 2012), https://www.sebi.gov.in/media/press-releases/nov-2012/international-advisory-board-of-sebi-meets-at-mumbai_23712.html.

SEBI issued the 'Consultation Paper on Proposed Regulation of Research Analysts' along with draft RA Regulations for public comments in November 2013.[64] PAFs, as a category of entity publishing research reports, was recognised categorically and was sought to be brought under the umbrella of the RA Regulations. This approach of SEBI was a deviation from the 'comply or explain' model being followed by most foreign securities market regulators at that time.[65] It was, however, proposed that PAFs would not be required to be registered with SEBI, unless they made their recommendations through public media.[66]

Subsequently, the RA Regulations came into force on September 1, 2014.[67] It defined PAFs as "*any person who provide advice, through any means, to institutional investor or shareholder of a company, in relation to exercise of their rights in the company including recommendations on public offer or voting recommendation on agenda items*"[68] and became the primary regulation for PAFs in India. Deviating from its initial proposal, SEBI put in place a mechanism for registration of PAFs. This requirement of mandatory registration has been argued by some, to

---

[64] *Consultation Paper on Proposed Regulation of Research Analysts*, SECURITIES AND EXCHANGE BOARD OF INDIA (2013), https://www.sebi.gov.in/sebi_data/attachdocs/1385713647782.pdf (hereinafter RA Consultation Paper); *See also,* Press Release, PR No. 114/2013 (Nov. 29, 2013), https://www.sebi.gov.in/sebi_data/docfiles/26869_t.html.
[65] RA Consultation Paper, *Id.*
[66] RA Consultation Paper, *Id.*
[67] RA Regulations, *supra* note 53.
[68] RA Regulations, Reg. 2 (p), *supra* note 53.

be a stamp of their legitimacy, especially in the Indian market where they are being pitted against Indian Goliathic listed company managements.[69] As per the RA Regulations, PAFs are obligated to follow the same standards as applicable to other research analysts (the provisions having been made applicable *mutatis mutandis* to PAFs), in addition to certain incremental diktats.[70] These include regulations relating to quality control (for example: standard of skill of analysts;[71] disclosure of research methodology;[72] record keeping of recommendations[73] etc.) and capital adequacy requirements.[74]

This article will not delve into a critique of the RA Regulations as the same has been discussed exhaustively in existing literature,[75] other than as may be necessary to analyse the Circulars. Nevertheless, it is pertinent to bear in mind that treatment of PAFs at par with other research analysts leads to a situation where the regulations are not tailored to suit the business requirements of PAFs. This one-size-fits-all approach leads to the stakeholders involved facing several issues.[76] Such issues drew public[77] as well as

---

[69] Nisha Poddar, *supra* note 1.
[70] RA Regulations, Regs. 23 & 24, *supra* note 53.
[71] RA Regulations,Reg 23(1), *supra* note 53.
[72] RA Regulations,Reg 23(2), *supra* note 53.
[73] RA Regulations,Reg 23(3), *supra* note 53.
[74] RA Regulations,Reg 23(1), *supra* note 53.
[75] Priya Garg, *supra* note 3.
[76] 2019 Report, *supra* note 2.
[77] Sajeet Manghat, *supra* note 52. *See also,* Souvik Ganguly & Aman Bagaria*, Why proxy advisors will assume greater significance in coming years*, VCCCIRCLE (Oct. 19, 2020),

SEBI's attention since the PAFs started assuming a greater role. To address these issues, SEBI set up a working committee under the helm of Mr. Sandeep Parekh, which issued its report on issues concerning PAFs in 2019 (2019 Report),[78] and thereafter to implement such recommendations from the 2019 Report, the Circulars[79] were issued. Coincidently, these developments are in tandem with comparable regulatory efforts of Securities Exchange Commission (SEC), even though, the causal factors may not be similar.[80]

IV. ANALYSIS: POTENTIAL IMPACT OF THE CIRCULARS ON RELEVANT STAKEHOLDERS

The 2019 Report analysed the business model of PAFs and addressed the issues being raised by PAFs and stakeholders i.e. listed companies and clients of PAFs, including institutional investors.[81] While highlighting the nascency of PAFs in India, the report stressed on not imposing such restrictions, which will either curtail existing competition or deter new entrants to the proxy advisory

---

https://www.vccircle.com/why-proxy-advisors-will-assume-greater-significance-in-coming-years.

[78] 2019 Report, *supra* note 2.

[79] *Supra note* 5.

[80] Cappucci, *supra* note 7; U.S. Securities and Exchange Commission Press Release, *SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information* (Jul. 2020), https://www.sec.gov/news/press-release/2020-161.

[81] 2019 Report, *supra* note 2.

industry.[82] While the 2019 Report prescribed business practices which will address conflicting concerns (particularly, in relation to quality of disclosures), the sole legal amendment it recommended to SEBI was inclusion of the provision for a grievance redressal mechanism.[83] In light of the 2019 Report, SEBI issued the Circulars.[84] The impact of the Circulars on the relevant stakeholders is discussed below:

A. IMPACT ON PAFS[85]

1. Applicability

The Circulars are unclear regarding their applicability to foreign PAFs. Currently, apart from the requirement of entering into an agreement with a SEBI registered research analyst,[86] a foreign PAF is not required to be registered under the RA Regulations. Given that the Circulars are issued under the RA Regulations, it can be argued that these Circulars will not be binding on foreign PAFs. This approach is consistent with the 2019 Report, which recommended that SEBI should put in place a non-binding code of conduct for foreign PAFs, instead of subjecting them to

[82] 2019 Report, *supra* note 2.
[83] 2019 Report, *supra* note 2.
[84] *Supra note* 5.
[85] *See also* Umakanth Varottil, *SEBI Tightens Reins over the Proxy Advisory Industry*, INDIA CORP LAW (Aug. 4, 2020), https://indiacorplaw.in/2020/08/sebi-tightens-reins-over-the-proxy-advisory-industry.html.
[86] RA Regulations, Reg 4, *supra* note 53.

Indian regulations, thereby encouraging their participation in domestic market.[87]

2. Conflict of interest

As per the Circulars, a disclosure in relation to conflict of interest and the safeguards for mitigating against them is required to be made on every advice shared by PAFs.[88] In case of any 'potential conflict of interest', PAFs are required to follow the same standard.[89] Further, in case they are engaged in other business activities, including consultancy services, they are required to put in place procedures to disclose, manage and mitigate any potential resultant conflict of interest.[90]

While this obligation is in line with the purpose behind implementation of the RA Regulations (as discussed in Section III above), this gives limited guidance regarding how it should be implemented. For example, the 2019 Report had provided the following recommendations/clarifications on this issue, which the Circulars have not included: (a) creation of 'Chinese Walls' or housing business in separate units, if PAFs offered consultancy or advisory services; (b) generic disclosure/disclaimer not being enough to satisfy the standards of avoidance of conflict; (c) making

---

[87] 2019 Report, *supra* note 2.
[88] Para 1(g), Procedural Guidelines Circular, *supra* note 5.
[89] Para 1(g), Procedural Guidelines Circular, *supra* note 5.
[90] Para 1(h), Procedural Guidelines Circular, *supra* note 5.

disclosures regarding the business model of PAFs (including: types of services provided, revenue breakup from various services, categories of clients served and any specific prohibition on services provided); (d) board of PAFs being independent of its shareholders in cases where shareholders are conflicted and disclosure of substantial shareholding or inter-locked boards; and (e) limiting disclosures regarding affiliate business only when such businesses exceeded a prescribed percentage of revenue etc.[91]

Further, what amounts to 'potential conflict' is unclear and is left to the subjective determination of the PAFs. Situations may arise where PAFs may not be aware of such potential conflict at the time of making such disclosure.

While it is open for debate whether 2019 Report was overly prescriptive in this regard, some guidance from SEBI would have been helpful. Especially, since the provisions of the RA Regulations and the applicable code of conduct[92]already have provisions obligating PAFs to address such conflict of interest which impacts their impartiality and make disclosures regarding the same. Further, research analysts are also directed to have adequate mechanisms to ensure independence of their research activities from their other

[91] 2019 Report, *supra* note 2.
[92] RA Regulations, Reg. 24(2) read with Code of Conduct, *supra* note 53.

business activities.[93] Therefore, the incremental clarification issued under the Circulars fails to clear the confusion regarding what might be acceptable as an adequate disclosure, particularly in relation to 'potential conflicts'.

3. Standardisation of practice

Following the 2019 Report and codifying the existing market practise, the Circulars propose that PAFs should put in place a voting recommendation policy which has to be followed while recommending.[94] The said policy should be reviewed and updated annually.[95] The policy should also clarify scenarios where PAFs will not issue recommendations.[96]These practices are directed towards creating transparency and accountability. The Circulars are silent whether it will be possible to deviate from the policy to allow for flexibility and addresses concerns of PAFs providing one-size-fits-all recommendations.

PAFs are also required to disclose their research methodology as well as the manner in which they came to its conclusion.[97] There is no clarity provided regarding the quality of disclosures in relation

[93] RA Regulations, Reg. 15, *supra* note 53.
[94] Para 1(a), Procedural Guidelines Circular, *supra* note 5.
[95] Para 1(a), Procedural Guidelines Circular, *supra* note 5.
[96] Para 1(a), Procedural Guidelines Circular, *supra* note 5.
[97] Para 1(b), Procedural Guidelines Circular, *supra* note 5.

to what amounts to research methodology.[98] For example, the 2019 Report had clarified that disclosure of methodology could involves the following: *"(a) the general approach that leads to the generation of research; (b) the information sources used; (c) the extent to which local conditions and customs are taken into account; (d) the extent to which custom or house voting policies or guidelines may be applied; and, (e) the systems and controls deployed to reasonably ensure the reliability of the use of information in the research process, and the limitations thereof"*.[99] Additionally, as per the 2019 Report, institutional investors should not be involved in preparation of the recommendations to ensure impartiality.[100] Given the lack of clarity, PAFs have the discretion to determine the extent of disclosure, particularly in cases where such disclosure may compromise their edge over their competitors. Further, one can argue that the requirement of including such additional information will make PAF's task cumbersome, especially since they function within tight deadlines[101].

Additionally, PAFs are also required to disclose in their recommendations the difference between the legal requirement vis-

[98] *See* Daksh Aggarwal, *Beware Proxy Advisers! The Big Brother is Watching: Key Issues with SEBI's Puzzling Guidelines for Proxy Advisers'*, THE CONTEMPORARY LAW FORUM (Oct.14, 2020), https://tclf.in/2020/10/14?beware-proxy-advisers-the-big-brother-is-watching-key-issues-with-sebis-puzzling-guidelines-for-proxy-advisers.

[99] 2019 Report, *supra* note 2.

[100] 2019 Report, *supra* note 2.

[101] The timelines for holding shareholding meetings are prescribed by the Ministry of Corporate Affairs, Companies Act, 2013 read with the applicable rules framed thereunder.

a-vis any higher standard which is being applied, as well as the rationale behind it.[102] This requirement will be useful in providing clarity to foreign investors who are not familiar with Indian legal standards. However, it is unclear if this obligation will be satisfied if such deviations are included in the voting guidelines instead of the reports for the sake of reducing the workload of PAFs.

4. **Interaction with listed companies**

In relation to PAF's interaction with listed companies, SEBI has prescribed the following methodology:[103]

(a) Simultaneous sharing of report with listed company and clients;

(b) Adoption of a policy prescribing the manner in which any information is shared with the listed company;

(c) Comments/clarifications received from listed company, within the timeline adopted by PAFs at its discretion, to be disclosed as addendum;

(d) In case of difference of viewpoints on recommendations with the listed company, PAFs will have the option of either revising the report and issuing a revised report or

[102] Para 1(f), Procedural Guidelines Circular, *supra* note 5.
[103] Para 1(c), 1(d) & 1(e), Procedural Guidelines Circular and Para 1(a), Modification Circular, *supra* note 5.

issuing its remarks in relation to the same - in either case, the same has to be issued as an addendum; and

(e) Any factual errors and impending material revisions to be intimated to the clients within 24 hours of receipt of information and the material revisions to be communicated to the clients within 72 hours of receipt of information, ensuring that the client has adequate time to make informed decisions.

The prescribed methodology may raise following potential concerns:

(a) Bilateral communication

The obligation to share reports simultaneously with the listed company encourages interactions between the listed company and the PAFs, thereby risking undue mutual influence. However, on the other hand, it can be argued that the requirement of sharing such communications as addendum to the clients creates transparency and ensures that the client is aware of conflicting positions. Further, this methodology also forces PAFs to share their report free of charge with listed company.

(b) Verbal communication

It is unclear whether it will be permitted to receive clarifications/comments through in-person meetings or over telephonic communications, and whether such communication necessities being recorded as an addendum to the report (either as conversation transcripts or otherwise). It can be argued that such communications may not be permitted in order to avoid sharing of non-publicly available information or any mutual undue influence.

(c) Factual errors & impending material revision v. comments & clarification

The Circulars[104] distinguishes between 'factual errors and impending material revision' and 'comments and clarifications', but they do not clarify the scope of these two categories of information received from the company. Comments/clarifications received from the company are required to be included in the addendum report if they are shared within the timeline provided by the PAFs. Information regarding 'factual errors and impending material revision' received from the company are required to be brought to the client's attention within 24 hours of receipt of such information, and material

[104] Para 1(c) & 1(e), Procedural Guidelines Circular and Para 1(a), Modification Circular, *supra* note 5.

revisions are required to be communicated within 72 hours of receipt of information, while ensuring that the client has adequate time to make an informed decision.

The Circulars do not provide flexibility to PAFs to not inform the clients regarding 'factual errors and impending material revision', even if they have been shared by the company after the time period provided to them to share their comments/clarifications. Further, the Circulars do not indicate whether an addendum to the report has to be issued in such a case, or whether communication in a manner acceptable to the PAFs would satisfy this obligation. Additionally, the threshold for determining materiality of such revision has been left to the judgment of the PAFs, which leaves room for potential difference of opinion with the company.

(d) Multiple reporting and timeline

Given the obligation of sharing the information regarding factual errors and material revisions with clients within the prescribed time,[105] in the event such information is shared by the company in multiple tranches, PAFs will have to issue multiple intimations to the clients – which may create confusion.

---

[105] Para 1(c), Procedural Guidelines Circular and Para 1(a), Modification Circular, *supra* note 5.

Further, the obligation to ensure that the client has adequate time to make an informed decision is on the PAFs. The company on the other hand does not have any obligation of ensuring that such information is shared in an expedited manner. In the event there is a delay on the part of the company, PAFs may not have the benefit of the prescribed 72 hours to prepare the communication on material revisions.

(e) Rounds of rebuttal & sharing of addendum report[106]

It is unclear whether addenda to the report are required to be shared with the listed company. One can argue that the requirement of sharing the report simultaneously, extends to addenda as well. This raises further questions regarding whether the listed company has the right to share their comments on the addendum/ revised report; and if yes, whether multiple addendums have to be issued in such a scenario.

(f) Draft reports

It is unclear whether the obligation to share report simultaneously with clients and listed companies apply at the draft stage, if sharing such draft is a business

---

[106] *See* Rabindra Jhunjhunwala & Saranya Mishra, *India: companies, know thy rights – the right to rebut proxy advisors and the right to redress*, INTERNATIONAL BAR ASSOCIATION (Sept. 25, 2020), https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=AE1D1788-24DA-4E3F-9275-200703518E4E.

practise of the PAFs. Given the obligation of share comments/clarifications as addenda as well as the requirement of simultaneous report sharing, it can be argued that SEBI does not encourage such practises.

(g) Prescribing time for comments

The timeline for receiving comments/clarification from the listed company is to be decided at the discretion of the PAF. In order to avoid subjective or preferential treatment of listed companies and promote transparency, PAFs may consider including a clear policy in this regard in the voting guidelines. The listed company has the option to disclose such clarification to the stock exchanges directly, if the PAF does not entertain delayed responses.

(h) Addressing difference of opinion on comments and clarification

As per the Circulars, PAFs are not bound to revise their recommendations in case of differences of opinion with the listed company on 'comments/clarification' received from the company. However, they will no longer have the option of not responding to such comments in the addendum report, provided they are received within the prescribed time.

5. **Grievance redressal**[107]

The mechanism of grievance redressal provided in the Circulars is not available to PAFs in the event they are the aggrieved party. Further, the Circulars are silent on the manner in which the grievance redressal process will be implemented.

B. IMPACT ON LISTED COMPANIES

1. **Right to be heard**

The Circulars have ensured that the listed companies have the right of being heard by PAFs and their clients, without having to make such clarification as disclosures to the stock exchange.[108]

2. **Grievance redressal**

The mechanism for grievance redressal, once the mechanism for implementation of the same is specified, will provide a formal channel for communication with SEBI for issues with PAFs.[109]

3. **Transparency and quality control**

The availability of the voting recommendation policy, the requirement of clarifying where standards higher than the prescribed

---

[107] *See* Rabindra Jhunjhunwala & Saranya Mishra, *Id.*
[108] *See* Rabindra Jhunjhunwala & Saranya Mishra, *Id.*
[109] *See* Rabindra Jhunjhunwala & Saranya Mishra, *Id.*

legal standards are followed, disclosure of research methodology will ensure that PAF recommendations are not arbitrary.[110]

C. IMPACT ON CLIENTS[111]

The mechanism proposed by the Circulars ensures sanctity and transparency of information flowing from the listed company to the clients, thereby helping clients make informed voting decisions. Further, the requirement of reporting errors to clients will help clients analyse their service providers i.e. the PAF's performance.

V. CONCLUSION

Through this article, the author has highlighted the role being played by the fledgling PAF industry in the Indian corporate governance landscape and the necessity which SEBI realised in standardising their business practices. The analysis of the provisions of the Circular leads us to the deduction that SEBI chose to adopt a light-touch approach, instead of being overtly prescriptive or paternalistic in their manner of regulating this nascent and relatively small industry. Provisions of the Circular in relation to conflict of interest reinforce some of the existing position under the RA Regulations, with certain added clarifications. The issues which are

---

[110] *See Umakanth Varottil*, *supra* Note 85.

[111] *For Black Rock's comments to SEBI while drafting the 2019 Report*, (Aug. 16, 2019), https://www.blackrock.com/corporate/literature/publication/consultation-to-securities-and-exchange-board-of-india-on-issues-related-to-proxy-advisors.pdf (Nov. 11, 2020).

left open-ended may lead to muddled waters for PAFs, until market forces settle such business practices. It is premature to answer the question whether the friction caused in this process, which had originally led to the review of this industry and 2019 Report, has been neutralised by the Circulars. Further, the introduction of the grievance redressal mechanism is a welcome addition. However, until clarity regarding its enforcement mechanism is available, it lacks lustre. It can be argued that time and market forces will likely clarify many of the concerns raised in this article, which seems to be SEBI's intention as well. Until such time, PAFs will have to navigate their way through these puzzlements to implement the standards prescribed by the Circulars.

INDEPENDENT DIRECTORS: WATCHDOGS OF THE COMPANY?

*Himani Shah**

ABSTRACT

The perennial tussle to align the interests of the management with the members of the company has once again drawn attention as an increasing number of independent directors resign from the board of companies. They play a crucial role in the corporate governance of the company. Yet, the scope of their duties and liabilities lack clarity. This paper explores the nature and extent of their duties and liabilities advanced by jurisprudence in India and under common law. It is argued that the ambiguity needs to be settled at the earliest to prevent any further independent director resignations so that corporate governance standards of companies are not compromised, especially at a time when the Indian financial markets are plagued with several scams and lacks investor confidence.

I. INTRODUCTION

Independent directors were introduced to tackle the perennial challenge of aligning the interests of directors with the company. This is commonly understood as the agency problem persisting between the directors and the company.[1] Directors act in the

---

* The author is an Associate at AZB & Partners.

[1] Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 BOSTON UNIVERSITY LAW REVIEW 1039, 1040 (2011).

capacity of an agent of the company.[2] However, while discharging this role, their interests often clash with that of the shareholders and stakeholders.[3] The term 'stakeholder' refers to any party that has an interest in the company and is affected by its business. Accordingly, the term stakeholders, includes all creditors, employees, investors, and workers, other than the management. Thus, the independence which independent directors possess, enables them to align the interests of the directors with the company and act as representatives of various stakeholders in the company.[4] It bridles corporate power and allows independent directors to act from an 'outside' point of view for the company.[5]

Independent directors are mandatory members of the board of a company but are not involved in the daily activities of the company. They are non-executive directors of a company. As part time directors, they are not involved in the decision making of the company. They are believed to enable fair and unbiased monitoring of the company's affairs and protect the interests of various stakeholders in the company.[6] This is because they are expected to possess professional qualities to ensure that they do not yield to pressure, economic, personal or otherwise, which inside directors

---

[2] Ferguson v. Wilson, [1866] 2 CH App 77.
[3] *Supra* note 1.
[4] Victor Brudney, *The Independent Director: Heavenly City or Potemkin Village?,* 95(3) HARVARD LAW REVIEW 599 (1982).
[5] *Id.*
[6] *Id.*; the Companies Act, 2013, sch. IV.

normally face.[7] They must be free of any biases that may arise from any vested interests in the company. This allows them to effectively monitor the company's affairs and protect shareholder interests.[8] This also ensures transparency and accountability in the affairs of the company.[9] Hence, they form the pillar of its corporate governance and are also known to be the watchdogs of the company.

Accordingly, independent directors play a vital role in protecting the interests of investors, the minority shareholders, employees and various other stakeholders in the company. This will have a significant impact on protecting the corporate climate and alleviating corporate governance standards in the country. For instance, in the Enron scam, the company manipulated its financial statements and hid losses.[10] This caused shareholders, investors and employees losses to the tune of billions of dollars.[11] Despite the presence of independent directors on the board, the remuneration of directors with stock options put additional pressure on them and prevented

---

[7] Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127 (2010) at 130; *supra* note 1.
[8] *Id.*
[9] *Who are Independent Directors and What Role they play*, THE ECONOMIC TIMES, January 2, 2013,https://economictimes.indiatimes.com/slideshows/corporate-industry/who-are-independent-directors-and-what-role-they-play/slideshow/17853907.cms.
[10] William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76(5-6) TULANE LAW REVIEW 1275 (2002).
[11] *Id.*

them from assessing the financial reports of the company.[12] This evinces the failure of the agency theory of aligning the directors' interest by linking their performance and remuneration and the wide informational asymmetry that existed between the management and investors. Similarly, in India, the Satyam scandal showcases that the inclusion of representation of suppliers, customers, shareholders, could have prevented the occurrence of such a scam.[13] In this scam also, the company manipulated its revenues and earnings, causing the investors a loss of around two billion dollars.[14] Thus, independent directors play an instrumental role in enforcing corporate governance practices and maintaining a healthy corporate environment.[15] Accordingly, a nuanced understanding of their duties and liabilities is important to understand their role as watchdogs of the company.

This paper seeks to discuss the duties and liabilities of independent directors under the Companies Act, 2013 (*hereinafter* referred to as "**Companies Act**") and the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015 (*hereinafter* referred to as "**LODR**"). The LODR lists additional compliances which independent directors of a public

---

[12] *Id.*
[13] Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) NATIONAL LAW SCHOOL OF INDIA REVIEW 1 (2009)at 32.
[14] *Id.* at 33 - 35.
[15] *Id.* at 35.

listed company are required to meet. Part II of the paper discusses the evolution of the concept of independent directors. It also discusses the definition of independent directors. Part III elaborates on the duties of independent directors. In Part IV, their liabilities would be discussed with reference to case laws. Thereafter, the author will critically analyze the existing legal framework. Part V contains the conclusion of the paper.

II. EVOLUTION OF THE CONCEPT OF INDEPENDENT DIRECTORS IN INDIA

In India, the concept of independent directors has evolved over time, prior to which it was governed by the principles of common law. It borrowed and adapted from the laws of other developed countries to strengthen its corporate governance standards and meet global standard practices.[16] This process is also known as legal transplant.[17] However, this transplantation of legal principles has several problems due to the differing political, social, economic climates in different countries.[18] For instance, the shareholding pattern in India is extremely concentrated, generally with the controlling shareholder, whereas companies in the US have a more dispersed shareholding.[19] In the US, emphasis is laid on board

[16] *Id.* at 24.
[17] *Id.*
[18] *Id.*
[19] *Id.* at 45.

independence, while in India the board generally consists of a mix of directors who represent the interests of the promoter and independent directors.[20] Further, in India, the law provides that directors can be removed and appointed by the passage of a simple majority resolution, which is absent in the US.[21] Thus, during transplantation, it is important, to tailor the laws as per the conditions and needs of the recipient country. India has not been entirely successful, but it has undergone several changes and is evolving for the better.[22]

In 1999, for the first time, the Kumar Mangalam Birla Committee defined the term independent directors. The committee was set up by the Securities and Exchange Board of India (*hereinafter* referred to as "**SEBI**") to promote and heighten the standards of corporate governance in the country. As per this committee, independent directors must receive director's remuneration only.[23] Apart from that they do not have any pecuniary interest in the company to ensure they can exercise independent judgment while making decisions.[24] They must possess leadership qualities and the ability to think strategically, they must show a degree of

---

[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *SEBI (LODR) Regulations, 2015 and Companies Act, 2013 – A comparison*, THE INSTITUTE OF COMPANIES SECRETARIES OF INDIA, available at https://www.icsi.edu/WebModules/CompaniesAct2013/INDEPENDENT%20DIRECTOR.pdf.
[24] *Id.*

commitment towards the progress of the company. In recognition of this, the concept of independent directors was conceived.[25] The recommendations also led to the inclusion of a clause called "Clause 49 – Corporate Governance" in the Listing Agreement.[26] This clause mandates the board of listed companies to appoint independent directors.[27]

Thereafter, the concept of independent directors was subject to constant evolution. Several committees were set up by SEBI and the Ministry for Corporate Affairs (*hereinafter* referred to as "**MCA**") to examine and strengthen corporate governance practices in the country. The reports issued and recommendations given by these committees were integral to the evolution of independent directors. The MCA appointed Naresh Chandra Committee gave its recommendations in 2002. It recommended their manner of appointment for listed entities.[28] It also advocated that listed entities must issue formal letters of appointment for independent directors. This letter must clearly lay down their duties, liabilities and remuneration.[29] Then, in 2003 SEBI constituted the Narayana Murthy Committee to review the corporate governance code for

---

[25] *Id.*
[26] *Id.*
[27] Clause 49 sub-clause 1 of the Listing Agreement of Listing Obligations and Disclosure Requirements.
[28] Naresh Chandra, REPORT OF THE COMMITTEE ON REGULATION OF PRIVATE COMPANIES AND PARTNERSHIPS 19 (July, 2003).
[29] *Id.*

listed public companies.[30] It proposed a revision to the definition of 'independent directors'.[31] It recommended that they must not have any pecuniary interest in the company, have not been the executive of a company in the preceding financial year and are not related to the promoter or management, among others.[32] Thereafter, in 2004 a report was issued by the J. J. Irani Committee. This report was a precursor to the Companies Act. Thus, it aids in understanding legislative intent while interpreting provisions of the Companies Act. It was set up under the aegis of the MCA. This committee elaborately defined the term independent directors, their desired attributes and their manner of appointment.[33] This gave a deeper understanding of the 'independence' of an independent director. Finally, in 2017 the Kotak Committee on Corporate Governance was constituted by SEBI.[34] The committee made several recommendations regarding the institution of independent directors. It noted that while the Companies Act mandates that at least one-third of the board of directors must comprise of independent directors, no such corresponding requirement was present in the

---

[30] Narayana Murthy, REPORT OF THE SEBI COMMITTEE ON CORPORATE GOVERNANCE 20 (Feb. 8, 2003).
[31] *Id.*
[32] *Id.*
[33] J. J. Irani, REPORT OF THE EXPERT COMMITTEE ON COMPANY LAW, 33 – 37 (2005): (On the basis of the report of this committee, the Companies Bill 2012 was introduced which was later notified as the Companies Act, 2013).
[34] Uday Kotak, REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE (October 5, 2017).

LODR.[35] The committee proposed that as per Regulation 17 of the LODR, independent directors must comprise of at least half the board.[36] It also proposed an amendment to the LODR regarding the eligibility criteria for independent directors and disclosures on resignation of independent directors.[37] These recommendations were accepted and hence, led to an overhaul of the independent director regime in India.

Currently, the term independent director is defined under Section 2(47) read with Section 149(6) of the Companies Act. They are defined as directors other than the managing director, whole-time director and nominee director who possess certain qualities.[38] These qualities are, *inter alia*, not having any pecuniary relationship with the company, not related to the promoter group, possess relevant expertise and experience in the opinion of the Board.[39] They are appointed in accordance with Section 149 of the Companies Act read with Rules 4 and 5 of the Companies (Appointment and Qualification of Directors) Rules, 2014. Recently, a notification issued by the MCA further qualified the eligibility criteria for independent directors.[40] It introduced a proficiency test

---

[35] *Id.* at 24.
[36] *Id.*
[37] Kotak, *supra* note 36.
[38] Companies Act, 2013, §§ 2(47), 149(6).
[39] *Id.* § 149(6).
[40] Ministry of Consumer Affairs in India (2019), http://www.mca.gov.in/Ministry/pdf/CmpFifthAmndtRules_ 22102019.pdf;

to be cleared by individuals in order to be eligible for appointment as independent directors.[41] The test evaluates their knowledge, in areas such as; *inter alia*, securities law and corporate law.[42] This is because; independent directors are required to be capable of taking stringent actions in the interests of the company.[43] Therefore, ensuring that they are able to monitor and point out the shortcomings in the management's performance.

III. DUTIES OF INDEPENDENT DIRECTORS

Independent directors are appointed to discharge an important role in the corporate governance of the company. This includes measures such as ensuring the adoption of good accounting practices, compliance with the applicable law and protection of interests of shareholders and stakeholders. Even if they are not in a position to prevent any fraud from taking place, they should be equipped to identify it and take preventive measures such as notifying the appropriate authority. Accordingly, it is important that the law guides independent directors in the form of duties and obligations. It will help them in discharging their role and ensuring the company follows good corporate governance practices. This part of the paper elaborates on the duties of independent directors wherein they have to overlook the affairs of the company and

[41] *Id.*
[42] *Id.*
[43] *Id.*

balance the varied interests associated with the running of a company.

A. APPLICABILITY OF COMMON LAW

As per the earlier jurisprudence on this subject, the independent directors, like any other director, were regarded as fiduciaries of the company and were bound to act with reasonable care and diligence,[44] supervise the discharge of delegated functions[45] and ensure that the interests of the directors do not conflict with those of the company.[46] Prior to the introduction of the Companies Act, the duties of independent directors were not codified. Thus, references were made to common law in order to determine their duties and liabilities. Under the Companies Act, Section 166 codifies directors' duties, but does not expressly preserve the application of common law principles.[47] It is an umbrella provision applicable for all directors, including both executive and non-executive. This means that the duties contained in Section 166 are also applicable to independent directors. It merely provides certainty and guidance to directors regarding their duties and manner of conduct thereby enabling them to discharge their duties more objectively. But, it is silent on the applicability of common law principles. Contrarily, in

---

[44] Aberdeen Railway Co v. Blaikie Brothers, (1854) 1 MAcq 461.
[45] In Re Bearing plc (No. 5) 1 B. C. L. C. 433.
[46] Chaalier I. Iyyappan v. The Dharmodayan Co. Ltd., AIR 1966 SC 1017.
[47] Companies Act, 2013, § 166.

the United Kingdom and Singapore, the statue explicitly preserves the application of common law principles to interpret the duties of directors contained therein.[48]

Section 166 of the Companies Act, does not expressly state whether the list of duties provided therein is exhaustive or illustrative. Opinion on this is divided. According to one view, the duties of directors are restricted to those provided in Section 166.[49] The second view propagates that Section 166 is only an illustrative list of duties. It merely guides the directors in discharging their role in the company. This second view is in consonance with the recommendations of the J. J. Irani Committee Report. As per this report, the Companies Act shall be "*inclusive, and not exhaustive in view of the fact that no rule of universal application can be formulated as to the duties of the directors.*"[50]

In the *Rajeev Saumitra* case, the Delhi High Court accorded a liberal interpretation to Section 166 of the Companies Act. It was held that the director's duties were not limited to Section 166. The scope of the section was thus expanded. In this case, the defendant was found guilty of violating her fiduciary duty of loyalty as she set up another educational coaching center despite being the director of

---

[48] UK Companies Act, 2006, § 170; Singapore Companies Act, § 157; Umakanth Varottil, *Codification of Directors' Duties: Is Common Law Excluded?*, INDIA CORP LAW (May 31, 2014) https://indiacorplaw.in/2014/05/codification-of-directors-duties-is.html.
[49] *Id.;*
[50] Irani, *supra* note 35.

one.[51] Section 166 does not specifically codify the common law fiduciary duty of loyalty. Only a resemblance of the said duty can be found in sub-section 2 of Section 166 as it requires the director to act in *good faith*. Thus, though the duties of directors are codified under Section 166, the court applied common law to determine the director's liability. The section was held to be merely an illustrative list of directors' duties.[52] An analysis of this case concludes that the court adopted a liberal view while interpreting the section. This is important while discerning the duties of independent directors because, as discussed earlier, Section 166 is an umbrella provision which codifies the duties of all directors, including independent directors. Thus, this case establishes a standard which can be adopted to understand the duties of independent directors under Section 166 of the Companies Act.

Additionally, while the Companies Act broadly lists the duties of directors, it does not provide for a specific remedy if these duties are breached. It is a settled principle of law that when a statue gives a substantive right to sue but provides no particular form of remedy, then the aggrieved party can proceed under common law.[53] This means that if the conduct of an independent director does not conform to the Companies Act, then proceedings can be instituted

---

[51] Rajeev Saumitra v. Neetu Singh, (2016) 198 Comp Cases 359 (Delhi).
[52] *Id.*
[53] N. P. Ponnuswami v. The Returning Officer, Nammakal Constituency, AIR 1952 SC 64.

against the director under common law, if there is no statute specific remedy. Otherwise, the purpose of enacting the provisions would be defeated. For instance, Section 166(2) of the Companies Act states, *"A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment."*[54] A bare reading of this section states that the duty codified therein is similar to the common law duty of loyalty to act in good faith and in the best interests in the company and protect stakeholder interests.[55]However, the statute does not provide a specific remedy if the director violated this duty, especially if stakeholder interests are compromised. In this respect, the statute lacks meaningful enforcement measures despite specifically recognizing stakeholder interests. Even a class action suit and derivative suit would be inadequate. This is because Section 245 of the Companies Act, which deals with class action suits, refers to the interests of the company, depositors and members, thereby indicating that the interests of other stakeholders were not intended to be covered under this section.[56] Whereas, derivative suits, a remedy available under common law, are to be made by aggrieved shareholders, thereby giving rise to the need to expand the law to capture stakeholder remedies through shareholder derivative action

[54] Companies Act, 2013, § 166(2).
[55] Re Smith & Fawcett, [1942] Ch 304 (CA).
[56] Companies Act, 2013, § 245.

suits.[57] Thus, preservation of common law remedies becomes important to accord purposive interpretation to the section.

This discussion also becomes significant to understand the legislative intent in drafting Section 166(2) regarding the adoption of the stakeholder model, shareholder model or the enlightened shareholder value model. This is vital in determining the scope of duties of independent directors, i.e., whether they must equate shareholder and stakeholder interests, or protect stakeholder interests to such an extent to which they are a means to further shareholder wealth maximization given that the statute recognizes the need to protect stakeholder interests but lacks an enforcement mechanism. It will, accordingly, influence the nature and scope of their scrutiny on the affairs of the company. Hence, it will determine the extent to which they are duty bound to represent stakeholder interests on the board of the company. Therefore, this is important to ascertain the contours of their duty, easily identify when they breach their duty and accordingly liable for acts of omission or commission. The uncertain nature of this duty and subsequent attribution of liability act as a hindrance and prevents independent directors from effectively discharging their role, especially due to the extensive scrutiny they are subjected to now.

---

[57] Umakanth Varottil & Mihir Naniwadekar, *The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis*, NUS CENTRE FOR LAW & BUSINESS WORKING PAPER 16/03 (2016) at 17.

Before the enactment of the Companies Act, stakeholder interests were recognized under Indian as well as common law.[58] As per common law, shareholder interests must be protected to preserve value in the long term and not short term.[59] This inevitably, required directors to balance the effect of corporate actions on stakeholders to generate wealth for the shareholders in the long term. This discretion was formulated into a duty under Section 172 of the UK Companies Act, 2006, which is today known to us as enlightened shareholder value.[60] It emphasizes on the benefits of recognizing and accounting stakeholder interests as a means to promote shareholder interests.[61] On the other hand, a plain reading of Section 166(2) states that the Indian legislature adopted a pluralistic approach. According to this approach, interests of all shareholders and stakeholders are placed at par without the creation of any hierarchy, thereby casting a positive duty on directors which they owe to the company.[62] This is similar to the approach followed in Canada and South Africa wherein, the interests of all stakeholders

---

[58] Hindustan Lever Employees' Union v. Hindustan Lever Ltd., AIR 1995 SC 470; Hutton v. West Cork Railway, (1883) 23 Ch D 645.

[59] Provident International Corporation v. International Leasing Corp Ltd., [1969] 1 NSWR 424. (This position was followed by courts in Australia and Delaware); Paramount Communications Inc. v. Time Inc., 571 A. 2d 1140 (Del, 1989).

[60] Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Apporach*, 29(4) SYDNEY LAW REVIEW 577 (2007) at 579.

[61] Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder Stakeholder Divide*, 36(1) JOURNAL OF CORPORATE LAW 59 (2010) at 62.

[62] It is an established position of law that directors owe their duties to all the shareholders collectively, not individually. *See* Percival v. Wright, [1902] 2 Ch421.

are balanced while also providing them with enforcement rights.[63] However, the section is widely and vaguely worded, thereby hindering its effective enforcement.[64] Hence, in order to accord meaning to the section, the section must be read such that the duty cast on directors is to promote the interests of the company as a whole and not individual shareholders. This gap would be filled by reference to common law. This would ensure that they act in good faith for the interests of all stakeholders also. Contrarily, jurisdictions such as Norway, accord primacy to stakeholder interests above shareholder interests, if required.[65]

In light of the above discussion it can be concluded that the application of common law principles must be read in addition to the duties provided under Section 166 of the Companies Act. Otherwise, it would lead to the formulation of a universal rule regarding the duties of directors that would defeat the role and responsibility which independent directors fulfill. They would fail to successfully monitor the affairs of the company, maintain transparency and ensure good governance practices are adopted. On the other hand, if Section 166 is viewed as an illustrative list of

---

[63] Shubhra Wadhawan, *Upholding Stakeholder Interest: What Way is the Best Way – A Comparative Analysis Across Diverse Jurisdictions*, SCC ONLINE BLOG (June 14, 2019) https://www.scconline.com/blog/post/2019/06/14/upholding-stakeholder-interest-what-way-is-the-best-way-a-comparative-analysis-across-diverse-jurisdictions/.

[64] *Supra* note 57 at 14.

[65] *Supra* note 63.

duties, the legislative intent as envisaged in the J. J. Irani Report would not be effectuated.[66]

B. DUTIES UNDER THE COMPANIES ACT, 2013

Independent directors are tasked with overseeing the affairs of the company and guiding the company to carry out its business efficiently with best practices. They also play a crucial role in protecting the interests of minority shareholders and ensuring accountability on the part of the management.[67] While independent directors are bound to act in accordance with the articles of the company,[68] they are also bound by the directors' duties enlisted in the Companies Act. Several provisions of the Companies Act enlist the duties of independent directors, directly or indirectly.

As discussed earlier, Section 166 of the Companies Act lists the duties of directors. But it does not distinguish between non-executive directors and whole-time directors.[69] Thus, independent directors being non-executive directors are also bound to act in accordance with this section. As per this section, they are bound to act in good faith in the interests of the company; they must avoid any situation wherein their interests conflict with those of the

---

[66] Irani, *supra* note 17.
[67] Companies Act, 2013, sch IV.
[68] *Id.* § 166(1).
[69] *Id.* § 2(34): (defines directors as any director appointed to the board of a company).

company;[70] exercise independent judgment while taking decisions and act with due and reasonable care, skill and diligence.[71] In case they breach any of these duties a fine may be imposed.[72]

A detailed Code of Conduct is contained in Schedule IV of the Companies Act.[73] It provides guidelines for professional conduct for independent directors in addition to the guidelines provided for by the company. Schedule IV lists, *inter alia*, their role and function, duties and manner of appointment of independent directors. These vary from regularly undertaking appropriate steps to updating and refreshing their skills; upholding ethical standards of integrity and probity; acting objectively and constructively while exercising his duties; striving to attend the general meetings of the company; scrutinizing the performance of management in meeting agreed goals and objectives; reporting concerns about unethical behavior or fraud; assisting in protecting the legitimate interests of the company, shareholders and its employees; moderating and arbitrating in the interest of the company as a whole; participating constructively and actively in the committees of which they are members, amongst others. Thus, it can be seen, that overall they are tasked with supervising and monitoring the affairs of the company.

---

[70] *Id.* § 166(2)-(4).
[71] *Id.* § 166(3).
[72] *Id.* § 166(7).
[73] *Id.* Sch. IV, cl. 3.

Sections 135, 177 and 178 mandate that independent directors must be members of the Corporate Social Responsibility Committee,[74] the Audit Committee,[75] the Nomination and Remuneration Committee respectively.[76] The Audit Committee examines the financial statements, internal financial controls and approves related party transactions.[77] The Corporate Social Responsibility Committee formulates the corporate social policy[78] and the Nomination and Remuneration Committee lays down the criteria for the appointment of key managerial persons and determines their remuneration.[79] As members of these committees' independent directors examine the financial systems, are involved in determining the remuneration and appointment of key managerial personnel and the corporate social responsibility policy of the company. Despite being members of these committees only in a reviewer capacity,[80] courts have held that independent directors are equipped to notice "red flags".[81] Hence, they are duty bound to ensure that they bring in more objectivity in evaluating and scrutinizing the performance of the board and management to

---

[74] *Id.* § 135(1).
[75] *Id.* § 177(2).
[76] *Id.* § 178(1).
[77] *Id.* § 177(4).
[78] *Id.* § 135(3).
[79] *Id.* § 178(4).
[80] *Id.* § 149(12).
[81] N. Narayanan v. Adjudicating Officer, (2013) 12 SCC 152.

achieve the desired goals and objectives.[82] Thus, by virtue of being a part of these committees, their duty to moderate the interests of the company and prevent frauds from happening is heightened. However, the scope of this duty is not clear and remains unsettled.

Further, Section 134 of the Companies Act lists the duties of independent directors implicitly. It lists the constituents of the report issued by the board of the company.[83] This imposes a duty on independent directors as they are members of the board of the company. The Section mandates that several statements must be attached to the report of board directors. It must cover particular subject matters such as, *inter alia*, adherence to accounting standards in the Directors' Responsibility Statement,[84] attaching the auditors' report to each financial statement,[85] the state of the company's affairs and particulars of loans, guarantees or investments under Section 186 of the Companies Act[86] and a statement on declaration given by independent directors under Section 149(6) of the Companies Act.[87]

[82] The courts approach is in consonance with § 149 (12) of the Companies Act, 2013. It reads as, *"Notwithstanding anything contained in this Act,— [(i) an independent director; (ii) a non-executive director not being promoter or key managerial personnel, shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently."*
[83] Companies Act, 2013, § 134.
[84] *Id.* § 134(5)(a).
[85] *Id.* § 134(2).
[86] *Id.* § 134(3)(g).
[87] *Id.* § 134(3)(d).

Furthermore, it is pertinent to note that the Companies Act provides for a very broad framework of duties for independent directors. The scope of their duties and performance is ambiguous and vague. For instance, one of the duties listed in Schedule IV states that independent directors must protect the interests of the company, shareholders and employees while acting within their authority.[88] But, the statute is silent on the scope of their authority, i.e. to what extent can they exercise their powers to protect the company, shareholders and employees. Additionally, it also states that any decision that the company takes must not be prejudicial to the interests of the shareholders, community or the environment.[89] However, these terms have not been defined under the Companies Act. This causes confusion regarding the extent to which they have a duty to protect the 'community' and 'environment' due to the wide scope of their meaning.[90] In this regard, it is important to note that the Supreme Court has held that directors' act as fiduciaries vis-à-vis the company but not individual shareholders, unless there is a special arrangement in place or under a particular factual matrix.[91] The court also held that even if the fiduciary relationship is extended to the existing shareholders, it cannot be imputed to exist between

---

[88] *Id.*
[89] *Id.* § 166(2).
[90] *Supra* note 57 at 14.
[91] Sangramsinh Gaekwad v. Stantadevi P. Gaekwad, (2005) 11 SCC 314.

the director and strangers to the company.[92] Accordingly, it can be seen that if the provision were to be accorded a wide interpretation, then it cannot be reconciled with the decision of the Supreme Court. It is important to settle this confusion because the duty of independent directors cannot be extended infinitely. This would place an unfair and onerous burden on them, given that they are only watchdogs of the company.

To summarize, the duties of independent directors have been broadly listed in the Companies Act, either directly or indirectly. However, it has been loosely worded and the nature and scope of their duties have not been defined clearly. This creates confusion amongst independent directors regarding the exact nature of their liability. Resultantly, independent directors are panic-stricken about the scope of their obligations, the role they are expected to play as members of the board and liability attracted in case they fail to discharge their duties. This uncertainty hampers them from discharging their role effectively and also resulting in several resignations.[93]

---

[92] Nanalal Zaver and Another v. Bombay Life Assurance Co. Ltd., 1950 SCR 391.

[93] Rica Bhattacharyya, *Resignations by Independent Directors Double in 2019 as Risk Grows*, INDIA TIMES (Dec. 26, 2019) available at https://economictimes.indiatimes.com/news/company/corporate-trends/resignations-by-independent-directors-double-in-2019-as-risks-grow/articleshow/72972968.cms?from=mdr.

C. DUTIES UNDER LODR

The LODR was notified by SEBI in 2015. It provides regulations for independent directors and imposes duties on them in addition to the Companies Act.[94] However, the LODR only regulates the conduct of independent directors of listed companies. It is not applicable to private companies or unlisted public companies. This is because, SEBI regulates the capital and securities market. It primarily seeks to protect the investors in the securities market. Otherwise, it can have lasting effects on the economy, overall public confidence as well as credit markets. For instance, the Yes Bank crisis had a grave impact on the credit market and investor confidence as the public had heavily invested in its financial instruments such as bonds. However, if it were an unlisted public company or private company, its financial implications would have been limited. Thus, independent directors of listed companies are required to be more vigilant and subjected to stricter corporate governance norms, under the LODR. However, the Companies Act makes no such distinction and it is applicable to all companies.

Regulation 25 of the LODR provides the obligations of independent directors. According to this Regulation, an individual cannot serve as the independent director of more than seven listed

---

[94] SEBI (Listing and Disclosure Obligations) Regulations SEBI/LAD-NRO/GN/2015-16/013, Reg. 17 (Sep. 2, 2015).

entities.[95] Regulation 18 and 19 regulates the functioning of the Audit Committee and Nomination and Remuneration Committee,[96] thereby regulating the duties of independent directors as members of these committees. It states the minimum number of meetings that must be conducted and that they must hold at least one meeting in a year wherein they can discuss the performance of non-independent directors, assess the quality and quantity of flow of information between management and the board of directors.[97] Further, as mandated under the Companies Act, even the LODR states that the board of directors must provide a separate Code of Conduct for all directors, including independent directors. This must be in addition to the obligations under the Companies Act. Therefore, in addition to regulating several aspects of corporate governance, the LODR also regulates the conduct of independent directors of a listed entity.

IV. LIABILITIES OF INDEPENDENT DIRECTORS

Traditionally, non-executive directors were not liable for defaults of the company because they were not involved in the day to day affairs of the company.[98] Thus, holding them liable for wrongs

---

[95] *Id.* reg. 25.
[96] *Id.* reg. 18-19.
[97] *Id.* reg. 25(3).
[98] In Re City Equitable Fire Insurance Co. [1925] Ch 407; Re Cardiff Savings Bank [1892] 2 Ch. 100; Victor Brudney, The Independent Director: Heavenly City or Potemkin Village 95 Harv. L. Rev. 597.

committed by the company was considered to be unjustified as they were not aware of all the decisions taken by the management.[99] However, with changing times and increased corporate governance measures, a more subjective view was adopted under common law. According to this view, directors were required to exhibit a reasonable degree of skill in discharging their duties and monitoring the affairs of the company.[100] In this context, the Companies Act seeks to strike a balance between their duties and role played by them while determining their liability for a wrong committed by the company. Section 149(12) of the Companies Act is a non-obstante clause which states that the liability of independent directors arises only when acts of omission or commission occur with knowledge, attributable through board processes, and with consent or connivance and they did not act diligently.[101] This has been reiterated by the Ministry of Corporate Affairs in its circular dated March 2, 2020 "**MCA 2020 circular**".[102] Over time the jurisprudence has developed in such a way that liability is imputed on a non-executive director if he possesses both actual and constructive knowledge.[103] Actual knowledge refers to something

---

[99] *Id.*
[100] Dorechester Finance Company v. Stebbing [1989] B.C.L.C. 498; Aberdeen Railway Co. case, *supra* note 44.
[101] Companies Act, 2013, § 149 (12).
[102] Ministry of Corporate Affairs (2020), https://www.mca.gov.in/Ministry/pdf/Circular_03032020.pdf
[103] Umakanth Varottil, *Director Liability under the New Regime*, INDIA CORP LAW, (June 16, 2014) https://indiacorplaw.in/2014/06/director-liability-under-new-regime.html.

about which the director has direct knowledge while constructive knowledge would mean something which the director ought to know,[104] widely known as "red flags", as the director is duty bound to conduct an inquiry in the irregularities spotted by him.[105] The ambit of their constructive knowledge becomes crucial as they are mandatory members of the Audit Committee and Nomination and Remuneration Committee.[106] By virtue of being members of these committees, their involvement in the affairs of the company increases thereby also increasing their knowledge and connivance for the omission or commission of acts. Thus, now they are better placed to identify the red flags and take appropriate corrective steps.

Due to the nature of the role played by them and the problem sought to be resolved, the imposition of liability upon occurrence of a breach becomes crucial. If their action or inaction had no consequences, then their appointment would be rendered futile. Essentially, in accordance with the above discussion, the exact meaning and nature of diligence they are required to exercise and knowledge which they must possess while performing their role must be determined as it lacks clarity and uniformity. This has often resulted in independent directors failing to effectively discharge their duties and role played by them in the company as was seen in the

---

[104] Ferguson v. Weaving [1951] 1 All ER 412.
[105] N. Narayanan v Adjudicating Officer (2013) 12 SCC 152.
[106] Companies Act, 2013, *supra* note 6, §§ 177, 178.

Punjab National Bank scam. Herein, independent directors turned a blind eye to the misgivings and manipulations of the management, thereby failing to mitigate risk for shareholders and various stakeholders.[107] Therefore, definitely determining the extent of their liability is imperative to ensure that they are better placed to discharge their role effectively.

A. JUDICIAL REVIEW

In *In re S. Rajagopal and V.K.Ramani*, "**Zylog case**", the company had declared the distribution of dividend to its shareholders at their annual general meeting in 2012.[108] However, the company defaulted in distributing the dividend and violated Sections 205(1A) and 207 of the Companies Act, 1956.[109] Investors, thus, complained to SEBI. Accordingly, SEBI issued show cause notices to the directors of Zylog, seeking reasons why any action should not be taken against them under Section 11 and 11B of the SEBI Act.[110] Independent directors argued that upon learning about the non-compliance, they raised concerns regarding the contravention in the board meeting about the payment of dues and demanded immediate

---

[107] Rishi Ranjan Kala, *Nirav Modi Firms Independent Directors Fail as Mentors says SFIO*, FINANCIAL EXPRESS (March 6, 2019) https://www.financialexpress.com/industry/nirav-modi-firms-independent-directors-failed-as-mentors-says-sfio/1506389/ Rishi Ranjan Kala

[108] In Respect of Mr. S. Rajagopal and Mr. V. K. Ramani, Independent Directors of Zylog System Limited, No. 1WTM/GM/EFD/26/JUNE/2017.

[109] *Id.*

[110] *Id.*

action on the part of the management.[111] Their dissent had been recorded in the minutes of the board meeting.[112] Even after the passage of two months, no action was taken. Thus, the independent directors resigned from the company. In light of these facts and circumstances, SEBI exonerated independent directors of any liability for the actions of the company as they had used their best efforts to remedy the company's default.

The Bombay High Court in *Jagjivan Hiralal Doshi* v. *Registrar of Companies* held that no distinction exists between a full-time and part-time director of a company.[113] The petitioners were part-time directors of the company in liquidation. The company had knowingly accepted deposits beyond the permissible limit. The petitioners prayed to be relieved from any criminal proceeding instituted against them for negligence, misfeasance, etc. under Section 58A of the Companies Act, 1956.[114] In deciding this question, the court held that both, full-time and part-time directors, participate in the board meetings wherein they get to know the financial picture without scrutinizing the account books. Accordingly, the petitioners cannot escape liability by arguing that they were part-time directors as, "*Notwithstanding the pressure on the company's finances, they cannot be permitted to shut their eyes to what was*

---

[111] *Id.*
[112] *Id.*
[113] Jagjivan Hiralal Doshi v. Registrar of Companies, 1990 Mh. L.J. 219.
[114] *Id.*

obvious to everyone who examines the affairs of the company even superficially".[115] This judgment determined the liability of part-time directors and not independent directors specifically. But, since independent directors fall under the board category of non-executive/part-time directors, the decision of this case is relevant in determining the liability of independent directors. In fact, today they not only take part in board meetings but are also a part of the Audit Committee. Thus, they have a better and more nuanced picture of the company's finances.[116] As members of the Audit Committee they also scrutinize the account books of the company.[117] Hence, they cannot simply take the defense that since they are part-time directors they do not have a sound understanding of the company's financial health as the function had been delegated to professionals.[118]

Further, in *Chitra Sharma v Union of India*, "**Jaypee case**", the Supreme Court passed an order barring independent directors, along with the other directors of the company, Jaiprakash Associates, from transferring their assets in light of the company's impending liquidation proceedings.[119] The court also prevented the transfer of properties and assets of their immediate and dependent family

[115] *Id.*
[116] Companies Act, 2013, § 177.
[117] *Id.*
[118] N. Narayanan v. Adjudicating Officer 80 (2013) 12 SCC 152.
[119] Chitra Sharma and Ors. v. Union of India [2018] 148 SCL 833 (SC).

members.[120] Proceedings had been instituted to protect the interests of homebuyers who were promised flats in the impending projects floated by Jaypee Infratech Limited, which is a special purpose vehicle of Jaiprakash Associates.[121] Thus, it can be seen that, here also independent directors were treated at par with full time directors of the company. Similarly, in *Union of India v. Gitanjali Gem Ltd.* "**Punjab National Bank fraud case**", the Mumbai bench of the National Company Law Tribunal passed an order restraining the directors, including independent directors from transferring or disposing their assets, funds, moveable and immoveable properties.[122] This was later upheld by the National Company Law Appellate Tribunal.[123] This gives rise to uncertainty regarding the extent of the liability of independent directors, i.e. whether they are also personally liable for a fraud committed by the company under their watch.

As far as fastening vicarious liability on independent directors is concerned, it is settled law that there must be specific averments in the complaint filed to show in what manner the director was

---

[120] *Id.*
[121] *Id.*
[122] Union of India, Ministry of Corporate Affairs v. Gitanjali Gem Ltd. and Ors., Company Appeal (AT) Nos. 103, 119, 124, 125, 126, 127, 128, 129, 130, 131, 132 and 133 of 2018, https://nclt.gov.in/sites/default/files/Interim-order-pdf/Union%20of%20India%2C%20MCA%20CP%20277%20of%202018%20NCLT%20on%2031.1.2019%20Interim.pdf.
[123] *Id.*

responsible for the conduct and was in charge of the business of the company.[124] Merely stating that the person is a director of the company at the time when the offence was committed is not sufficient.[125] It has to be shown that the person was 'in charge of the business'[126] or that the offence was committed with the consent or connivance of the director.[127] Specific statements setting out the role of the director in the commission of the offence must be explained.[128] But in the *Har Sarup Bhasin v. Origo Commodities India Pvt. Ltd.*,[129] despite making specific averments in the complaint, no liability was attributed to independent directors. It had also been specifically stated that the independent director was a part of the Audit Committee, Nomination and Remuneration Committee and Corporate Social Responsibility Committee. The director had also attended all the meetings. Accordingly, it was argued that he ought to have been aware of the finances and working of the company. He resigned only after a legal notice was received. However, the court held that no liability can be attributed to the independent director as he did not participate in the daily affairs of the company. In fact, it

---

[124] Pooja Ravinder Devidasani v. State of Maharashtra, (2014) 16 SCC 1.
[125] *Id.*
[126] Girdhari Lal Gupta v. D. H. Mehta and Anr. (1971) 3 SCC 189: (In this case, the court interpreted it to mean a person who is in overall control of the day to day business in the case of).
[127] State of Karnataka v. Pratap Chand and Ors. (1981) 2 SCC 335.
[128] National Small Industries Corporate v. Harmeet Singh Paintal and Anr.(2010) 3 SCC 330; Sabitha Ramamurthy and Anr. v. R.B.S. Channbasavardhya (2006) 10 SCC 581.
[129] Har Sarup Bhasin v. Origo Commodities India Pvt. Ltd. 2020 SCC Online Del 11.

was held that the independent director resigned before the cause of action arose, i.e. the company failed to make payment after receiving a legal notice. Thus, the court adopted a lenient view in fastening liability to the independent director for the company's defaults.

It is to be noted that judicial opinion regarding the liability of independent directors has been inconsistent. There is a great degree of confusion regarding the exact nature and extent of their liabilities especially after the introduction of the Companies Act, 2013 and additional duties discharged by them. This is because their role and duties have significantly changed and are continuously being remodeled to ensure they possess professional qualities that help them effectively monitor and protect the interests of the shareholders, investors and other stakeholders who are not adequately represented on the board.

B. ANALYSIS

Board independence as part of corporate governance strategy is necessary in India where shareholding is concentrated and the minority faces potential of oppression perpetrated by the dominant majority. Overtime, the independence of the board has been connected to a string of corporate scams, misdemeanors and offences committed by 'inside directors'. Independent or outside directors are tasked with acting as watchdogs of corporate governance by remaining faithful in protecting the interests of

various stakeholders. Their unique position allows them to examine matters involving a conflict of interest and detect frauds at an early stage by verifying critical points. They are custodians of the governance of the company. An independent board allows fair and unbiased scrutiny of the company's affairs. This is due to the distinction drawn between ownership and control in the company by the introduction of independent directors. It is felt that in the age of corporate autonomy, a one-size fits all approach should be done away with to definitely determine the duties and liabilities of independent directors. A localized approach must be followed to achieve maximum alignment of interests.

As seen from the discussion above regarding the *Zylog* case,[130] independent directors were exonerated of any liability since they used their best efforts in discharging their duties. In the *Jai Prakash Associates* case,[131] the court treated them at par with full-time directors whereas in the *Narayanan* case,[132] the court held that independent directors are expected to discharge their duties as a reasonable diligent person in the same position. Thus, the interpretation of the nature and scope of their duties has varied depending on facts and circumstances. This is also because, though the Companies Act only provides for imposition of a fine or

[130] In Respect of Mr. S. Rajagopal and Mr. V. K. Ramani, Independent Directors of Zylog System Limited, 1WTM/GM/EFD/26/JUNE/2017.

[131] Chitra Sharma and Ors. v. Union of India [2018] 148 SCL 833 (SC).

[132] N. Narayanan v. Adjudicating Officer (2013) 12 SCC 152.

imprisonment, courts have gone further and restrained them from transferring their personal assets. Thus, the liability attracted upon breach is uncertain. Some guidance in this regard can be sought from the MCA 2020 circular. As per the circular, the criteria mentioned under Section 149(12) is met an independent director should not be arrayed in any criminal or civil proceedings.[133] It also further clarifies that unless any specific requirement for filing information/ records with the registry is specified, independent directors are not responsible.[134] Thus, this can be seen as an attempt by the legislators to clarify and limit the scope of liability of independent directors.

Further, what actions of an independent director would constitute 'efforts of a reasonable diligent person' or 'best efforts' is ambiguous. Accordingly, the law on when a duty is said to be breached and to what extent is unsettled. For instance, is it enough for them to record their dissent in the board meeting; are they required to take any active step to remedy the default, such as calling for a meeting of all shareholders to bring the default to their notice of the regulator; whether they are obligated to call for documents to check for compliance for matters discussed at the board meeting; whether their liability can be restricted to a few instances or is the act of merely resigning from the board after recording dissent

[133] *Supra* note 104.
[134] *Ibid.*

amounts to the fulfilment of their role in the company. Juxtaposing the decision in the *Zylog*case[135] and *Har Bhasin* case[136] will shed more clarity on this point. In the latter, despite making specific averments in the complaint, the independent director was not held liable for the company's defaults as he resigned before the cause of action arose. However, it was not considered by the court that he was in a position to know the details of the financial health of the company as he was a part of several committees despite not being involved in the day-to-day functioning. The court ignored the fact that independent directors though not involved, are aware of the company's affairs since they are a part of the Audit Committee. Instead, the court found a mere resignation to be sufficient to discharge the independent director of any liability even if the director took no active steps to remedy the default or voiced dissent. Contrarily, in the *Zylog* case the independent directors were exonerated from liability as they voiced dissent about the misconducts of the company.[137] In my opinion, the approach of the court in the *Zylog* case must be upheld and followed as it is more balanced. It recognizes that despite being watchdogs of the company, independent directors are not as intricately involved as executive directors in the functioning of the company. On the other hand, the approach of the court in the *Jaypee* case and *Punjab National*

---

[135] *Supra* note 130.
[136] Har Sarup Bhasin v. Origo Commodities India Pvt. Ltd. 2020 SCC Online Del 11.
[137] *Supra* note 130.

Bank fraud must only be adopted in exceptional circumstances involving serious fraud and misconduct by independent directors. However, the approach of the court in the *HarBhasin* case must not be followed. This is because, in this case the court upheld their resignation as enough to not impose any liability. This dilutes the standards of corporate governance as the purpose sought to be achieved, i.e. to get a clearer picture about the finances, by making independent directors mandatory members of several committees is defeated.

However, if their duties and liabilities are continually understood as a fluid concept, then it would dissuade people from accepting positions as independent directors particularly due to their lack of pecuniary or personal interest in the company. As a result, there has been a mass exodus of independent directors from the boards of several companies.[138] This exit took place due to the uncertainty regarding the liability, chances of personal reputation being compromised, fraud risk, increasingly stringent corporate governance norms, and now the burden of passing an exam too.[139] Additionally, the risks attached with being appointed as an independent director are too high owing to lack of a uniform judicial view or a consolidating statute about the nature and extent of liabilities of independent directors. Therefore, it is imperative to

[138] *Supra* note 93.
[139] *Id.*

clearly lay down their duties and liabilities to ensure alignment of interests, achieve greater transparency and protect shareholder interests. This will allow them to exercise their duty of care with skill and knowledge as a reasonable diligent person and have *a hands on approach* in the running the company.[140]

V. CONCLUSION

The concept of independent directors is relatively new in India and still in its nascent stage of development. The role played by them in the company, their appointment and remuneration has been fairly settled due to the limited pecuniary interest they have in the company. However, the law relating to their duties and liabilities still remains a grey area.

Duties should be owed to all stakeholders who get affected by the decisions taken by them. But at the same time, their duties cannot be said to extend to people on behalf of whom no decisions are taken, or do not have a direct stake in the company. The statute mandates them to protect the interests of the environment and community, without defining the meaning of these terms. But at the same time the Supreme Court decided that a fiduciary relationship must not be extended even to shareholders in the absence of a specific agreement. This causes confusion regarding the scope and

[140] *Supra* note 132.

nature of duties to be fulfilled by independent directors thereby preventing them from successfully discharging their role in the company. Thus, it can be seen that the legislature must amend the statute to seek and give more clarity on the scope of nature of their duties.

Further, since the very object of introducing independent directors on the boards of companies is to resolve the agency problem, independent directors must be mandated to take steps to prevent the management from committing a default, instead of merely resigning from the company. A mere resignation would not achieve the purpose which independent directors seek to achieve. A formal and structured mechanism must be laid down in the Companies Act, 2013 to determine when independent directors become liable for a wrong committed by the company. Thus, it is important to determine what steps taken by them would constitute towards successful fulfillment of their duties, and to what extent. It is crucial to determine the quantum and nature of liability, i.e., civil or criminal, to be imputed on independent directors. This is because, if the statute is silent and determination of their liability is left to the discretion of courts, it will give rise to a lot of confusion and ambiguity. Hence, even if the courts have the discretionary power to determine their liability, this power must be exercised uniformly and only under exceptional circumstances. More

importantly, it will bring in more uniformity and certainty in the law. It will help in reposing faith amongst independent directors which was lost as an aftermath of the IL&FS debacle.

Therefore, it is imperative to amend the law to clearly lay down the duties and liabilities of independent directors to overcome the existing deterrence in the market against accepting the post of an independent director. It will ensure that independent directors are better equipped to perform their role effectively as a watchdog, overseer and risk mitigator for various stakeholders. This will go a long way in ensuring that Corporate India is better equipped to adopt effective governance practices and arrest future frauds and scams from taking place.

BURSTING THE BUBBLE OF CORPORATE GOVERNANCE: ATTEMPTING TO UNDERSTAND THE LACUNAE IN SPECIAL COURTS

Aman Raj Singh Bajwa and *Anushka Agrahar Murugkar*[*]

ABSTRACT

This paper deals with the topic of special courts under Companies Act, 2013 and analyzes whether or not it is able to realize the objective for which it was introduced. Chapter 1 of the paper attempts to analyze various amendments and reports introduced by the government to lessen the gap between the reality and the objective sought to be achieved by the special courts. Chapter II analyzes the shortcomings of the legal provisions themselves which have rendered the efforts by the government redundant, and suggests plausible solutions.

I. AN EVOLUTIONARY ANALYSIS OF SPECIAL COURTS UNDER COMPANIES ACT 2013

"Special courts are bodies within the judicial branch of government that generally address only one area of law or have specifically defined powers.[1]The concept of special courts is not new to India. The British Government had set up several special courts

[*] The authors are 4th year, B.A. LL.B. students at Jindal Global Law School, Sonipat, Haryana.

[1] Special Courts, West's Encyclopedia of American Law Edition 2 (2008) https://legal-dictionary.thefreedictionary.com/Special+Courts

under different enactments to suppress the freedom movement.[2] These courts had special judges, adjudication on specific issues, special penalties etc. Post-independence, various state governments adopted this method of having special courts and the Supreme Court allowed adjudication through special courts as long as violation of Article 14 of the Constitution did not take place.[3]

The jurisdiction of special courts under company law has long been contested as the erstwhile Companies Act, 1956 did not comprise any specific provision in this context. Cases such as the case of *S. Satyanarayana v. Energo Masch Power Engineering*[4] settled this issue by stating that "special courts are empowered to try the offences under the companies act along with other acts by the notification issued by the state government", thereby empowering the special courts' jurisdiction over the the Companies Act 1956 ("Act of 1956") as well. Following this, various State governments incorporated special courts within their adjudication system in order to reduce the burden on their courts and various tribunals. Acknowledging such developments with respect to changes in the economy and governance structure in various states, the Ministry of

---

[2] Raviskhararaju, *Socio-Economic offences - A study with special reference to the prevention of corruption act 1988*, SHODHGANGA Ch.6 338 (2017) http://hdl.handle.net/10603/126738.
[3] S. Satyanarayana v. EnergoMasch Power Engineering and Consulting Pvt. Ltd. and Others, (2015) 13 SCC 269.
[4] *Id.*

Corporate governance undertook the formulation of Companies Act 2013, while scrapping the act of 1956.

The Companies Bill 2011 was introduced by the 57th Standing Committee report on finance, 2011[5] with the intent to refurbish the regulatory structure of corporate sectors.[6] It is pertinent to accentuate the recommendation in the aforementioned report that spearheaded the designation and setting up of special courts for the adjudication of offenses in the sphere of company law.[7] It became clear from the drafting that the ambit of special courts would be wide, as both 'designation' and 'setting up' of such courts was included.[8]

In 2012, the drafted bill was to contain Chapter 28 on special courts and Sections 435 to 446 were subsequently drafted.[9] Section 435 incorporated the object of establishing special courts so as to ensure speedy trial. The Companies Act 2013, ("companies act") was hence implemented on the basis of the recommendations of the

---

[5] MINISTRY OF CORPORATE AFFAIRS, STANDING COMMITTEE ON FINANCE (2011-2012) 15TH LokSabha: The Companies Bill, 2011 57th Reporthttp://www.prsindia.org/uploads/media/Company/Companies_Bill_%20SC%20Report%202012.pdf.
[6] *Id.*
[7] *Id.* at General clause 132 {2}(c).
[8] *Id.*
[9] MINISTRY OF CORPORATE AFFAIRS, GOV'T OF IND., Annual Report (2012-13), http://www.mca.gov.in/Ministry/pdf/annualreport_2012_2013.pdf.

J.J. Irani Committee Report.[10] Despite the implementation of the new act, pendency and prolonged trials under special courts were noticed. To tackle this issue, the *Companies (Amendment) Act, 2015*[11] was drafted to reduce the burden on special courts, by reducing their jurisdiction such that they tried only those offences which carried imprisonment of 2 or more years and by allowing the government to set up as many special courts as were deemed necessary.[12] Various special courts were thus established all across the country.

The 2016-17 Annual report, while reviewing the Bill of 2016, recommended that, normatively, the special courts must also be formed at the grass-root level of the judicial magistrate of the first class.[13] This was to ensure "ease of doing business and reducing the burden on special courts"[14], by increasing the number of adjudicating authorities. Further, 'other courts' were also to share the power of compounding offences under section 441 of the Act.[15] This process of decentralisation of adjudication of power was done to reduce the gap between the objective of instituting special courts

---

[10] DR. JAMSHED J. IRANI MINISTRY OF CORPORATE AFFAIRS, GOV'T OF IND., EXPERT REPORT ON COMPANY LAW (2005), http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf.
[11] MINISTRY OF LAW AND JUSTICE, GOV'T OF IND., THE COMPANIES (AMENDMENT) ACT 2015, http://www.mca.gov.in/Ministry/pdf/AmendmentAct_2015.pdf.
[12] MINISTRY OF CORPORATE AFFAIRS, GOV'T OF IND., Annual Report (2015-16), http://www.mca.gov.in/Ministry/pdf/Annual_Report_20152016.pdf.
[13] MINISTRY OF CORPORATE AFFAIRS, GOV'T OF IND., Annual Report (2016-17), http://www.mca.gov.in/Ministry/pdf/AnnualReport_20162017.pdf.
[14] *Id.*
[15] *Id.*

and the reality. After the amendment of the bill in 2018, the necessary steps of implementation of the Act were undertaken during 2017-18.

Notwithstanding these efforts, in 2018, a law committee report ("Injeti Srinivas Committee")[16] highlighting the problem of "clogging of the NCLT and excess burden on special courts"[17] was presented. The committee headed by Injeti Srinivas was constituted to review the 'categorization of offences' under the companies act. It was noted that post the 2017 amendment of section 435, 'all offences' under companies act fell under the purview of special courts.[18] This had defeated the earlier efforts to reduce the burden on special courts. They recommended that "to free the courts from dealing with offences that are essentially procedural and technical, certain offences should be removed from the jurisdiction of courts. It should rather be shifted to an in-house e-adjudicating mechanism."[19]Therefore, within the 8 categories of penal provisions in the Companies Act, 2 categories constituting 16 offenses of trivial nature would be covered by the adjudicating mechanism.[20]This had

[16] INJETI SRINIVAS, MINISTRY OF CORPORATE AFFAIRS, GOV'T OF IND., REPORT OF THE COMMITTEE TO REVIEW OFFENCES UNDER COMPANIES ACT, 2013,http://www.mca.gov.in/Ministry/pdf/ReportCommittee_28082018.pdf.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*

been expected to reduce the case load of special courts by 60 %.[21] However, this re-categorization was not taken up in the Rajya Sabha and subsequently the two Companies Amendment ordinances of 2019[22] came up to implement these issues. Therefore, in order to achieve the objective of the special courts to provide speedy trial and effective adjudication, the 2019 Act[23] came into effect.

E-in-house adjudication as a mechanism under companies act is to be undertaken by an adjudicating officer.[24] Within this, defaults of minor technical compoundable offences which earlier had imprisonment will now have penalties. The defaults under the specific re-categorised offences shall be settled through a transparent and mechanical platform that will require minimum human interaction.[25] The online platform, by sending out e-notices, penalties etc., is to overtake adjudication in turn leading to these offences falling out of the jurisdiction of special courts, thereby lessening their burden. Currently, the government has undertaken

---

[21] *Govt re-promulgates ordinance to amend company law*, ECONOMIC TIMES (Jan. 19, 2019) https://economictimes.indiatimes.com/news/economy/policy/govt-re-promulgates-ordinance-to-amend companies-law/articleshow/67511322.cms?from=mdr.

[22] MINISTRY OF LAW AND JUSTICE (LEGISLATIVE DEPARTMENT), GOV'T OF IND., COMPANIES AMENDMENT ORDINANCE (2019), http://www.mca.gov.in/Ministry/pdf/NotificationCAO2019_15012019.pdf.

[23] MINISTRY OF LAW AND JUSTICE (LEGISLATIVE DEPARTMENT), GOV'T OF IND., COMPANIES AMENDMENT SECOND ORDINANCE (2019), http://www.mca.gov.in/Ministry/pdf/AMENDMENTACT_01082019.pdf.

[24] Anubhav Pandey, *Setting Up of In-House e-Adjudication Mechanism for Settling Compoundable Offences under The Companies Act,* I PLEADERS (Feb.6, 2019) https://blog.ipleaders.in/e-adjudication-under-company-law-soon-to-be-a-reality/.

[25] *Id.*

this process of decentralization to diversify the process of implementation of penalties for particular offences via the 2019 Companies Amendment Act.

While this process of de-centralization of power and re-categorization of offences is predicted to make things better as far as offences under companies act are concerned, the ministry has been unable to recognize and address the inherent fallacies of the legal provisions that enable special courts [As will be discussed in chapter 2]. It is because of these statutory fallacies that even though over time the government has been constantly reviewing and revising the provision and execution of special courts, the fissure between the objective and reality of special courts continues to exist. Though the process of de-centralisation is required to manage the enormous case load with limited number of judicial officials, the special courts will not be able to undertake fast-track trial until necessary changes are introduced in the provisions in the first place. The obvious gap therefore will keep increasing until these problems within the legislation are addressed.

II. LOCATING THE SITUS OF FALLACIES WITHIN CHAPTER XXVIII OF THE COMPANIES ACT, 2013

'Chapter I' serves as the backbone of the current chapter as it gives the legal background necessary to locate the situs of fallacies

within chapter XXVIII of the Companies Act, 2013. The purpose of special courts as pointed out in the last chapter is 'speedy trial of offences' with the modus operandi of bifurcating offences in order to focus specifically on grave offences. However, the legal provisions have been drafted in such a manner that this objective seems like a mere eyewash, thereby leading to further decentralization of adjudicating authorities with the aim to somehow achieve the objective.

Without much deliberation, one can say that the factor of 'time' is at the heart of 'speedy trial'. In other words, time and speed are not mutually exclusive concepts; the former is an indication of the latter. The legal drafters of section 435 of companies act[26] completely disregarded this point and drafted a section which laid down the objective without stipulating the necessary check of time that is instrumental in achieving the said objective. The fact that there is no provision in the act prescribing the time limit within which cases should be decided has defeated the very purpose of special courts. Comprehensive reading of the companies act suggests that it is not only the adjudicating authority that has taken the hit because of this drafting error but the investigating agency has also been rendered ineffective because of the same mistake. In the case of *Serious Fraud Investigation Office and anr. v. Rahul Modi and*

[26] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §453 (Ind.).

others,[27] the Supreme Court said that the time limit prescribed for completing investigation under section 212(3) of the companies act, 2013[28] is 'directory and not mandatory'. The implication of this judicial pronouncement is that the investigating agency can take as much time as it requires in completing the investigation without paying any heed to the purpose for which the adjudication authority, bound to try the offence, was constituted. Investigation is the first stage before trial and if at this stage also there is no concept of binding statutory time limit then reaching the stage of trial will be a tedious task in itself. Thus, the objective of 'speedy trial' would be nothing but a black letter law fantasy.

The modus operandi of special courts is bifurcation of offences under the companies act on the basis of the term of punishment. This is done to enable special courts with a single judge, holding office as a session judge or additional session judge, to concentrate only on grave offences punishable with imprisonment of two years or more under the companies act.[29] The purpose served by this specific allotment of jurisdiction for specific offences is declogging of courts to ensure maximum efficiency. This multi layered jurisdiction of special courts is no exception to the threat of

[27] Serious Fraud Investigation Office v. Rahul Modi and Anr., (2019) 5 SCC266 (Ind.)
[28] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §453 (Ind.).
[29] *Id.*

fallacious drafting. In the case of 'S. Satyanarayana v. EnergoMasch Power Engineering and Consulting private limited and other'[30], the Supreme court held that according to section 436(2) of the act, even if a number of persons are accused of the offences under a special enactment such as companies act and also IPC in respect of the same transaction or facts and "even if some could not be tried under the special enactment, it is the special court alone which would have jurisdiction to try all the offences based on the same transaction". Here, the purpose of specific focus on grave offences under the act is defeated as the special courts would also have to try cases of Indian Penal code which are fundamentally different from company law so as to avoid multiplicity of proceedings. Over a period of time there will be accumulation of cases in the special courts ranging from company law to criminal law and in the absence of a statutory time limit, to decide cases, the situation will be back to square one because special courts will neither be 'speedy' nor 'specific'.

It is specifically in light of these drafting errors that the 'InjetiSrinivas Committee' had to recommend e-adjudication for declogging of special courts.[31] The question which arises at this juncture is 'When and where does this process of decentralization stop?' Until and unless the drafting errors mentioned above are

---

[30] *Supra* note 3.
[31] *Supra* note 16.

rectified, the process of decentralization will keep feeding on time and efficiency like a termite.

Quite simply, the objective of 'speedy trial' can be understood to be divided between 'speedy' and 'trial', 'speed' is concerned with special courts whereas 'trial' is concerned with the enforcement agency as it is their duty to bring the wrongdoer to trial. Therefore, ridding special courts of drafting errors alone will not help, provisions concerning the enforcement agency need to be revisited as well. Section 439 of the companies act states that all offences under the companies act except fraud (section 447) are non-cognizable, which means that a warrant is required in order to make arrests concerned with these offences.[32] However, following are some offences in the act which are serious enough to be reconsidered as cognizable offences so as to ensure that wrongdoers are put to justice by special courts:

- Under section 26(9)[33], if prospectus is issued without compliance with the provisions of this section, every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment up to three years. If the investigating authority is made to wait for an arrest warrant after

[32] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §453 (Ind.).
[33] *Id.* at § 26(9).

the issuance of prospectus, it is possible for the directors of the company to abscond with the money so raised and circumvent the ends of justice.

- Under section 74(3)[34], if any deposit is accepted by a company, before the commencement of the companies act, then the company is supposed to file a statement with the registrar about the amount including interest due and the arrangement made for repayment of the same. If the company fails to repay this amount within the prescribed time limit then, along with fine, every officer in default shall be punishable with imprisonment which may extend to seven years. In such a scenario, every card is in the company's hand, if the company doesn't disclose the information, it will be extremely difficult for the enforcement agency to obtain the same. Furthermore, till the time the enforcement agency gets an arrest warrant, a suitable time frame is provided to the directors of the company to illegally wind up affairs of the company and abscond. However, if the offence is made cognizable then the enforcement agency backed by the special courts will serve as a strong force of deterrence thwarting companies from escaping the ends of justice.
- Quite similar to section 74(3) is section 76A[35], under this section if a company accepts deposit in contravention of provisions

[34] *Id.* at § 74(3).
[35] *Id.* at §76A.

under section 73 or section 76, or if a company fails to return the deposit along with the interest then every officer of the company in default shall be punishable with imprisonment which may extend to seven years. The problem with this section is a replica of the problem with section 74, the company already has a huge sum of money along with the time window to escape with it. Furthermore, the proviso in this section states, if intention of officers to deceive the company is established then the action will lie under section 447 (fraud) with a severe punishment of ten years. This proviso works as an incentive for such officers to escape the ends of justice while at the same time provides them with the required time frame to do so by making the offence cognizable.

It is only after we take a holistic or a three sixty-degree view of the companies act as well as the Indian special courts, that we will be able to free our special courts from their inherent shortcomings.

III. CONCLUSION

Since the inclusion of the idea of special courts, the government has been trying to improve the efficiency of its working. 'Chapter I' has traced the developments undertaken by the Ministry of Corporate Affairs so as to achieve the aim of speedy trial and reduction of pendency of cases, to ensure that the aim of

introducing the special courts is met. To do this, the ministry took various steps like introducing multi-layered jurisdiction of special courts, enabling them to concentrate on specific offences, increasing the number of special courts all over the countries, enabling the judicial magistrate of the first class to undertake cases, etc. Finally, with the 2019 amendment, the government introduced an e-in house-adjudication mechanism and shifted various offences to be addressed by this mechanism. It did so looking at the comparative success of the Income Tax mechanism. While this mechanism might help in achieving the aim of having special courts, 'Chapter II' makes it clear that the inherent provisional problems are the major cause of hindrance with regard to the working of the courts.

At present, the situation of special courts under companies act in India is such that the extensive punishments mandated for offences under the act are merely black letter law and in reality, the process rarely leads to such punishments. It is because the path to punishment is filled with procedural and technical lacunae.

The American law can be taken as a model, as some aspects of American law if adopted by the Indian courts can help make the situation better. For instance, the punishment for offences under American company law are more relaxed in comparison to India and they still serve the purpose of deterrence because they have achieved both prongs of 'speedy trial', i.e. not only are their special courts free

of drafting errors but their enforcement agency is well equipped with legal provisions to ensure that wrongdoers are put to justice.[36] Therefore, if these lapses are not taken care of and more courts are not 'constituted' instead of being 'designated' as special courts, justice will be lost in the spiral web of jurisdiction and decentralization because an already suffocated body of courts cannot be expected to ensure speedy trial.[37] Secondly, the provision of 'plea bargaining', under which the offender accepts the responsibility of offence and requests reduction in sentence, so that the burden of prosecution to prove its case is removed, should be permitted. This will ensure speedy disposal of cases where the defendant accepts the guilt, and pendency will decrease. "The United States Supreme Court has recognized plea bargaining as both an essential and a desirable part of the criminal justice system".[38] "The benefits of plea-bargaining are said to be obvious: the relief of court congestion, alleviation of the risks and uncertainties of trial, and its information gathering value".[39] Hence, allowing plea

---

[36] PTI Mumbai, *SEBI seeks special courts for speedy trials in market frauds*, THE HINDU, BUSINESS LINE, (Oct. 22, 2012) https://www.thehindubusinessline.com/markets/sebi-seeks-special-courts-for-speedy-trials-in-market-frauds/article23086146.ece.

[37] Sakshi, *What is special about special courts?*, THE HINDU, (Jan. 3, 2017) https://www.thehindu.com/opinion/op-ed/What-is-special-about-special-courts/article16978952.ece.

[38] Santobello v. New York, 404 U.S. 257, 261 (1971).

[39] People v. Glendenning, 127 Misc.2d 880, 882 (1985).

bargaining will facilitate efficient functioning of the special courts as well.

In conclusion, the companies act introduced a variety of changes, one being the introduction of special courts with the aim of providing speedy trial. The reality of the functioning of the special courts over time became more and more distant from the aim it sought to achieve. The government took variety of steps to reduce this inherent gap by external methods without focusing on the internal aspect of legislation. Therefore, until and unless the internal deficiencies of special courts are re-visited, external solutions will be redundant.

RECONFIGURING STAKEHOLDER-ORIENTED DIRECTORS' DUTIES AS UNDER SECTION 166(2) OF THE INDIAN COMPANIES ACT 2013: THE BEDROCK OF CORPORATE GOVERNANCE

Parnika Sharma[*]

ABSTRACT

Section 166(2) of the Companies Act, 2013 is a noteworthy legislative insertion in the Indian statute as it envisages a pluralist approach towards directorial duties wherein all non-shareholder interests alongside shareholder interests have been recognized. While this inclusive approach may perhaps be valuable from a larger philosophical perspective, this paper presents its potential practical irregularities in the Indian corporate landscape. For this, the author makes an attempt at analyzing the provision from the stakeholder lens to understand if it is a mere lip service or a flawless legislative intervention. Through the use of qualitative and comparative methodology, the paper first presents the observed contemporary relevance of directorial duties and its underlying stakeholder approach as a component of corporate governance framework in India; part II gives a prologue to Section 166(2), its significance and legislative history; part III breaks down the statutory duty for an in-depth examination through four different standpoints namely shareholder primacy vs. stakeholder approach, accountability of directors, good faith and best interest obligation, practical enforcement; part IV attempts at procreating a normative understanding through

[*] The author is a 4th year B.A. LL.B. student at Jindal Global Law School, Sonipat, Haryana.

a comparative study with stakeholder oriented countries like Germany and Japan; and part V offers some normative recommendations for amending the prevalent arrangement.

I. INTRODUCTION

Whether be it amidst concerns of inefficiency in corporations[1] or be it worrisome macroeconomic situations in a country,[2] alterations are often suggested in the corporate framework. This is generally advocated through stronger enforcement of corporate governance where internal structures of responsibility are established. One such structure is the edifice of directorial responsibilities which interests the Indian legal community even today due to its conceptualization as a regulatory strategy under the Companies Act, 2013. With constant changes in the socio-political affairs of an economy, these regulatory strategies continue to initiate legal dialogue and discourse. Especially with the recent COVID-19 outbreak being declared pandemic, corporate governance issues had come to fore, compelling boardrooms to engage in exceptional and cooperative deliberations. For instance, cautious India Inc. had taken swift control of the stakeholders' interests by shifting to virtual operations and allowing their employees to work from home besides taking

[1] Shouvik Kr. Guha & Abhyudaya Agarwal, *Criminal liability of corporations: Does the Old Order Need to Change,* 1 NUJS L. REV. 329, 329 (2008).

[2] Press Trust of India, *Improve corporate governance to lift economic efficiency: RBI to India Inc*, BUS. STANDARD, Dec. 27, 2019; *See* Aviral Kumar Tiwari, *Corporate Governance and Economic Growth,* 30 (4) ECON. BULLETIN 2825 (2010).

many other difficult decisions pertaining to dividend payments (whether to continue the practice of paying dividends to shareholders or to retain that amount to save employees from being furloughed).[3] Seeming to be a mere social concern, this health emergency resulted in various strategies which advertently or inadvertently steered corporate governance towards the holistic model of stakeholder engagement. Directors were advised not only to re-evaluate their revenue generation and profitability for upholding shareholder confidence but also to maintain communication with their consumers and other stakeholders on account of any disruption in service or to provide alternate supply of services due to the lockdown[4] besides devising novel plans for community support. The pandemic made corporations discern the importance of employees' physical & emotional well-being and of maintaining customer, supplier and creditor confidence over and above mere shareholder profit-maximization objectives. In the Indian context, these considerations have presented a visible demonstration of the director's exercise of fiduciary duties based on

---

[3] Press Trust of India, *Coronavirus: Tata Motors asks staff to work from home,* LIVEMINT, Mar. 15, 2020, https://www.livemint.com/companies/news/coronavirus-tata-motors-asks-staff-to-work-from-home-11584284913649.html; Lynn S. Paine, *Covid-19 is Re-Writing the Rules of Corporate Governance,* HARVARD BUSINESS REVIEW, Oct. 06, 2020, https://hbr.org/2020/10/covid-19-is-rewriting-the-rules-of-corporate-governance.

[4] Cyril Amarchand Mangaldas, *Coronavirus: Key Legal Issues For India Inc. With Covid-19,* BLOOMBERG QUINT, Mar. 14, 2020, https://www.bloombergquint.com/opinion/coronavirus-key-legal-issues-for-india-inc-with-covid-19.

the stakeholder approach, as envisaged in Section 166(2) of the Companies Act, 2013. But the practical implementation of this regulatory strategy may still be fraught with some irregularities and it is legally pertinent to identify and remedy the same in order to improve the contemporary corporate governance framework of India.

A conjoint reading of Section 166 along with other duty-focused provisions like that of Corporate Social Responsibility[5] depicts how the 2013 Act doesn't recognize 'shareholder primacy' model as the sole approach for decision making.[6] Whilst some scholars continue to find merit in the shareholders primacy model, others contend that the stakeholders approach is broader and better.[7] Here, the former emphasizes on maximization of shareholder's values and the latter focuses on the interests of diverse stakeholder constituencies.[8] Section 166(2) mirrors a similar ambiguity as it is observed that while the provision might encompass a pluralistic approach, the statute mostly provides shareholder focused remedies.[9] While this regulatory provision of Section 166(2) is lauded for creating social responsibility towards stakeholders through its pluralistic approach,

---

[5] Companies Act, 2013, No. 18 of 2013, §135 (Ind.).
[6] Afra Afsharipour, *Redefining Corporate Purpose: An International Perspective*, 40 SEATTLE UL REV. 465, 466 (2017).
[7] Navjyoti Samanta, *Judging the Remedy: An Analysis Of The Methods Employed To Solve Corporate Governance Problems* 7 (6) NSLR 91, 91 (2011).
[8] *Id.* at 93.
[9] *Supra* note 6 at 468.

confusion often crops up with regard to its true fruition.[10] It is here that a qualitative assessment of this provision is necessitated.

II. SECTION 166(2): FIDUCIARY DUTIES TOWARDS STAKEHOLDERS

Post-independence India's corporate law was molded by socialism to extend the purpose of corporations beyond the protection of shareholders.[11] Creditors' and employees' concerns were accorded significance under different provisions.[12] In a corporate sphere marked by concentrated shareholding,[13] this recognition of non-shareholder interests showcases a different inclination. The Supreme Court of India also advanced a parallel rationale in the Sangramsinh P. Gaekwad judgment where it acknowledged that the directors owed no special responsibility to the shareholders and their fiduciary duty to the company couldn't be equated with their responsibility towards the shareholders.[14]

Such an intention to adapt to the stakeholder-oriented model was first made visible in clause 147(2) of the Companies Bill, 2008

---

[10] *Id.* at 468.
[11] Umakanth Varotill & Richa Naujoks, *Corporate Governance in India: The Business Opportunity,* 306 (Linda Spedding ed., 1st ed. 2016).
[12] Companies Act, 1956, No. 1, Acts of Parliament, 1956, §§439, 529A (Ind.); The Companies Act, 2013, No. 18, Acts of Parliament, 2013, §326 (Ind.).
[13] *Supra* note 11 at 293.
[14] Sangramsinh P. Gaekwad and Ors. v. Shantadevi P. Gaekwad, (2005) 3 Comp LJ SC 385 (Ind.)

where codification of director's duties was propounded in accordance with the J. J. Irani Expert Committee Report and international best practices.[15] According to this clause, an obligation was vested in the directors in order to uphold the company's interests considering the benefits accrued to its members. This proposition didn't categorically mention any specific stakeholders and thus, the attempt mostly conveyed shareholder primacy when it didn't recognize the diverse stakeholder interests ubiquitous in companies. But the Irani Report had made recommendations to put in place the category of '*employees*'[16] whereby directors would exercise their duties in their interests as well as in the in the interests of the company.

It was later through the Companies Bill of 2011 that the non-shareholder interests of employees, community and environment, as stated under clause 166(2),[17] were approved and inserted as a positive duty in the Companies Act, 2013. Inserted to resolve the unsatisfactory situation caused by the absence of codification of director's duties during the pre-2013 regime, Section 166 reinforced a pluralist approach where finally not only the shareholders but

---

[15] Bikramaditya Ghosh & Karmendra Singh, *Director's Duties in India- Strengthening the Laws On Trusteeship*, 91 SCL 83 (MAG) ¶ 5 (2009).

[16] MINISTRY OF CO. AFFAIRS, GOVT. OF INDIA, *REPORT OF THE EXPERT COMMITTEE ON COMPANY LAW 2005,* 43 (2005-06). http://reports.mca.gov.in/Reports/23Irani%20committee%20report%20of%20the%20expert%20committee%20on%20Company%20law,2005.pdf

[17] The Companies Bill, 2011, 121 of 2011, cl. 166(2) (Ind.)

stakeholders were also recognized under sub-section 2 of the said provision.[18]

> "***166. Duties of directors***
>
> *(2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.*"

Whilst the previous Act of 1956 had recognized stakeholders interests like that of the employees, creditors under various situations,[19] it was for the first time in the 2013 statute that the best interests of not only the company but all shareholders, employees, community and environment could be specifically codified under the head of 'duties of directors'.[20] Though this pluralist approach is commendable for instituting inclusivity of interests, it's still questioned if a mere classification of distinct stakeholder interests necessarily implicates its actual enforcement. Moreover, while this

---

[18] *Supra* note 11 at 307; Mihir Naniwadekar & Umakanth Varottil, The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis, NUS-CLB Working Paper SeriesNo.16/03 1, 9 (2016). https://poseidon01.ssrn.com/delivery.php?ID=511022123009020080115114086001015100015085067047049006069119018121017028093001083010059033063005047062023007010122098086098092038043041039017019069009016079120000100065016018100116003021123120101024095065096030119093065109067077020002027077102113091001&EXT=pdf.

[19] The Companies Act, 2013, No. 18, Acts of Parliament, 2013, §§326, 439 (Ind.); The Companies Act, 1956, No. 1, Acts of Parliament, 1956, §529A (Ind.).

[20] The Companies Act, 2013, No. 18, Acts of Parliament, 2013, §166 (Ind.).

approach may perhaps be valuable from a larger philosophical perspective, there may exist a possibility that this approach or the way it is defined could raise practical issues in the Indian corporate landscape.[21] The following section evaluates these contentions.

III. ASSESSING SECTION 166(2)

A. SHAREHOLDER PRIMACY VS. STAKEHOLDER APPROACH

Ubiquitous in Section 166(2) is an overarching debate between the 'shareholder primacy' theorists and 'stakeholder approach' theorists. The former find merit in promoting shareholder interests due to its measurability where it can be assessed through financial and other indicators like share price, shareholder satisfaction, company growth and stability.[22] On the other hand, stakeholder interests are mostly subjective in nature where the Board is more likely to face a dilemma when it comes to choosing between conflicting stakeholder interests.[23] Some scholars note that the bigger object of social welfare can be achieved only when the company strives to maximize its shareholder wealth.[24] This is in line

---

[21] *Supra* note 11 at 307.
[22] *Supra* note 11 at 308.
[23] *Id.*
[24] Henry Hansmaan & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEO. L.J. 1, 10 (2001).

with the theory Milton Freidman proposed viz. that company's management owes primary responsibility only to the shareholders.[25]

Conversely, the Godrej Committee (a committee constituted in 2012 by the Ministry of Corporate Affairs to articulate policy recommendations for improving Indian corporate governance) pronounced its support in favor of the stakeholder approach in India and recognized that the shareholder primacy should not be the sole approach of the corporations. Both models could co-exist provided stakeholder interests were balanced as that would result in sound relationships between the company and the stakeholders, ultimately leading to shareholder profit maximization. It would be shareholders' responsibility as well, to foster stakeholders' interests in order to prevent probable negative responses from those entities that render support to the company's establishment and growth.[26] It has been observed that these strategies under the corporate governance framework, as formulated in the report, could bring convergence between the seemingly divergent interests of shareholders and stakeholders.[27] Many other scholars and international institutions like the Organization for Economic

---

[25] Eugene Schlossberger, *A New Model of Business: Dual Investor Theory,* 4(4) BUS. ETHICS QUARTERLY 459, 459 (1994).
[26] MINISTRY OF CORP. AFFAIRS, GOVT OF INDIA, *REPORT OF THE COMMITTEE CONSTITUTED BY MCA TO FORMULATE A POLICY DOCUMENT ON CORPORATE GOVERNANCE*, 5 (2012-13).
http://www.nfcg.in/UserFiles/Guiding-Principles-of-CG.pdf
[27] *Supra* note 6 at 479.

Cooperation and Development (OECD) endorse the corporate governance principles and framework to recognize stakeholder approach as a key determinant in corporate success.[28]

While there exist strong arguments for both sides, the approach which suits the Indian corporate landscape should be examined. Though Section 166(2) has been intended to create a balance between the two approaches, there exist practical difficulties. For instance, most Indian companies comprise of controlled/concentrated shareholding where only a few shareholders hold the majority shares.[29] In such a scenario, it is essentially likely that the majority shareholders' interests might overshadow the stakeholders' interests like that of the minority shareholders, resulting which Section 166(2) would pay a mere lip service.[30] Thus, it is worth stating in passing that such an arrangement of concentrated shareholding can even render futile the words '*benefit of its members* ***as a whole***' as mentioned in Section 166(2), when practically implemented.

---

[28] Lyman P. Q. Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose* 38 DEL. J. CORP. L. 405, 435 (2013); OECD, *G20/OECD Principles of Corporate Governance,* 34 (2015).
[29] *Supra* note 6 at 475.
[30] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance,* 6 Hastings Bus. L.J. 281, 283 (2010); Umakanth Varottil, The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony, 55 CLB Working paper Series No.15/01 1, 55 (2015).

But evident from the aftermath of scams like the Satyam scandal, is a fact that the theory of protecting stakeholder interests is being reinforced.[31] This theory also stands in consonance with the socialistic development of corporate law in India.[32] Indian legislators have, thereby reflected their intention to relegate Freidman's stark motives with respect to free market shareholder oriented enterprises. A similar view is now being accepted to hold that shareholder profits would be best realized if stakeholder approach is followed as this theory takes into consideration the long term interests of not only the investors but also of the employees, community, customers etc. who would be willing to repeatedly associate themselves with the company provided their expectations are met simultaneously.[33]

B. ACCOUNTABILITY OF DIRECTORS

According to this provision, the director is responsible to the enlisted stakeholder constituencies, namely the company's shareholders, its employees, the community and environment. While this pluralist view fixes directors' duties, it doesn't fix their

---

[31] Afra Afsharipour, *The Promise and Challenges of India's Corporate Governance Reforms,* 1 (1) IJLE 33, 48 (2010); *Supra* note 6 at 477

[32] Umakanth Varottil, The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony*,* 55 CLB Working paper SeriesNo.15/01 1, 61 (2015); *Supra* note 11 at 307.

[33] JUSTICE ALEX CHERNOV, CORPORATE GOVERNANCE AND THE DUTIES OF COMPANY DIRECTORS, 45-47 (Ian M Ramsay ed., 1st ed., 1997).

accountability to an identifiable personality. This implies that even if directors would be able to justify the discharge of their duties to ascertainable constituencies like that of the shareholders and employees, they won't be able to prove it as against the community and environment which largely remain public interest duties.[34] For these broad and indefinite constituencies, one may infer that the legislature created the provision as merely a preachy regulation where it risks leaving the directors unaccountable to certain entities and thereby, countenancing potential public interest violations.

Further, there exists a lack of guidance as to how the varied interests between various stakeholders should be balanced when there is a conflict between the interests of one stakeholder constituency vis-à-vis another constituency or even the shareholder interests.[35] Since the provision is broadly worded, it is contended by some scholars that the consequential discretion that flows from such a section would leave the directors less answerable to anyone.[36] While this section gives directors the opportunity to balance competing stakeholder interests, the vague wording could result in having them favor their own interests and subsequently diluting all other interests given the substantial amount of adjudicatory and

[34] Jaison John, *Section 166(2) of the Companies Act 2013; Protection of Stakeholders Or Primacy Of Company?,* 4 COMP LJ 138,139 (2016).
[35] *Supra* note 6 at 482.
[36] *Supra* note 19 at 20.

discretionary powers vested in them.[37] This also leaves open the possibility of directors favoring the shareholders as they are the primary controllers of company's functioning and also hold the exclusive right to either hire or fire any director.[38]

C. GOOD FAITH AND BEST INTEREST OBLIGATION

On a plain reading of the provision keeping in mind the expressions and punctuation used, two different literal interpretations can perhaps be inferred by dividing sub-section 2 of Section 166 into 2 parts differently.[39] While, in both the interpretations, the first part of Section 166(2) remains the same, the dissimilarity lies in the construing of second part of Section 166(2) mainly. According to the first interpretation, the second part of Section 166(2) can be read to have a director *act in best interests of the company, employees, shareholders, community and environment*. On the contrary, according to the second interpretation, the same sub-part can be read to have a director *act in good faith in the best interests of the company, employees, shareholders, community and environment.*[40] While the former interpretation creates a "best interests" obligation, the latter

---

[37] *Id.* at 20; *Supra* note 11 at 308.
[38] Companies Act, 2013 No. 18, Acts of Parliament, 2013, §§151, 152, 169 (Ind.).
[39] Companies Act, 2013, No. 18, Acts of Parliament, 2013, §166(2) (Ind.).
[40] *Supra* note 19 at 10.

construes it as a "good faith and best interests" obligation and arguably issues exist in both the types.[41]

What ensues from the first interpretation is that the director will be obligated to act in the best interests of the stakeholders and the good faith obligation is not extended in their favor but is limited only to the promotion of company's objectives. This alludes to a divergence in the standards of obligations owed separately to the members as whole and other stakeholders. On one hand, the director may be required to subjectively determine her/his actions as bonafide when promoting the company's objects and working for the members' benefit, but on the other hand the director is to objectively discharge the duties based on the best interests of the stakeholders.[42] However, such an objective interpretation would be unfeasible during conflicting stakeholder interests as it would be nearly impossible for a director to objectively uphold the best interests of employees over the shareholders' interest.[43] Not only would this interpretation ultimately reinstate shareholder primacy over stakeholder interests but when coupled with assessment (A), it wouldn't resolve competing stakeholder interests and may cause maximization of director's personal interests. Ultimately, not sparing the objective approach any objectivity thereon.

---

[41] *Supra* note 34 at 139.
[42] *Supra* note 19 at 19; *Supra* note 34 at 140.
[43] *Supra* note 19 at 19.

According to the second interpretation, the good faith obligation applies to the promotion of company's objects as well as to all the stakeholder interests. This also alludes to the Standing Committee's reading of the clause according to which this provision seems to cast no independent obligation on the director with respect to the stakeholders as the good faith obligation is owed to both the company and stakeholders.[44] With such a good faith obligation being cast on the directors, while the interests of the company as well other stakeholders' interest are to be considered, their primary duty is about 'promoting the company's objects' without any independent consideration being paid to the stakeholders' interests.[45]

Furthermore, in both interpretations, the term 'company' is repeated in both sub-parts of Section 166(2) which implicates primary placing of company's interests over any other stakeholder's interest. Such an arrangement has been ironically argued to possibly strike out any conflicts between the interests of the stakeholders and the company, as with such phrasing of the provision company's interests are likely to prevail.[46] And traditionally company's interests are considered synonymous to the interests of its existing and future

---

[44] *Supra* note 19 at 10; MINISTRY OF CORP. AFFAIRS, GOVT. OF INDIA, STANDING COMMITTEE OF FINANCE, *THE COMPANIES BILL, 2009: TWENTY FIRST REPORT,* ¶ 11.75-11.80 (Aug. 26, 2010).

[45] *Supra* note 19 at 10.

[46] *Supra* note 34 at 142.

shareholders.[47] This paradoxically indicates to the implicit hierarchizing of interests even when the section is claimed to espouse a pluralist approach. Essentially, in practical reality it is the directors who are vested with the decision making power and thereby positioned in such a way that it leads to the inevitable creation of a hierarchy between competing interests in peculiar situations.[48] For instance, directors may be burdened in the process of prioritizing the interests of the company (shareholders) over that of the employees (stakeholders) in a particular circumstance.

D. PRACTICAL ENFORCEMENT

Whilst the provision's key beneficiaries may be the stakeholders, enforceability of the diverse stakeholder interests still remains a question. If understood practically, shareholders being the owners of the company can vote out a director from power through a simple majority if the shareholders feel disadvantaged by the director's actions (Section 169 of Companies Act, 2013).[49] Thus, in nexus with the aforementioned points of assessment, one can possibly infer from this that the director is unlikely to advocate the interests of stakeholders over that of the members. This is not only because the community represents a public interest unmarked by

[47] *Supra* note 33 at 45-47.
[48] *Supra* note 11 at 308.
[49] Parker Hood, *Director's Duties Under The Companies Act 2006: Clarity Or Confusion?,* 13 (1) JCLS 1, 15 (2013).

any ascertainable identity to whom the director could owe his duty but also because the standard laid down for judging the fulfillment of their interest remains imprecise. In other words, the best interest standard may not allow any call for action against the directors unless the stakeholders can justify a serious departure from this standard.[50] Further, the statute doesn't seem to provide any remedy to the stakeholders for enforcing and protecting those interests as against any breach of directors' duties.[51] While Section 178 provides for a Stakeholders Relationship Committee, it doesn't consider the grievances of key stakeholders other than the 'security holders of the company'.[52] For other breach of duties, the affected party generally has a possible recourse to initiate legal actions in the court of law. Shareholders have the opportunity of bringing in a class-action remedy (Section 245 of Companies Act, 2013) or a derivative law suit in exceptional situations against the director but such legal claims remain unavailable to all other stakeholders.[53] This raises doubt as to the justifiability of such interests and efficacy of the pluralistic approach adopted by the legislature in the provision.[54]

---

[50] *Supra* note 34 at 142.
[51] *Supra* note 6 at 488.
[52] The Companies Act, 2013, No. 18, Acts of Parliament, 2013, §178(6) (Ind.).
[53] *Supra* note 19 at 16.
[54] *Supra* note 11 at 308.

IV. COMPARATIVE UNDERSTANDING OF DIRECTOR'S FIDUCIARY DUTIES

Though it is impractical for a country's corporate governance system, that is constantly determined by its unique social, political and economic features, to adopt a different model from another country,[55] but an attempt can still be made at formulating a normative understanding for such a regulatory provision by gauging an international perspective.

While the Indian corporate law often takes into account comparative examples from UK and USA, it is imperative to take due notice of other western and eastern stakeholder model countries like Germany and Japan besides them. Unlike the Indian provision where there exists ambiguity on how directors should settle competing interests between stakeholders and shareholders, UK's 'Enlightened Shareholder Value' (ESV) approach arguably vests directors with the clear duty of upholding shareholder primacy over stakeholder interests.[56] It has been argued that though this approach emerged apparently to strike a balance between shareholder interests and company's socialistic responsibilities by having regard to non-shareholder interests,[57] Section 172 of the 2006 statute is formulated

---

[55] Victor Andres Ortiz Fandino, *Towards the Convergence of National Corporate Governance Systems? Unlike to Happened,* 5(1) E-MERCATORIA 1, 3 (2006).
[56] *Supra* note 6 at 487.
[57] Cynthia A. Williams & John M. Conley, *An Emerging Third Way?: The Erosion Of The Anglo-American Shareholder Value Construct*, 38 (2) CORNELL INT. LAW J. 493, 558 (2005).

in a way that it ultimately fosters protection of shareholder interests.[58] Further the Company Law Review didn't recommend the adoption of the stakeholder approach even when it had recognized the merits.[59] On the other hand, the US have created 'Benefit Corporations' to have the directors adhere to stakeholder interests in the long term by deviating from the common law principle of shareholder-wealth maximization.[60] However, several counter arguments run parallel demonstrating how the actual law of the land has been in lines with the shareholder primacy approach.[61]

Another important model of corporate governance is prevalent in Germany and Japan which is sometimes referred to as the 'insider' system as here while shareholding may be concentrated, stakeholders have an equal say with shareholders (for instance, like shareholders, employees' representatives are also consulted during takeover bids).[62] These countries' corporations are demarcated by a '*two tier board*' (i.e. management board and supervisory organ) which foster active employee and investor participation in decision making processes pertaining to management and control.[63] Unlike the

---

[58] Arad Reisberg & Ian Havercroft, *Dierctor's Duties under Companies Act 2006 and the Impact of the Company's Operations on the Environment*, SSRN 1, 7 (2010).
[59] *Id.* at 7.
[60] *Supra* note 11 at 308.
[61] David G. Yosifon, *Opting Out of Shareholder Primacy: Is the Public Benefit Corporation Trivial?*, 41 DEL J CORP LAW 461, 462 (2016).
[62] *Supra* note 57 at 498.
[63] *Supra* note 55 at 2.

Anglo-American system, these countries invest in employee training and education to develop and enhance the skills of their human capital which thereby results in increased productivity and decreased turnover.[64] It is established almost as a managerial philosophy that it's the management's duty to mediate between different stakeholder-shareholder interests and to treat employees as important players in corporate governance.[65]

In Germany, employees through the supervisory board seek mutual cooperation instead of confrontation for which work councils are established as consultation bodies. These councils provide a forum for discussion and negotiation of decisions being taken by the management board like employees' working conditions, remuneration, safety, holidays, vocational trainings etc.[66] For example, a German pharmaceutical company 'Bayer' took its trade union's approval before reducing wages.[67] While the German corporate governance system has introduced changes in order to adapt itself to the neoliberal ideology and globalization, it continues to remain an exemplar of stakeholder corporate governance.[68] Since banks still exercise a dominant role over the management as a board

---

[64] *Id.* at 4.
[65] Sanford M. Jacoby, *Corporate Governance in Comparative Perspective: Prospects for Convergence,* SSRN 1, 3, 14-15 (2001).
[66] *Supra* note 55 at 3.
[67] *Id.* at 3.
[68] *Id.* at 4.

member & lender[69] and there exists a system of collective bargaining through work councils along with co-determination practices, there is little possibility of the German system converging into a shareholder oriented model.[70] It is pertinent to note here that the Indian stakeholder framework fails to accord a categorical recognition to 'creditors' in Section 166(2) which are an important stakeholder constituency vis-à-vis directors' duties. While Section 166(2) may recognize employees, shareholder, community and environment, there is no specific mention of creditors, banks, suppliers or even customers in the aforesaid provision and this needs to be remedied to avert potential disputes.

Like Germany, in Japan the corporate governance systems are concerned with employee value unlike the English system where the focus is on shareholder value. Managers are incentivized for safeguarding employee's jobs and internal legal protection regimes as against job cuts. For instance, companies like Toshiba and Fujitsu though decided to dissolve certain job positions but did ensure that the path of mass firings was not implemented. They rather executed it through employee attrition and early retirement plans.[71] Through career development and promotion plans, Japanese companies commonly believe in creating long relations of trust with employees,

---

[69] *Id.* at 3.
[70] *Id.* at 4.
[71] *Supra* note 65 at 14-15.

besides customers, banks and suppliers which also contributes in reducing effects of agency issues.[72] So, while German companies uphold stakeholder corporate governance through work councils, Japanese companies have joint committees and enterprise unions who maintain a link with the management.[73]

Some critique this model because their analysis shows that such models of worker protection can lead to destruction of firm value, for instance in cases like India where workers have been observed to have opposed their substitution with new machines.[74] In contrast, other analysts argue that in a corporate world demarcated by incomplete contracting system and problems like agency costs and imperfect information, stronger protection of stakeholder interests will produce maximization of firm value.[75] This is because enforcing employee protection and proportional bargaining powers will not only incentivize workers to advance firm oriented skills but will also create '*knowledge-intensive industries*'[76] and promote '*welfare capitalism*'.[77]

Some comparative studies note that this model shows better results than other corporate governance systems as the

---

[72] *Supra* note 55 at 4.
[73] *Supra* note 65 at 3.
[74] Stijin Claessens & Kenichi Ueda, *Stakeholder Corporate Governance: The Combined Effects of Bank Competition and Employment Protection*, SSRN 5, 5 (2014).
[75] *Id.* at 5.
[76] *Id.*
[77] *Supra* note 55 at 2.

commitments this approach makes in Germany and Japan, have contributed in creating stable and long-term relations with all stakeholders by allowing their co-determination, participation and representation instead of privileging the shareholders.[78] For instance, in contrast to Germany and Japan, there is lesser representation of employee interests in USA where often they aren't afforded a role in corporate governance due to which employees are more mobile in such companies.[79] Previously in the period of 1970s – 1990s, UK's approach didn't garner good growth rates as its GDP levels remained low and lagged behind Japan and Germany.[80]

As observed from the approaches of these countries, stakeholder theory presents as a 'voice model' where not only the shareholders but also other stakeholders like the employees etc. are made capable of expressing their interests to the management and the latter is obliged, in their fiduciary capacity, to attend to them in the best interests of the company. Studies show that despite being important stakeholders, employees are given little role under the

---

[78] *Supra* note 65 at 16; *See* Ruth V. Aguilera & Gregory Jackson, *Comparative and International Corporate Governance*, 4(1) The Academy of Management Annals 485, 495, 499 (2010); *See* Simon Deakin & Alan Hughes, *Comparative Corporate Governance: An Interdisciplinary Agenda*, 24 J.L. & Soc'y 1, 5 (1997); Michael J. Rubach & Terrence C. Sebora, *Comparative Corporate Governance: Competitive Implications of an Emerging Convergence,* 33(2) Journal of World Business 167, 172-173, 176-177 (1998).

[79] *Supra* note 65 at 16.

[80] Id. at 23; *See* Organisation for Economic Co-operation and Development 2021, *Gross domestic product (GDP) (indicator)*, https://data.oecd.org/gdp/gross-domestic-product-gdp.htm (last visited Feb. 07, 2021).

Anglo-American corporate governance system when nations like Japan and Germany accord them moderate to important role through customs and statute.[81] German literature recognizes how this approach makes companies act as 'good citizens' when they contribute to the community or other stakeholders in any possible way, for instance, donating to universities, providing for employees' job security during merger or winding up,[82] reducing carbon emissions etc. But what occasionally ensues from such an approach is the detriment of shareholders' commercial interests which in itself may be a practical concern.[83] While the provision of Section 166(2) might not entail clarity on how the 'good faith' and 'best interests' standards have to be adjudged, it is ambiguous on how the director can actually implement this pluralistic approach (if it goes against shareholder's profit generation) rather than rendering it a mere lip service.

Here, the most viable alternative to such an issue can be by acknowledging that since these stakeholder concerns are enormously important, the best way to safeguard these interests would be by promoting 'stakeholder participation' in decision making which would in turn help directors discern the significance these concerns hold in producing an 'overall increase in business value'.

---

[81] *Id.* at 3.
[82] Theodor Baums & Anja Birkenkaempar, *Corporate Governance in Germany,* SSRN 6, 6 (1998).
[83] *Supra* note 58 at 10.

V. SOME NORMATIVE RECOMMENDATIONS

Since this paper is not a direct attempt at investigating the intrinsic worth of the stakeholder approach amidst the inconclusive debates between the shareholder advocates and the stakeholder advocates, it is essential to move a step beyond and strive for an infallible stakeholder model in India. While the legislators have already made a noteworthy stride in that direction through Section 166(2) and other pluralistic schemes, limited jurisprudence is emerging out of courts regarding the merits of this corporate governance strategy.

The Indian companies are perhaps well ahead of their USA & UK counterparts, as they have already begun to implement the pluralistic goals of the stakeholder approach which the Anglo-American corporations are now beginning to realize.[84] Some measures are needed to avoid the same predicament being faced by the Anglo-American(s) where the seemingly stakeholder oriented schemes have been criticized for proving to be mere rhetoric and practically fallible. While the legislative purpose seems to be clear in India, it is important to not reduce the black letter law to mere words on paper and ensure the true fruition of the stakeholder interests alongside shareholder interests. As observed through the

[84] BUSINESS ROUNDTABLE, *Statement on the Purpose of a Corporation,* Aug. 19, 2019, https://opportunity.businessroundtable.org/ourcommitment/.

in-depth structural, terminological and rationale analysis of this provision in the previous sections, there exist some lacunae and the following recommendations are an attempt towards resolving those.

- Even though Section 166(2) is regarded as a manifestation of a pluralist approach, it fails to take note of the important stakeholders of creditors, suppliers as well as consumers. Though the constituency of creditors may find some mention in other provisions of the statute,[85] they along with suppliers and consumers/customers should be mentioned in Section 166(2) as they play a key role in the working of the company and the directors should be categorically responsible towards them as well.
- Further, the provision requires an explanatory note on the ambiguous constituencies of community and environment in order to avoid copious public interest violations owing to the vagueness in their stipulations. It is unclear if the legislature intended to encompass the general public, consumers, suppliers and creditors within this stakeholder constituency of 'community' or even 'environment' so to say.
- There should be an effective redressal mechanism and/or remedies for stakeholders to use if the directors breach their duty, similar to that of shareholders. Remedies specific to

[85] The Companies Act, 2013, No. 18, Acts of Parliament, 2013, §§113, 213(b), 241(1)(b), 287(2) (Ind.).

stakeholder interests should be legislated in order to minimize the risk of breach of directorial responsibility and also to award legitimacy to director's duties towards various stakeholders through some legal backing. Stakeholders' rights will remain implied rights if they aren't created as enforceable obligations. Some suggest that through the creation of mandatory redressal mechanisms, stakeholders receive a forum to have their concerns addressed and can also expect stronger enforceability of their rights.[86]

- As observed through the second part of Section 166(2), shareholders are placed as one of the stakeholder constituencies. But it's important to realize that they are only one out of the several constituencies mentioned. Thus, on a prima facie understanding, shareholder interests should be accorded equal weightage as that of the employees, community and environment. In order to achieve this, an alteration is needed in the related discourse so as to avoid the implicit hierarchization of interests. But there exists a lack of guidance from the legislature, executive and judiciary as to whose interests should be prioritized by the directors in situations of conflicting interests between the shareholders and the non-shareholder constituencies or even amongst the

[86] Deva Prasad M, *Companies Act 2013: Incorporating Stakeholder Theory Approach into the Indian Corporate Law,* STATUTE LAW REVIEW 1, 10 (2017).

non-shareholder constituencies. For example: (a) Environment/Community vs. Company- A pharmaceutical company tests certain medicinal drugs on animals. They are being opposed by several animal rights organizations who have apprehensions regarding animal testing. Should the company's management ignore these concerns so as to avoid any stoppages in its production activities or should it become cognizant of stakeholder interests that may have an impact on their reputation and even long run production?;[87] (b) Employee vs. Shareholders- A company is purchasing new technology to achieve higher, efficient and environment friendly production. Whose interests should prevail? Should it be the shareholders who would gain out of the firm's higher productivity & the environmental activists who had been demanding such eco-friendly solutions or should it be the employees who would be laid off due to their substitution with new technology if the directors don't cognize their concerns? Whose interests should weigh more? Since the law vests such decisions on the director's good faith and best interests' discretion and since no effective guidelines/parameters exist for this kind of subjective determination, the directors more often than not are likely to

[87] Global Corporate Governance Forum, International Finance Corporation, *Stakeholder Engagement and the Board: Integrating Best Governance Practices,* FOCUS 8, 41 (2009).

side with such interests that would tangibly result in corporate growth.[88] Thus, while the general notion during conflicting interests is for the company to comply with its immediate profit making and legal requirements & goals, the management should be motivated to negotiate and address these concerns in order to achieve long term gains and not neglect them due to the potential short term costs.[89]

- Further, proper guiding policies are needed to supplement directorial discretion when catering to the myriad stakeholder interests, not only to avoid conflicts in these interests but also to avoid the possibility of directors catering to none of them on account of large number of responsibilities towards so many diverging stakeholder interests. Again, we need a normative model on how to avoid the prioritization of shareholder interests over other non-shareholder interests. This is also because in practical reality shareholders hold the exclusive rights of electing, appointing and removing directors to or from the Board of the company.[90] So even if stakeholder interests are accorded recognition in the law, there still persists a gap in this functional shift from

---

[88] Andrew Keay, *The Duty to Promote the Success of the Company: Is it Fit for Purpose?*, University of Leeds School of Law, Centre For Business Law and Practice Working Paper No.20, 20 (2010).
[89] *Supra* note 87 at 41.
[90] Companies Act, 2013, §§151, 152, 169 (Ind.).

shareholder to stakeholder theory. Another way of resolving this could be by involving stakeholders in decision making processes through advisory boards like work councils in Germany and joint committees in Japan. In order to have meaningful engagement with stakeholders, we should think beyond establishing consultation boards as these merely foster one-way communications. The management should instead be provided with mechanisms and forums for conducting dialogues and two-way conversations. Not only does this give representation to the stakeholders but also an opportunity to the company alongside the stakeholders for negotiating each other's interests. For instance, communities can effectively represent their concerns through advisory councils and mutual cooperation.[91] It has been found that many companies have established stakeholder panels and independent committees to review their performance and receptiveness towards stakeholder interests.[92] This way of inviting inputs from different stakeholder constituencies can abate risks and ensure a suitable action plan is reached through this process.[93]

---

[91] *Supra* note 87 at 37-38, 48.
[92] *Supra* note 87 at 49.
[93] Rabindra Jhunjhunwala & Stuti Galiya, *Corporate Governance: Director's duties and Liabilities under Companies Act, 2013,* LEXOLOGY, Sept. 16, 2014, 3 https://www.lexology.com/library/detail.aspx?g=aabc1dae-ab94-4f58-893d-f8f68b51c731.

- It has been observed that the Ministry of Corporate Affairs has taken some steps to enhance business responsiveness to stakeholder interests through "National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, 2011". But such guidelines should preferably derive legitimacy from law and their implementation should be mandated in all companies through simple compliance procedures and action plans.[94] These mandatory guidelines when coupled with a 'due diligence exercise' can help balance conflicting shareholder and non-shareholder interests when the directors have to exercise their discretion.[95]
- It is contended that even the problem of concentrated shareholding (which is largely specific to the Indian corporate landscape amongst many other nations) can facilitate meaningful stakeholder engagement as such shareholders also intend to strive for long term gains for the company. For example, Tata Group despite being a family-controlled firm continues to engage with its stakeholders.[96]

---

[94] PIB, *MCA releases national guidelines on responsible business conduct*, MANUPATRA(New Delhi) Mar.13, 2019.
[95] *Supra* note 87 at 10-11.
[96] *Supra* note 6 at 491.

Despite all of these recommendations, one thing is clear that when the Indian companies law recognizes stakeholders' interests beyond mere shareholders' interests under Section 166(2), there certainly is some light at the end of the tunnel. Nonetheless, this black letter law should be made implementable by the judiciary and the legislature through the development of relevant legal principles.[97] Having said that, it shouldn't be the courts/legislature alone who should determine the aforesaid, rather the collective work of corporations and academicians to contribute in sustaining this stakeholder framework and not render it a mere lip service. Likewise, the abovementioned solutions merit further research and investigation as they are hypothesized normative solutions due to the paucity of precedents.

VI. CONCLUSION

While the Indian move towards a pluralistic model as envisaged in Section 166(2) is a laudable approach, there remain certain justifiable ambiguities pertaining to the underlying objectives, standards and enforcement concerns that could be addressed. Given the concentrated shareholding landscape in Indian corporations, the problem of stakeholder interests' being overshadowed by majority shareholders' interests can be resolved by directors through more holistic stakeholder & shareholder engagements (like Germany and

---

[97] *Supra* note 33 at 45-47.

Japan's mutual-cooperation based 'insider models') wherein the shareholders are apprised of the long-term benefits of integrating stakeholder concerns. In order to avoid the said provision from becoming a mere lip service, it should be supplemented with definitive guidelines (for reconciling conflicting shareholder-stakeholder interests), unambiguous interpretations and specific redressal mechanisms. Through legislative reconsideration of the identified structural deficiencies along with a proper reassessment of its substance, this regulatory effort can perhaps be an instrument in transforming the Indian corporate landscape. As inferred through several international arrangements like those present in German &Japanese corporations, such an evolved legal insertion envisions the corporations to not only engage in dialogue with their shareholder-owners but also their stakeholders and this institutional objective itself indicates how a remarkable leap can be made towards reinforcing 'responsible corporate behavior' when rectified for its inadequacies. Through the directors' meaningful collaboration with stakeholder interests, the company can certainly create higher shareholder wealth and stakeholder benefits at the same time.[98] This is especially important during and post COVID-19 era as corporate boardrooms have observed the shareholder primacy model being challenged by a more inclusive model of stakeholder-oriented

[98] *Supra* note 87 at 52.

decision making. Going forward, it will conceivably remain crucial for directors to remain cognizant of the significance of materiality assessments, long-term decision making, healthy working environment/human capital and the role of mutual cooperation with principal stakeholders, in order to have their firms cope and survive any such situations of crisis. It is to this effect that policy makers, corporations and academicians should continue their quest for reconfiguring directors' duties as enhanced stakeholder-oriented obligations, for that will continue to constitute the substratum of all corporate governance matters.

MAKING THE LEGAL CASE FOR ESG INVESTING

Jayadeep Manchikalapudi and *Anomitra Debnath**

ABSTRACT

"Sustainability" is the buzzword in all ecosystems at the moment, and the finance sector is no exception to the trend. Contrary to popular belief however, its effects in the financial world may be greater than that of an ethical fad. So-called non-financial factors such as climate change are steadily making their presence felt in stock price fluctuations, and investment managers are waking up to the role of Environmental, Social, and Governance (ESG) factors in risk assessment. In this article, we advocate for change in conventional governance norms at asset management companies by re-examining their fiduciary role in light of ESG investing. In achieving the same, we firstly discuss the correlation between ESG integration and returns, establish the business case for ESG integration by evaluating its costs and benefits in light of a holistic concept of profitability. Thereafter, we pose the question - does neglecting ESG criteria in investment decisions constitute breach of a fiduciary's duties? The answer is discovered to be in the affirmative. The materiality of ESG risks and the positive correlation between ESG and returns in certain sectors, make it obligatory upon fund managers to incorporate ESG in their risk assessment procedures failing which, they must disclose such risks to their clients so as to fully discharge their duty of care and loyalty. Our approach finds support in recent regulatory changes in India as well as abroad thus proving that the way

---

* The authors are 3rd year B.A. LL.B. students at Hidayatullah National Law University, Naya Raipur, Chhattisgarh.

investment managers perceive profits and risks must be altered astronomically in a post-crisis commercial world.

I. INTRODUCTION

At the beginning of 2020, European nations were in the process of assessing their crisis-management systems by running a perfect storm simulation.[1] As it turned out, the effects of COVID were unprecedented, even in comparison to a perfect storm. The question arose—what does our lack of preparedness indicate? Nothing new. It is not unknown that our risk-assessment/risk-management systems are largely vulnerable to market-wide risks that we consider immitigable by investment choices. However, changing theories suggest that this is not the case. Research indicates that practices of sustainable investing may actually impact systemic risks in a market; and further, that incorporation of environmental, social, and governance (ESG) factors may prove to be just as (if not more) "profitable" than conventional processes. It is in light of these observations that we seek to analyze the scope of a fiduciary's duties, and how fund managers may insulate from liability by ensuring ESG integration within their services.

---

[1] Jack Ewing, *European Banks Prepared for a Crisis. But Not This One.,* THE NEWYORK TIMES (May 20, 2020, 09:30 AM), https://www.nytimes.com/2020/04/06/business/european-banks-coronavirus.html.

II. THE CONCEPT OF ESG

A. WHAT IS ESG?

Environmental, social and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.[2]

B. RE-ASSESSING PROFITABILITY

Before diving into the debate on whether ESG Investing yields better results as compared to conventional investment patterns, it is important to first establish an ideal result—a theory of what we consider profitable, so to speak. Two factors primarily govern the process (aside from magnitude) i.e. the certainty of the result and the time period over which we get these results. With respect to the first, the ideal result would be maximum possible certainty; and regarding the second, it's a question of the investment remaining profitable till the very end of the investment period. To simplify, the

---

[2] James Chen, *Environmental, Social, and Governance (ESG) Criteria*, INVESTOPEDIA (June 02, 2020, 02:21 PM), https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.

answer may be distilled down to two concepts—firstly, accurate risk assessment and secondly, the appropriate time horizon.

1. **<u>The Assumption of Risk</u>**

Modern Portfolio Theory (widely accepted by many as an ideal investment strategy) proposes that there are two components or categories of risk—systemic and non-systemic.[3] The theory focuses on the non-systematic or 'specific' risks and tries to minimize the overall risk across a portfolio by diversifying said portfolio. There is an assumption that the systemic risks are non-diversifiable and cannot be mitigated through investment decisions. Consequently, the focus has always remained on the latter category of risks, but that may soon change.

In their revolutionary paper[4], the Hawley-Lukomnik pair proposes that investment decisions can, and do affect systemic risks owing to the changed investment landscape today where institutional investors have significant greater impact than before. Secondly, that ESG factors that are initially considered as alpha may transform into beta as the industry begins to seclude and recognize them as legitimate influences on systemic risk.

---

[3] Ben McClure, *Modern Portfolio Theory: Why It's Still Hip*, INVESTOPEDIA (June 01, 2020, 11:20 AM), https://www.investopedia.com/managing-wealth/modern-portfolio-theory-why-its-still-hip/.

[4] Jim Hawley & Jon Lukomnik, *The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons*, 41 SEATTLE U. L. REV. 449 (2018).

It is the aforementioned view that we subscribe to herein—that inclusion of ESG factors is a tool for obtaining higher risk-adjusted returns[5] or at the very least, better understanding of the risks associated with investing in a particular stock. Even without concerning ourselves with actual returns, it may be said that the non-inclusion of ESG factors clearly skews processes of risk assessment and renders them incomplete. Additionally, it is common sense that as we move towards more sustainable patterns of investment, the incidental (as it may be a result of non-ethical considerations) improvement of E, S, and G factors are likely to mitigate systemic risks (for example, natural disasters).

2. <u>The Time Horizon Problem</u>

One need not undergo an in-depth analysis to conclude that capital markets are rife with a multiplicity of investor horizons. Clearly, the question of what constitutes an appropriate time frame has assumed some significance then. Naturally, investors prefer voluminous returns as soon as possible. As a result, asset managers tend to bend over backwards to ensure short-term profits as opposed to sustenance of these profit levels. On the other end of the spectrum, risk-averse managers use the pretext of long-term aims in order to excuse their underperformance in the short term.

---

[5] Ashwin Kumar et al., *ESG factors and risk-adjusted performance: a new quantitative model*, 6 J. SUST. FIN. & INV. 292 (2016).

Needless to say, both these approaches result in undue focus on time horizons as opposed to investing fundamentals, or "wrong-terminism".[6]

We consider it unnecessary to evolve a bright-line test for a subjective question. What is paramount here is the alignment of manager's time preferences with that of the client.[7] For the purpose of assessing profitability therefore, we conclude that any investment manager who makes an investment decision with a view to maximize profits over the full length of the investment period (as opposed to, say quarterly earnings) has managed to look beyond the horizon. Of course, we do not discount that this may be coterminous with a long- term risk management view.

C. BUSINESS AND ESG INTEGRATION

What distinguishes the business case approach from generic Socially Responsible Investing (SRI) approaches is that the former extols the 'financial benefits' of integrating ESG factors as opposed to the ethical or moral incentives. There is substantial research done, not just by academicians but also, financial institutions around the world, as to whether ESG investing is practically feasible and leads to better returns. In research done by Morning Star (a prominent

---

[6] Andrew Verstein, *Wrong-Termism, Right-Termism, and the Liability Structure of Investor Time Horizons*, 41 SEATTLE U. L. REV. 579 (2018).
[7] Anne Tucker, *20/20 Vision in the Long & Short-Termism Debate*, 41 SEATTLE U.L. REV. 337 (2018).

ESG ratings agency) it was found that mutual funds with a 5-globe Sustainability Rating (the highest possible score), when compared to 1-globe funds, have better risk-adjusted returns relative to their category, less volatility, and greater exposure to financially healthy companies.[8] Research by another global investment firm revealed ESG ratings to be a strong source of alpha in emerging markets equities.[9] Firms with sincere CSR efforts performed better financially during the 2008-09 financial crisis.[10] Cash flow, risk management and profitability were positively correlated with high ESG ratings.[11] Similarly, a study commissioned by Deutsche Bank found positive relationships between ESG factors and financial performance.[12] This list is not exhaustive and the data favouring

---

[8] Jon Hale, U.S. *ESG Funds Outperformed Conventional Funds in 2019,* MORNINGSTAR (Apr.16, 2020), https://www.morningstar.com/articles/973590/us-esg-funds-outperformed-conventional-funds-in-2019.

[9] Chris Varco, *The Value of ESG Data: Early Evidence for Emerging Markets Equities*, CAMBRIDGE ASSOCIATES (June 10, 2020, 2:20 PM), https://www.cambridgeassociates.com/insight/the-value-of-esg-data/.

[10] Lins K.V et al., *Social capital, trust, and firm performances: The value of corporate social responsibility during the financial crisis*, 72 J. FIN. 1785 (2017).

[11] Giese, et al., *Foundations of ESG Investing Part 1: How ESG Affects Equity Valuation, Risk and Performance,* MSCI (November 2017), https://churchinvestment.org/wp-content/uploads/2018/03/MSCI-How-ESG-Affects-Equity-Valuation-Risk-and-Performance.pdf.

[12] DB CLIMATE CHANGE ADVISORS, *SUSTAINABLE INVESTING: ESTABLISHING LONG-TERM VALUE AND PERFORMANCE,* DEUTSCHE BANK GROUP 49 (2012), https://www.db.com/cr/en/docs/Sustainable_Investing_2012---Establishing-long-term-value-and-performance.pdf.

incorporation of metrics relating to climate change, gender diversity in the board rooms etc. are aplenty.[13]

Notably, another principal concern is the possible overvaluation of major companies having 'unburnable' assets. *Carbon Tracker's* 2012 Report—Unburnable Carbon—laid forth the premise that the world's 20 biggest companies were substantially overvalued; in that only 20% of their assets were usable in compliance with international global warming objectives.[14]All signs thus point to the existence of a "carbon bubble" in capital markets due to overvalued fossil-fuel assets and companies heavily reliant on them. A risk-return ESG analysis would conclude that the company's foreseeable litigation and regulatory risks are underestimated by its share price, and that reducing or avoiding investment in the company will improve risk-adjusted returns.

1. **Balancing the Drawbacks**

Irrespective of the pros discussed, there remain valid concerns regarding ESG mainstreaming which we seek to tackle hereinafter:

[13] Filbeck. A, et al., *Performance Assessment of Firms Following Sustainalytics ESG Principles*, 28 J. INV. 7 (2019).

[14] James Watkins, *The Future of Finance: The Post-Crisis Commercial Culture*, 35 HARV. INT'L. REV. 8 (May, 2020) [hereinafter Watkins].

Firstly, that ESG is hard to quantify and there are disagreements with respect to how ESG is best measured.[15] The breadth and vagueness of the factors as a whole, and the likelihood that different factors bear on different investments, pose barriers to their widespread use as investment guides.[16] Thus what may be considered to be a potential risk for a tech company need not be the same for a fossil fuel company. Lack of objective standards and the means to comprehend vague corpus of data prevents the mainstreaming of ESG integration. Furthermore, a gap in awareness poses a functional barrier to its implementation. A survey[17] revealed that more than half of surveyed asset managers did not receive any ESG-related training and complained about the lack of quantitative ESG information. In such cases, asset managers may not have a clear sense on how to incorporate ESG into the portfolio. It is difficult, therefore, to attach liability for non-consideration of ESG factors when there exists no set criterion. Regardless, we view this as an opportunity to encourage region and industry-specific research. The absence of a 'one-size-fits-all' theory may, in fact, allow ESG

---

[15] Christensen. H et al., *Adoption of CSR and Sustainability Reporting Standards: Economic Analysis and Review,* EUR. CORP. GOVERNANCE INST., Finance Working Paper No. 623/2019. See also, Khan. M et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697 (2016).
See also, A. Yoon et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697 (2016).

[16] Paul Brest et al., *How Investors Can (and Can't) Create Social Value*, EUR. CORP. GOVERNANCE INST., Law Working Paper No. 394/2018.

[17] SVIATOSLAV ROSOV, *THE EVOLVING FUTURE OF FIDUCIARY DUTY IN AN ESG WORLD,* CFA INSTITUTE 20 (2018), https://www.cfainstitute.org/-/media/documents/survey/esg-survey-2018.ashx.

integration policies to be more adaptive to markets and hence forward the notion of sustainability upon which it is principally based.

Secondly, green washing, mis-selling and misrepresentation of investment strategies are all listed as potential sources of "sustainability" conflicts.[18] Green washing refers to instances where fund managers choose to reflect their own ethical choices in investment decisions even when such ESG guidance is not financially viable (or material). It is in these instances where responsible investing becomes murky. Nevertheless, this does not posit itself as a legitimate excuse to turn a blind eye to ESG risks. It is worth noting, in the same breath, that these issues are easily remediable and in no way serve to subtract from the materiality of ESG criteria in investment decisions. Ultimately, it is this materiality which attracts potential liability of fund managers as fiduciaries (failing ESG integration/disclosures).

III. ESG AND FIDUCIARY'S DUTY

Over the years, through academic discourse and judicial decisions alike, a presumption of inevitable conflict between a fiduciary's duties and ethical considerations can be seen to have

---

[18] Ick Jin, *Is ESG a systematic risk factor for US equity mutual funds?* 8 J. SUST. FIN. & INV. 72 (Oct. 2017); Huw Jones*, EU watchdog says ESG rating firms need rules to stop 'greenwashing'*, REUTERS (Feb.12, 2020), https://in.reuters.com/article/us-eu-climate-regulator/eu-watchdog-says-esg-rating-firms-need-rules-to-stop-greenwashing-idINKBN2062H6.

arisen. The infamous Cowan v. Scargill[19] case is oft-cited to support this narrow presumption. The case involved the trustees of UK-based National Coal Board pension fund. Half of the trustee board sought to restrict the fund from investing in "energies which are in direct competition with coal". However, doing this would prevent the fund from maximising its returns potential. The remaining trustees sought legal proceedings claiming that to limit investment through the consideration of any reason other than financial was in breach of their fiduciary duty. The resulting judgment was perceived to require that profit maximisation should be placed above all other considerations. For a number of years this misguided interpretation meant that the long-term value of many E,S and G issues were simply ignored by both trustees and investment managers.[20] It is no surprise therefore that institutional investors tend to be phobic about values, and there exists a belief that one might violate his fiduciary duties if he applies non-financial factors (such as ESG) as opposed to investment values to the process.[21] Sadly, this works to their own detriment in failing to recognize that risk factors are

---

[19] Cowan v. Scargill, (1985) Ch 270.

[20] Neil Dwane, *The complex and changing world of fiduciary duty*, ALLIANZ GLOBAL INVESTORS (June 10, 2020, 11:01AM), https://www.allianzgi.com/-/media/allianzgi/globalagi/documents/the-complex-and-changing-world-of-fiduciary-duty.pdf.

[21] Ali Murad Syed, *Environment, social, and governance (ESG) criteria and preference of managers*, 4 COGENT BUS. & MGMT. 1340820 (2017).

dynamic and consequently, prominent asset pricing models are prone to losses in efficiency.[22]

Although modern ideas do not assail the fact that the client's "financial best interests" are above all other, the correlation between ESG factors and stock performance is swiftly gaining cognizance; it is this very correlation that may lend new meaning to "financial best interests" as the goal. For instance, according to the landmark Freshfields report on fiduciary duty, published by the United Nations Environment Programme's Finance Initiative in 2005: "… it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists." [23] The UN perspective only serves to strengthen our own views—that ESG integration is more aligned with pure financial considerations than is generally acknowledged.

A. THE EXISTENCE OF A FIDUCIARY RELATIONSHIP

The first step that one must take in order to establish any fiduciary obligation is to establish the existence of a fiduciary

---

[22] Maiti. M*, A Critical Review on Evolution of Risk Factors and Factor Models,* 34J. ECON. SURV. 175 (2020).
[23] *Id.*

relationship. Fiduciary duties of asset managers are codified either directly or using phrases that indicate the same in India. For example, Regulation 25 of SEBI Mutual Fund Regulations state that, *fund managers (whatever the designation may be) shall ensure that the funds of the schemes are invested to achieve the objectives of the scheme and in the interest of the unit holders.*[24] Similar regulations for institutional investors (apart from mutual funds) directly state that fund managers are to act in fiduciary capacity towards the investors[25] or client's funds.[26] Regulators around the world also followed the black letter approach to codify fiduciary duties of the asset managers. For example, French regulators established that "investment services providers shall act honestly, fairly and professionally, with due skill, care and diligence, in the best interests of clients and the integrity of the market".[27]

The scope of fiduciary relationships that we seek to cover include (but may not be limited to) mutual fund managers, portfolio management services, alternative investment funds including hedge funds etc. which operate on institutional bases (to the exclusion of individual investors). The nature of fiduciary duty attached to these relationships is usually either that of a trustee/beneficiary, or agent/principal depending on the case.

---

[24] SEBI (Mutual Funds) Regulations, 1996, Reg. 25 (6b).
[25] SEBI (Alternative Investment Funds) Regulations, 2012, Reg. 21.
[26] SEBI (Portfolio Managers) Regulations, 2020, Reg. 23 (3).
[27] Article 314-3, General Regulation of The Autorité Des Marchés Financiers.

B. SCOPE OF A FIDUCIARY'S DUTIES

Fiduciary law is messy and eludes theoretical capture.[28] Therefore, it is beyond our scope to debate upon the merits of the various theories of fiduciary duty. Consequently, we find ourselves subscribing to relevant elements of fiduciary obligations for the purposes of the forthcoming discussion. Essentially, fiduciary duty is a legal relationship between two or more parties, most commonly a "fiduciary" or "trustee" and a "principal" or "beneficiary".[29] Fiduciary relationships form when one party (the "fiduciary") acts on behalf of another party (the "beneficiary") while exercising discretion with respect to a critical resource belonging to the beneficiary.[30] In the *Marcel Martins* case,[31] the Indian courts went into great detail with regard to this subject. To state the position briefly, fiduciary relationships are differentiated from non-fiduciary relationships on the basis of the peculiar confidence reposed in a fiduciary and the high standard of duty to which he is held in acting for the ends of the beneficiary.

Justice Frankfurter wrote, "To say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is

---

[28] Alexander Styhre, *What we talk about when we talk about fiduciary duties: The changing role of a legal theory concept in corporate governance studies*, 13 MGMT. & ORG. HIST.113 (2018).
[29] John Murray, *Fiduciary Duties*, EXPERT WITNESS DIRECTORY (Feb. 07, 2021, 01.59 PM), http://expertwitness.com/es/resume-categories/fiduciary-duties.
[30] Smith, D. Gordon, *The Critical Resource Theory of Fiduciary Duty*, 55 V AND. L. REV. 1399 (2002).
[31] Marcel Martins v. M. Printer, (2012) 5 SCC 342.

he a fiduciary? What obligations does he owe as a fiduciary?"[32] Although the former question brooks no fresh discourse, the exact obligations that an asset manager has towards his client may be distilled down to two principal precepts—first, the duty of care; and second, the duty of loyalty.

C. DUTY OF CARE

All fiduciaries have, as part of their core duties, an obligation to act in good faith and to exercise due care and diligence. The duty of care is essentially a non-fiduciary duty which is a part of a fiduciary's duties[33] but for our purposes, the distinction is redundant. In our paradigm, the duty of care is a tortious duty rooted in concepts of negligence and whether it is considered a part of fiduciary duties properly so-called does not change the fact that our fiduciaries must meet both a standard of care, as well as a standard of conduct (in discharging his duty of loyalty). However, they must do more than simply believe that they are acting in the best interests of the corporation i.e. only good faith will not suffice. A fiduciary must act *carefully and make himself fully aware* of the breadth of information material to his decision.[34] A failure to discharge this obligation results in breach of the fiduciary duty of care.

---

[32] SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).
[33] Gregory. A, *The Fiduciary Duty of Care: A Perversion of Words*, 38 *AKRON L. REV.* 181 (2015).
[34] Kahn v. Roberts, 679 A.2d 460 (Del. 1996).

1. The Risk of Neglecting ESG

On deciding whether or not a fiduciary is in breach of their duty, the test we apply is the 'prudent investor' test; or, that a fiduciary shall exercise "care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims."[35] Naturally, it is implicit herein that an asset manager must consider all *financially material information* before making their investment decision. The question naturally follows—do ESG factors constitute "financially material information"?

In short, yes. For instance, the UK Law Commission states, "Trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors (ESG). The law goes further; trustees should take account of financially material risks."[36] Clearly, where ESG factors do become financially material (materiality of ESG having been illustrated in the first part of the paper), it is imperative to take

---

[35] William G. Droms, *Fiduciary Responsibilities of Investment Managers and Trustees*, 48 FIN. ANA. J. 58 (1992).
[36] UK LAW COMMISSION, FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES REPORT GUIDANCE 3 (2014), https://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties_guidance.pdf.

them into account. Negating the assumption that ESG is nothing more than a cluster of non-financial factors, the Law Commission further illustrated the distinction as: "Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor."[37] The perspective is shared by a number of regulatory bodies as has been discussed in the coming chapters.

2. <u>Liability</u>

Consider a situation wherein a fund manager X has knowledge of Risk Factor E of a stock. However, he faces losses due to inadequate application of mind and/or risk assessment. Would we then consider X liable for breaching his duties?

Here, it is not sufficient to say that X has acted in good faith and that mere knowledge of E signifies that he has incorporated it into his investment decision. "*It is the failure to take the steps which a reasonably competent administrator would take which constitutes negligence (or gross negligence), not the failure to consider it."*[38]Thus, not conducting a risk/reward analysis of the merits of the investment, which the investment manager knew (or should have known) was uneconomic

[37] LAW COMMISSION, FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES, HC 368 at 113 (UK).
[38] Primeo Fund (In Official Liquidation) v. HSBC Securities Services, (2017) 2 CILR 334.

at the outset, is an act of negligence.[39] Incompetence is no excuse as there is a presumption of reasonable competence in the established 'prudent investor' test. Even when the asset manager argues that he acted in good faith and what he perceived to be the best interests of the clients as in the above case, he cannot avoid liability for wilfully ignoring red flags.[40] Since it is established now that ESG factors are red flags (risks) in the investment process, there exists fiduciary obligation on the part of asset managers to integrate the same.

On the question of whether a trustee of a fund house may also be liable for the negligent acts of asset managers, the Calcutta High Court answered in the affirmative stating that *a failure to ensure that due care is taken to protect that which another has handed over in trust, would constitute breach of the obligation*[41] thus indicating that trustees may also be held liable for the acts of asset managers who fail to consider ESG factors.

D. DUTY OF LOYALTY

The principal is entitled to the single-minded loyalty of his fiduciary. This core duty has several aspects. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may

[39] SPL Private Finance v. Arch FP, (2014) EWHC 4268 (Comm).
[40] Zutty v. Rye Select Broad Mkt. Prime Fund, (2011) 939 N.Y.S.2d 745.
[41] ITC Limited v. JP Morgan Mutual Fund India, (2018) AIR CC 3108.

conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.[42]

The fiduciary duty of loyalty may be understood by adherence to two rules:

1. The "No Conflict Rule" – a fiduciary must avoid acting where there is a conflict between their duty and their interest (a "duty-interest" conflict), and also where there is a conflict between duties owed to multiple principals (a "duty-duty" conflict).
2. The "No Profit Rule" – a fiduciary must not make an unauthorised profit by reason or in virtue of the fiduciary office or otherwise within the scope of that fiduciary office.[43]

1. <u>Conflict of Interest</u>

Currently, it is the non-ESG factors that drive executive compensation. Compensation systems that reward portfolio managers based on the short-term and relative performance measures create clear disincentives to incorporate long-term measures of environmental or societal sustainability—at least in

[42] Bristol & West Building Society v. Mathew (1996) EWCA Civ. 533.
[43] UK LAW COMMISSION, FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES REPORT 55 (2014), http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf.

publicly listed firms whose results are tracked quarterly.[44] Preventing the exit of an investor for preserving its management fee is in violation of fiduciary obligation of the investment manager.[45] Since ESG investing may hurt the pockets of the asset managers, they may choose to not proceed with the same even though they are aware of its benefits. In that case, it becomes a classic case of conflict of interest i.e., the asset manager isn't acting in the unit holder's or client's best interests and is considering his own benefit over the performance of the securities. The resolution of this conflict necessitates the full and frank disclosure of all *material facts* to the client.[46] As we have previously established, this includes the disclosure of material ESG risks.

At this point, it may be noted that what we propose is not the steering of investment decisions in an ESG-positive direction but instead, the mere *consideration* of ESG factors in the decision-making process. This implies that the fund managers could still choose not to opt for ESG-positive stocks if not suitable to the investment agreement or fund scheme or the objectives of the fund by providing reasons for the same. Thus, we seek to propose a 'comply or explain' model to be followed when it comes to the question of ESG integration and further suggest that failing to discharge this

---

[44] Christina Leijonhufvud & Jeffrey P. Fitts, *Global Warming's Unlikely Antidote: Why Capital Markets hold the Key to Addressing Climate Change*, 82 SOC. RES.: INT'L Q. 761 (2015).
[45] Paige Capital Management, LLC v. Lerner Master Fund, (2011) Del. Ch. LEXIS 116.
[46] New Zealand Netherlands Society Oranje Inc. v. Kuys, [1973] 1 WLR 1126.

burden breaches our concept of fiduciary duty. The evidence of materiality in combination with commoditization of ESG data thus imposes positive duties on asset managers[47] to integrate ESG issues into their decision-making process[48] hence paving the way for a targeted litigation strategy that could address common law impediments to an adapted definition of "fiduciary duty."[49]

E. THE POSSIBILITY OF CONTRACTUAL WAIVER

The US Securities and Exchange Commission (SEC) recently published its interpretation of the standard of conduct applicable to investment advisers – including managers of private funds which reaffirms and clarifies the SEC's position on the fiduciary duty of investment advisers. The Interpretation clarifies that an agreement to waive off an adviser's fiduciary duty, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts, or (iii) a waiver of any specific obligation under the Advisers Act, is inconsistent with the Advisers Act and may be a violation of law. Such a waiver in the fund's offering documents can lead to liability for the general partner or sponsor of the fund.

---

[47] RORY SULLIVAN ET AL., *FIDUCIARY DUTY IN THE 21ST CENTURY*, UNITED NATIONS GLOBAL COMPACT ET AL. 16 (2015), http://unepinquiry.org/wp-content/uploads/2015/09/Fiduciary-duty-21st-century.pdf.

[48] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731 (2019).

[49] Keith L. Johnson & Frank Jan de Graaf, *Modernizing Pension Fund Legal Standards for the 21st Century*, Network for Sustainable Financial Markets, Consultation Paper No. 2 (February 2009).

Although an adviser's fiduciary duty cannot be completely waived, the SEC acknowledges that the adviser and client can shape their relationship by contract, depending on the sophistication of the client, and whether there is full disclosure and informed consent.[50]

This effectively abolishes the notion that fiduciary duty may be contractually waived without limit. Even in other territories, courts are unlikely to give effect to such clauses that seek to fully absolve fiduciaries of any duty of care. The actions of investment advisors are subject to tortious liability for failure to exercise reasonable care, irrespective of their contractual duties, since it is policy and not the parties' contract, that actually gives rise to a duty of due care.[51] Unless there exists an explicit conflict of interest with the fund's objectives (such as hedge funds who tend towards shorter horizons), ESG integration is obligatory although it may not be discussed in the scheme information document (or investment agreement or any other such document).

IV. REGULATORY APPROACHES

The arguments forwarded by the authors find support in the regulatory approach being adopted towards ESG investing around

[50] Carrington Coleman, *SEC Clarifies Fiduciary Duty of Private Equity Fund Managers*, LEXOLOGY (May 22, 2020, 10.05 PM), https://www.lexology.com/library/detail.aspx?g=681a61b9-7e44-45fb-9a87-86a1353b9a07

[51] Bullmore v. Ernst & Young Cayman Islands, (2008) 45 A.D.3d 461, 463.

the world. With more ESG labelled funds being popped up on the block, it troubles regulators as to the authenticity of these funds considering the nascent stage of data available.

A. THE EU WAY

The revised Shareholder Rights Directive ("SRD II"), which aims to increase the level and quality of engagement that asset managers have with their investee companies, has recently introduced a requirement for asset managers *to make disclosures* around their engagement policies with companies they invest in.[52] Further, the European Securities Management Authority (ESMA) proposed revisions to the Alternative Investment Fund Managers Directive and Undertaking for Collective Investment in Transferable Securities regimes where under, in addition to complying with the general due diligence obligations, managers would be required to take into account s**ustainability risks** (defined in recent drafts of the Disclosure Regulation as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact"); and pursuant to the proposed reforms, asset managers in question would be required to develop corporate engagement strategies (including

[52] See *Points 17 and 18 of Directive (EU) 2017/828*, European Parliament and of the Council (May 20, 2017).

the exercise of voting rights) with a view to reducing the principal adverse impact of investee companies on sustainability factors. ESMA also proposed new guidelines on ESG disclosure requirements for Credit Ratings Agencies ("CRAs")[53] which signify that credit ratings agencies must also battle for ESG integration as the non-financial factors take the lead in driving prices of securities.

Under the current regime, the information sought by firms about their clients' investment objectives generally relate to financial objectives, while non-financial objectives, such as ESG preferences, are rarely addressed. The European Commission's reforms aims to incorporate an assessment of each client's ESG preferences into the suitability test thus making it mandatory for investment advisors to discuss or disclose information relating to ESG and how they are likely to affect fund performance.

Clearly the EU has put considerable thought into the significance of ESG integration and will reap its benefits as an early adopter.

B. THE U.S. APPROACH

In contrast to the EU's clear and comprehensive plan of action, the United States is yet to formulate a defined approach towards

---

[53] *ESMA33-9-320*, Final Report Guidelines on Disclosure Requirements Applicable to Credit Ratings, European Securities Management Authority (18 July 2019).

sustainable investing. Regulators have failed to take a proactive approach to ESG investing (besides directing ESG labelled fund houses to take into account internationally-recognized standards such as United Nation's Sustainable Development Goals and Principles for Responsible Investing).[54] Regulators thus clarify that ESG integration is not in conflict with financial goals but have refrained from going further. There are currently no federal requirements compelling issuers to make ESG disclosures in their public filings, unless they are otherwise material. But if a company issues an ESG disclosure and the same is either false or misleading, then the same can be actionable under state and federal securities laws in the United States.[55]

In fact, recently, a new rule was proposed, which would require the overseers of pension funds to mandatorily put *economic interests ahead of so-called non-pecuniary goals.* This rule does not mention ESG factors specifically, although it is clearly aimed at them.[56] The concerned regulator explained that the term lacks a precise definition and its use in the proposal conflated each individual "E" "S," and "G" factor. It is to be noted that a 'pecuniary factor' is a factor that will have a material effect on the risk or return of an

---

[54] Matt Levine, *The SEC Is Asking About ESG*, BLOOMBERG (Dec. 2019), https://www.bloomberg.com/opinion/articles/2019-12-17/the-sec-is-asking-about-esg.
[55] In re BP P.L.C. Sec. Litig., 10-md-2185 (2013).
[56] *Financial Factors in Selecting Plan Investments*, Department of Labor, (Feb 07, 2020, 09:11 PM), https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf

investment based on appropriate investment horizons and as was elaborated upon in the earlier sections, ESG are not non-pecuniary anymore. It is interesting to note that the ESG landscape in the US is purely driven by funds voluntarily, to keep up with the global standards as well as to achieve sustainable returns.

C. INDIA'S EFFORTS

The first instance of ESG investing in India can be traced to Kotak Committee Recommendations on Corporate Governance wherein it is explicitly stated that

> *Aspects like ……… ESG (environment, sustainability and governance) are critical to the medium-term and long-term future of a listed entity. Committee recommended that, at least once a year the said aspects should be specifically discussed by the board.*[57]

Although the report isn't directed towards asset managers, it illustrates the materiality of ESG factors.

These recommendations were followed up by something more concrete i.e. a Securities and Exchange Board of India ("**SEBI**") circular[58] setting up a stewardship code for Asset

---

[57] *Report of the Committee on Corporate Governance*, Securities and Exchange Board of India (Oct. 05, 2020, 11:01 AM), https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html.

[58] *Circular CIR/CFD/CMD1/168/2019*, Securities and Exchange Board of India (Dec. 24, 2019).

Management Companies ("**AMCs**"), Mutual Funds ("**MFs**") and all the categories of Alternative Investment Funds ("**AIFs**") investing in listed Indian companies (**Stewardship Code** similar to the EU counterpart). The Stewardship Code prescribes certain principles which, aim at enhancing the responsibilities of the AMCs/ AIFs to protect the interests of their investors/beneficiaries.The code suggests that institutional investors shall formulate a policy on *monitoring risks, including Environmental, Social and Governance (ESG) risks.*[59] Further, Institutional Investors are mandated to have a clear policy on intervention in their investee companies in the circumstances of ESG risks, inter alia, to preserve the interests of the ultimate investors. Such engagement may be through detailed discussions with management, interaction with investee company boards, voting in board or shareholders meetings, etc.[60] Notably, these guidelines, unlike other stewardship codes, are mandatory (unlike the 'comply or explain' approach).

More importantly, the amended SEBI (Portfolio Managers) Regulations 2020 lay out in explicit terms that all "portfolio risks"[61] as well as all "material disclosures"[62] must be brought to the client's knowledge. ESG criteria have also been recognized as 'material' in

---

[59] Watkins, *supra* note 14.
[60] Final Report Guidelines on Disclosure Requirements Applicable to Credit Ratings, *supra* note 53.
[61] SEBI (Portfolio Managers) Regulations, 2020, Reg. 22(4)(b).
[62] SEBI (Portfolio Managers) Regulations, 2020, Reg. 19(4).

the context of SEBI's Integrated Reporting initiatives and mandates[63] thus solidifying our stance.

D. COMPARING THE EU, US, AND INDIAN APPROACHES

From the foregone discussion, it is clear that the US, the EU and India all have distinct approaches to the integration of ESG criteria in risk-management. While the latter two have recognized the need for inclusion and integration of these criteria and have proposed certain regulatory changes aimed at attaining this objective, the US seems to be stuck on the proposition laid out in *Cowan v. Scargill.*[64]

Notwithstanding the outdates and skeptical attitude adopted by the US, all three jurisdictions have one principle in common—if Factor X is 'material', it must be taken into account. In this respect, the EU has clearly defined Factor X— 'sustainability risk' and its constituents—while India's approach is not as exhaustive (ESG criteria having been mentioned only by name). Furthermore, while we notice clear guidelines to support ESG integration in risk assessment in the EU (such as a system of credit ratings on ESG bases), the Indian scenario has only directives that pronounce upon what should be done, as opposed to creating the means to do it. However, if there is one clear advantage that India has over the

[63] *Circular SEBI/HO/CFD/CMD/CIR/P/2017/10*, *Integrated reporting by listed entities*, Securities and Exchange Board of India (Feb 06, 2017).
[64] Cowan v. Scargill, (1985) Ch 270.

European Union, it is that the EU has merely proposed these progressive changes to their existing regime; whereas in India the changes have been implemented already, and ESG integration made mandatory. In view of these factors, India cannot be faulted for inaction at the very least. Nevertheless, it is necessary now that like the EU, India must also set up a robust regulatory support for the legal changes effected—for instance, ensuring the availability of adequate information and statistics regarding ESG through reporting initiatives, the formulation of ESG-integrated ratings of investment opportunities, education and awareness initiatives, etc.—in order to ensure that the changes adopted find realization in reality, and not on paper only.

V. SUGGESTIONS & CONCLUSION

The ongoing pandemic did not break the system, but simply exposed a broken one. From the 2008 global crisis[65] when the financial sector choked the economy to the COVID-19 pandemic—not much has changed when it comes to our financial systems taking action about systemic risks. To say that investment decisions cannot affect such risks is to turn a blind eye to the changing investment landscape. Fiduciaries today have an enhanced duty to integrate theoretical changes in investment theories. It is not sufficient,

---

[65] Kimberly Amadeo, *2008 Financial Crisis: Causes, Costs and Whether It Could Happen Again,* THE BALANCE (June 10, 2020, 10:10 PM), https://www.thebalance.com/2008-financial-crisis-3305679.

however, to put the onus squarely on fund managers alone. Firstly, although Stewardship Codes (such as that in India) have made it mandatory to incorporate ESG, the implementation structures to facilitate such laws are eons behind. India, as well as other nations, must clarify a set standard of ESG and further initiate work to improve awareness about the significance of such factors. It is indispensable, more than ever, precise clarifications that bring certainty and stability to the sector. Moreover, courts must also catch up to such changes and modernize themselves while sitting upon judgment in these matters. Secondly, we opine that setting up of ESG funds, or the sidelining of ESG integration as an alternative investment strategy is wholly undesirable. It is essential to recognize that any decision-making process that ignores material facts is incomplete and flawed in itself, and so is the case with ESG. The mainstreaming of ESG integration is hence strictly necessary.

Thus, our conclusions may be briefly stated as:

First, the concept of "profitability" must transcend narrow ideas of abnormal returns in quarterly spaces in order that we may take the first step towards an evolved thought process which allows for sustained levels of returns future-proofed by improved risk assessment procedures. Second, that ESG and risk-adjusted returns are positively correlated. Third, that a fiduciary's duty of care may be breached by non-consideration of ESG owing to the fact that ESG

risks are often financially material and to account for it is the set standard of care for a prudent investor. Fourth, that by not making full and frank disclosure of ESG risks, or the decision to either incorporate or not incorporate ESG criteria, fund managers breach the fiduciary duty of loyalty. And last, that the regulatory landscape is rapidly evolving to accommodate ESG considerations so far as to have been made mandatory for asset managers in India. In the words of Andrew Warwick-Thomson,

> *"I would urge any trustee or asset manager out there who still thinks these things (ESG) don't matter to wake up and smell the coffee."*

MERGERS AND ACQUISITIONS TRANSACTIONS: IMPACT OF SHAREHOLDER ACTIVISM ON CORPORATE GOVERNANCE

Naman Devpura and *Varnik Yadav*[*]

ABSTRACT

Mergers and Acquisitions (M&A) has evolved into an important corporate transaction for responding to ever increasing global competition, rapid expansion into new markets and economic survival of corporations. Sound governance practices in such transactions add to their effectiveness while creating higher value additions to the involved parties. Through the lens of corporate governance mechanisms, this paper aims to analyze this coincidence of M&A transactions and shareholder activism, a relatively new phenomenon in the Indian corporate landscape. While analyzing the major mechanisms for governing M&A transactions, this paper dives deeper into the advent of shareholder activism, its development in India and wave of regulatory reforms associated with it. Further, the paper signifies the role of Proxy Advisory Firms (PAF) in relation to M&A transactions by promoting activism amongst institutional investors and retail investors. With due reference to the hybrid model of Indian corporate market, the paper discusses four different models of shareholder activism, covering both externally and internally regulated systems, in relation to such transactions and recommends certain preliminary implications from this comparative analysis. The paper concludes by suggesting broad incentive-based policy and procedural

---

[*] The authors are 3rd year students at Gujarat National Law University, Gandhinagar, Gujarat.

framework for a sophisticated development of shareholder activism in India, paving way for increased effectiveness in corporate transactions such as M&A while fulfilling the objective of establishing enhanced governance mechanisms.

I. INTRODUCTION

The fundamental goal of corporate law and governance rests in improving outcomes for various stakeholders in business organized and structured as corporations which can be achieved through regulation of significant corporate transactions such as Mergers and Acquisitions. By regulating such transactions, the corporate law and governance eyes towards value addition to such transactions and care and loyalty towards the corporate decision makers involved in such transactions. The milestone of interface of corporate governance and M&A was marked by proposition "market for corporate control", where it was suggested that firms with inefficient management attracts takeovers by other firms with more efficient management, reflecting in the former's lower stock prices.[1] Much water has flown since this analysis, marking for stronger governance mechanisms.

The consolidation of two or more firms and their assets constitutes Merger and Acquisitions. While the former specifically involves forming of a new entity, the latter involves purchase of one

[1] George H. Manne, *Mergers and the Market for Corporate Control*, 73 J. POLIT. ECON. 110-120 (1965).

firm by another. In both the cases, value maximisation is the inherent motive[2] while also involving strategic actions such as reduction of competitors, invention of industry[3] or creating synergies or economies of scale.[4] The phases involved in M&A transactions are due diligence, negotiation, and integration.[5] M&A transactions can be divided into asset purchases, stock purchases, and mergers as per their legal nature. In India, stock purchases are the dominant M&A transaction which involves owning the business or stock rather than the assets such as Vodafone's acquisition of 67% of Hutchison and Vedanta's acquisition of 59% of Cairn India.[6]

The 21st century has marked the crest of corporate governance when WorldCom and Enron scams in the US led to the enactment of the Sarbanes Oxley Act, 2002. In India, the Satyam scam forced the Ministry of Corporate Affairs to revise governance regulations to protect the shareholders. Similarly in Australia, CLERP reforms were made while the Palamat failure in Italy forced various

---

[2] M.C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76(2) AM. ECON. REV. 323-329 (1986).
[3] J. L. Bower, *Not All M&As Are Alike–and That Matters*, 79 Harv. Bus. Rev. 93-101 (2001).
[4] Andrade Gregor, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15(2) J. E. P. 103-120 (2001).
[5] M. Zollo & H. Singh, *Deliberate learning in corporate acquisitions: post-acquisition strategies and integration capability in US bank mergers*, 25(13) STRATEG. MANAG. J. 1233-1256 (2004).
[6] John C. Coates IV, *Mergers, Acquisitions and Restructuring: Types, Regulation, and Patterns of Practice* in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon and Wolf-Georg Ringe eds., July 2015).

regulatory reforms.[7] The ongoing spate of crisis and scandals has led to greater legislative reforms which call for strengthening the presence of institutional and retail shareholders in corporate transactions such as M&A, as analysed in this paper. The requirement becomes even prominent in India where controlling shareholders or promoters rule the corporate landscape. The phenomenon of shareholder activism, although not a widely practised phenomenon in India, has found its rapid mark on various M&A transactions and turns out to be a larger force of corporate governance in the Indian corporations. With the demands of greater efficiency associated with M&A transactions[8], we discuss and analyse the interface between such transactions and the impact of corporate governance in the following sections.

This paper is divided into four parts. The paper, first, discusses the existing mechanisms of corporate governance in Mergers and Acquisition transactions. The paper then narrows upon the impact of shareholder activism on M&A transactions. The paper traces its growth in India, the various regulatory reforms in its relations and the journey of Proxy Advisory Firms in upbringing shareholder activism in India. The paper then takes upon a multi-national perspective and discusses four shareholder activism models covering

---

[7] Surbhi Bedi & Sandeep Vij, *The Interface of Corporate Governance with M&A: Research Themes*, 15(3) THE IUP JOURNAL OF BUSINESS STRATEGY 19-38 (2018).
[8] M. Jensen, *Takeovers: their causes and consequences*, 2(1) J. E. P. 21-48 (1988).

United States, United Kingdom, Germany and Japan. The paper concludes by putting forth preliminary, policy based and practical implications upon the subject area to address the underlying and forthcoming issues for the Indian corporate governance landscape.

II. GOVERNANCE MECHANISMS IN M&A TRANSACTIONS

A mergers and acquisition transaction marks a significant watershed in the life of any company. There are various business and economic factors that influence the M&A decisions such as managerial hubris,[9] winner's curse or over-pricing of the deals.[10] A more serious concern arises in cases pertaining to confidentiality and speedy procedure where the decisions rest with the Chief Executive Officer and top-management, without wider consultation of stakeholders.[11] However, endurance of sophisticated and mature governance mechanisms would diminish the risk of failed transactions. In this regard, various well-established mechanisms can be identified in the context of Mergers and Acquisitions.

[9] Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS.197-216 (1986).
[10] Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 853, 860-65 (2011).
[11] Umakanth Varottil, *Corporate Governance in M&A Transactions*, 24 Nat'l L. Sch. India Rev. 50-62 (2012).

A. BOARD OF DIRECTORS

An important function of board of directors is decision-making in relation to an M&A transaction by analyzing the merit and demerits of such a transaction.[12] The board plays an important role in providing strategic inputs and performing monitory functions during the period of M&A transactions which involve analysis of due diligence reports, addressing capital structure and legal documentation and the fairness in price to shareholders. The board acts as a substantial internal governance mechanism for protecting shareholders' interests.[13]In the current times of global financial crisis, the board's actions are subjected to strict scrutiny. In this regard, a board should not only act, but also be seen to act thus involve in creating greater responsibility and duties to the stakeholders.[14] Therefore, the objectivity of the board of directors and their business acumen play a vital role in the evaluation of the proposed M&A deals.[15] The structure of board, however plays a

[12] Martin Lipton & Andrew J. Nussbaum, *Corporate Governance and Cross-Border M&A: Key Challenges and Responsibilities*, Third International Conference, "Global Capital Markets and Corporate Governance: Quest for Global Standards" (2012).
[13] Eugene Fama & Michael Jensen, *Separation of ownership and control*, 26 J. LAW ECON.301-325 (1983).
[14] Varottil, *supra note* 11, at 57.
[15] S. A. Zahra & J. A. Pearce, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15(2) J. MANAGE.291-334 (1989).

major role in determining the threshold of governance with higher independence playing a major variant in active takeover markets.[16]

B. INDEPENDENT DIRECTORS

The representation of interest of shareholders plays a very important role in M&A transactions. Thus, independent directors who play the role of "watchdogs" help to mitigate the agency problems in between shareholders and management and perform a significant monitoring role in large scale transactions such as mergers and acquisitions.[17] Independent directors bring a larger breath of experience to the board and add to its effectiveness.[18] In cases of related party transactions, this role of independent directors gains even greater force. The presence of independent directors on audit committees and special committees help to arrive at a deeper vie of such transactions. An increase in the number of independent board members raises the efficiency of M&A deals.[19]

---

[16] James Brickley & Christopher James, *The takeover market, corporate board composition, and ownership structure: The case of banking*, 30 J. LAW ECON.161-180 (1987).
[17] *Id.* at 170.
[18] P. B. Firstenberg & B.G. Malkiel, *Why corporate boards need independent directors*, 69(4) J. MANAG. REV. 26-38 (1980).
[19] James Cotter, Anil Shivdasani, & Marc Zenner, *Do independent directors enhance target shareholder wealth during tender offers?*, 43 J. FINANC. ECON. 195-218 (1997); J.W. Bryd, & K.A. Hickman, *Do outside directors monitor managers? Evidence from tender offer bids*, 32 J. FINANC. ECON.195-222 (1992).

C. MANAGERIAL SHARE OWNERSHIP

Share ownership by managers is another significant determinant of merger market efficiency.[20] Increased managerial ownership encourages diligence and leads to reduction in poor decisions. There is also a lesser managerial resistance where greater share ownership by managers leads to a larger managerial gain.[21]Clearly, managerial ownership is a strategic governance mechanism for aligning the interests of management with those of the shareholders.[22] Larger proportion of share ownership by managers intensifies firm value and thus leads to larger purchase premium in such transactions.[23]

D. GATEKEEPERS

Various external organizations such as investment banks and accounting firms paves road for higher fairness in M&A transactions with increased regularity.[24] They help to balance the biases of directors and decision-makers of such transactions.[25] Not only institutional organizations but lawyers involved in such

---

[20] Wayne Mikkelson & Megan Partch, *Managers' voting rights and corporate control*, 25 J. FINANC. ECON.263-290 (1989).
[21] James Cotter & Marc Zenner, *How managerial wealth affects the tenders offer process*, 35 J. FINANC. ECON. 63-97 (1994).
[22] Randal Morck, Andrei Shleifer & Robert Vishny, *Management ownership and market valuation: An empirical analysis*, 20 J. FINANC. ECON. 293-316 (1988).
[23] John McConnell & Henri Servaes, *Additional evidence on equity ownership and corporate value*, 27 J. FINANC. ECON.595-612 (1990).
[24] Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 81 (2011).
[25] Andrew Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583 (2010).

transactions also assist in enhancing value and diminishing risks in M&A transactions by performing their advisory functions.[26]

E. SHAREHOLDER ACTIVISM

Shareholder activism acts as corrective mechanism for governance of corporate bodies.[27] Although India stood at a difficult position with lack of prominent shareholder activism in the past,[28] the recent trends and reforms have managed to bring a change in this position as discussed in the next section. A serious role in corporate governance of M&A transactions is played by large shareholders or blockholders, who own 5% or more shares of the firm.[29] There shareholders who are generally institutional investors have greater motives for monitoring and influencing the managers owing to their large holdings, and use their powers to impend for takeovers or replacement of management.[30] While dealing with M&A transactions, the presence of blockholders in targeted firms positively impacts the acquisitions and also lowers the acquisition

---

[26] Marc I. Steinberg, *Counsel Conflict Dilemmas in Mergers and Acquisitions*, 47 S. TEX. L. REV. 3 (2005).
[27] Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU. L. REV. 1014 (2014).
[28] Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) NAT. L. SCH. IND. R. 1 (2009).
[29] C. G. Holderness, *The myth of diffuse ownership in the United States*, 22(4) REV. FINANC. STUD. 1377-1408 (2009).
[30] J. E. Bethel, J. P. Liebeskind & T. Opler, *Block share purchases and corporate performance*, 53(2) J. FINANC.605-634 (1998).

premium.[31] These shareholders are also prodded by SEBI in past for greater active participation.[32] Minority shareholders although having minuscule holdings also play a major role in determining the efficiency of such transactions. With the emergence of proxy advisory firms, corporate transactions such M&A have higher merit owing to their advisory function to institutional investors and also affecting the retail investors.[33] The subsequent section deals with various aspects of shareholder activism in detail with such transactions.

III. SHAREHOLDER ACTIVISM IN M&A TRANSACTIONS

M&A transactions have long been the center ring and main tool for shareholder activism while emerging as a dominant tactic in the present economy. From 1942, which marks the first instance for shareholders being granted an opportunity to submit resolutions[34] to 2019, which marks 209 activist campaigns launched against sizeable

---

[31] A. Shleifer, & R. W. Vishny, *Large shareholders and corporate control*, 94(3) J. POLIT. ECON. 461-488 (1986).

[32] Circular for Mutual Funds No. 18/198647/2010, Security Exchange Board of India, 2010.

[33] Bhuma Srivastava, *Proxy advisory firms give a boost to shareholder activism*, The Mint (Jun. 29, 2012, 12:57 AM), https://www.livemint.com/Companies/HeuG8SPSw3zXE4sUYhecqN/Proxy-advisory-firms-give-a-boost-to-shareholder-activism.html.

[34] E. M. Reid & M. W. Toffel, *Responding to public and private politics: Corporate disclosure of climate change strategies*, 30 STRATEG. MANAG. J. 1157-1178 (2009).

company globally,[35] the landscape of shareholder activism has evolved drastically. A range of approaches in regard to the activities involve pushing for break-up or sale of a company or opposing vulnerable transactions.

Shareholder Activism can be defined as set of actions of any shareholder or shareholder group with the purpose of bringing a change within the company without gaining control.[36] Often perceived as a tool for activist shareholders for changing corporate behavior or internal governance rules owing to dissatisfaction,[37] it contradicts the passive shareholder's actions who intend to only sell their shares, thereby, denominating a "wall street walk".[38] Shareholder Activism can also be bifurcated as performance driven activism because hedge fund activists and corporate governance aim at long-term value addition, executive compensation and social policy, which further leads to higher buyout values or increase in premium in M&A transactions.[39] There exist encouraging signs in M&A market for shareholder activism with the advent of publicly-

---

[35] Lazard, *Lazard Ltd Reports Full-Year and Fourth-Quarter 2019 Results,* LAZARD (Jan. 30), https://www.lazard.com/media/451147/lazard-ltd-reports-full-year-and-fourth-quarter-2019-results.pdf.
[36] Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP.FIN.55, 55-73 (2007).
[37] Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001).
[38] Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance*, 11 DEPAUL BUS. L. J. 43 (1998).
[39] James R. Copland, Yevgeniy Feyman & Margaret O'Keefe, *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism*, CTR. FOR LEGAL POLICY AT THE MANHATTAN INST. 11 (2012).

contested M&A transaction of Fortis Healthcare, where minority shareholders succeeded in removing a director.[40]

A. DEVELOPMENT IN INDIA

Post-independence, the Indian corporate landscape had shallow equity markets with negligible holdings of retail investors.[41] Significant control was exercised by leading Indian houses, leaving retail investors with no influence on the controlling shareholders who usually ignored such minority voices.[42] This was further marked with lack of legal mechanism for enforcing the minority rights.[43] With remotely located registered offices and physical company meetings at specific location, the passivity was further enhanced.[44] The institutional investors who had larger holding also maintained a passive position owing to bureaucratic control and governmental influence that stood in complete support of decisions of management.[45]

---

[40] Nikhil Narayan, *The Shareholder Rights and Activism Review,* THE LAW REVIEWS (Oct. 2020), https://thelawreviews.co.uk/edition/the-shareholder-rights-and-activism-review-edition-5/1232580/india.
[41] John Armour & Priya Lele, *Law, Finance, and Politics: The Case of India*, 43 LAW & SOC'Y REV. 491, 496.
[42] Umakanth Varottil, *The Advent of Shareholder Activism in India*, 1(6) JOURNAL ON GOVERNANCE 592, 582-639 (2012).
[43] *Id.*
[44] *Id.*
[45] Omkar Goswami, *The Tide Rises, Gradually: Corporate Governance in India,* OECD (2000), http://www.oecd.org/corporate/corporateaffairs/corporategov ernanceprinciples/1931364.pdf.

However, post liberalization, this position of large stocks of institutional investors started to decrease and *statuts quo* was finally instilled with the disclosure of Satyam scam.[46] This led to various regulatory reforms and activism amongst institutional investors for closely monitoring their investments. With the blossoming of proxy advisory firms in 2010, the trend of inclusion of monitoring and activism functions in M&A transactions has seen an uplift. Although, shareholder activism still lacks its true position in the Indian landscape, these factors seek to bring a greater dawn of the phenomenon.

B. REGULATORY REFORMS

These past decades have seen several reforms in India for inducing greater participation in shareholder decision-making and monitoring corporate transactions such as M&A. This has been executed through a bit by bit approach that tends to various aspects of investor activism. Indian law confers special powers on minority shareholders in M&A situations by preventing the board from taking frustrating actions.[47] M&A transactions can also be structured through court schemes with approval of at least 3/4th value in shares.[48]

---

[46] Varottil, *supra note* 42, at 595.
[47] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Reg. 26.
[48] Companies Act, 2013, No. 18 of 2013, § 230(6) (India); Companies Act, 2013, No. 18 of 2013, § 232(1) (India).

1. <u>Voting Method</u>

Voting plays a critical role in M&A transactions as with lower institutional ownership, high agency costs and high deal risk can lead to bypass in shareholder voting in acquirer's firm.[49] Various methods of voting are being adopted to involve more shareholders. One of them is postal ballot that was introduced in 2001.[50] Under this voting method shareholders can send their votes through and they need not be present personally attending a meeting to a cast their vote about any resolution.[51] This method of voting was expected to bring a new tide of involvement as it was a great opportunity for shareholders to mark their presence in such corporate transactions, where attending physical meetings was cost-incurring affair in terms of time and money. Although, removing various procedural difficulties for shareholders, this method turned out to be a failure with lack of activism due to lack of consultations before casting their votes marking greater extensive issues of lack of concerns, non- reliability and aggregate activity amongst shareholders. This insufficient working led to technical advancements and use of e-voting.

---

[49] Kai Li, Tingting Liu & Juan (Julie) Wu, *Vote Avoidance and Shareholder Voting in Mergers and Acquisitions*, ECGI Working Paper Series in Finance no. 481/2016 (2018).
[50] The Companies (Passing of the Resolution by Postal Ballot) Rules, 2001.
[51] Companies Act, 2013, No. 18 of 2013, § 192.

Section 108, Companies Act, 2013[52] provides for electronic voting on resolutions[53] and allows minority shareholders to have their say, while avoiding arduous tracks to far-flung locations, or use of age-old postal ballots. SEBI also made it mandatory for top 500 listed companies at BSE and NSE to follow e-voting.[54] While exercising the option of e-voting, a shareholder is not restricted from attending the general meeting.

2. **Voting as responsibility**

Shareholding voting leads to higher acquirer announcement return along with lower premium offers.[55] Shareholding in an organization is viewed as a heap of rights. One such right presented is to take an interest in M&A transactions through the activity of the democratic force. As clearly stated under Section 47, Companies Act, 2013[56], every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company. Further appointment of proxy[57] and related rules[58] mark the higher inclusion of voting responsibility. Subsequently, shareholders can't, by and large, be

---

[52] Companies Act, 2013, No. 18 of 2013, § 108.
[53] Clause 44, Security Exchange Board of India (Listing Obligation and Disclosure Agreement), 2015; Rule 20, Companies (Management and Administration Rules), 2014.
[54] Circular No. CIR/CFD/DIL/6/2012, Security Exchange Board of India, 2012.
[55] Becht, Marco, Andrea Polo, & Stefano Rossi, *Does mandatory shareholder voting prevent bad acquisitions?,* 29 REV. FINANC. STUD. 3035–3067 (2016).
[56] Companies Act, 2013, No. 18 of 2013, § 47.
[57] Companies Act, 2013, No. 18 of 2013, § 105.
[58] Rule 19, Companies (Management and Administration Rules), 2014.

constrained to practice their democratic rights in any way, or by any stretch of the imagination. Thus, marking an essential feature of shareholder activism in corporate governance.

3. Approval of Related Party Transaction

As per Section 188, Companies Act, 2013[59] a resolution is required to be passed by the board of directors before a company can enter into any transaction involving M&A arrangements with related party. Details of such transactions should be alluded in board's report to the investors along with the clarification for entering into such contract or transaction or arrangement. Where any contract or course of action is entered into by a director or some other representative, without acquiring the consent of the board or endorsement by an special resolution in the comprehensive gathering and in the event that it isn't sanctioned by the board or, all things considered, by the investors at a gathering inside a quarter of a year from the date on which such transaction was entered into, such transaction will be voidable at the alternative of the Board and if the contract or course of action is with a related party to any director, or is approved by some other director, the directors concerned will have the duty of indemnifying the company against any misfortune brought about by it.

---

[59] Companies Act, 2013, No. 18 of 2013, § 188.

4. Oppression and Mismanagement

Minority shareholders can seek relief against oppression and mismanagement by the majority on grounds of affairs being conducted in prejudicial manner and can also initiate an investigation by applying to National Company Law Tribunal (NCLT) in certain circumstances with at least 10% shareholdings or 100 members.[60]Further as per section 241, Companies Act 2013[61] states that any individual from a Company (counting minority investors) can document an application before the Tribunal if the issues of the Company are being directed in harsh and biased manner.

5. Shareholders Class Action Suit

As per Section 245 of the Companies Act, 2013, Minority shareholders can also institute a class action suit against such transactions or affairs, if the same are being prejudicial to the interests of company or its shareholders. Incorporation of class action suit leads to Indian Corporate law moving far from restrains of exceptions laid in English law.[62] Tribunals are further vested with power to protect the rights of minority shareholders under Section 242[63] and 244 of the Act.[64] However, given the state of litigation in

[60] Companies Act, 2013, No. 18 of 2013, § 213.
[61] Companies Act, 2013, No. 18 of 2013, § 241.
[62] Foss v. Harbottle, (1843) 2 Har 361.
[63] Companies Act, 2013, No. 18 of 2013, § 242.

India, this remedy remains to be effectively seen in M&A transactions.

6. Appointment of Director by Minority Shareholder

Section 151 of the Companies Act 2013 necessitates that a company that is listed ought to have one director chosen by minority investors in such a way and with such terms and conditions as laid down by the Central Government. Presence of such an independent director on the board leads to significant contributions of minority shareholders in M&A transaction.

These regulations clearly pave a way for greater shareholder participation especially in essential corporate transactions such as M&A. The shareholder activism can also be seen to be promoted by inclusion of research analysts and Proxy Advisory Firms who play a significant role by acting as advisors directly to institutional investors and indirectly to retail investors and monitoring M&A transactions.

C. PROXY ADVISORS FIRMS

Proxy Advisory Firms (PAF) are significant corporate governance intermediaries who advice institutional investors on exercising their votes especially in M&A proposals by analyzing such

[64] Companies Act, 2013, No. 18 of 2013, § 244.

proposals and making recommendation to these investors.[65] These recommendations, being public are also utilized by retail investors.[66] With international footprint, PAF has become a force to be reckoned with, especially in more matured markets such as U.S[67] although having relatively new impact in Indian market while covering M&A transactions.[68] With SEBI forcing various corporate governance standards through Clause 49, Listing Agreement, 2000, PAF have turned into an impactful intermediary in keeping up with corporate governance strategy in such transactions.[69] PAF reduce the costs of performing monetary functions by the investors themselves while adding value to M&A transactions.

Prominent instances of role of PAFs involve the Akzo-Nobel merger case, where the recommendation given by a prominent PAF, against the proposal of merger of 3 over-valued subsidiaries, influenced the voting of institutional investors.[70] Similarly, in case of merger of Vedanta Aluminium Limited (VAL) with Sesa Goa and Sterlite India, various facts regarding human rights issues and

---

[65] Paul Rose, *On the Role and Regulation of Proxy Advisors*, 109 MICH. L. REV. FIRST IMPRESSIONS 62 (2010).
[66] *Id.*
[67] James R. Copland, Yevgeniy Feyman & Margaret O'Keefe, *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism* 22 (2012).
[68] Naren Karunakaran, *Proxy firms wade through proposed resolutions*, THE ECONOMIC TIMES, Nov. 29, 2011, https://economictimes.indiatimes.com/proxy-firms-wade-through-proposed-resolutions/articleshow/10913732.cms.
[69] Vandana Gupta, R. K. Mittal & V.K. Bhalla, *Role of the credit rating agencies in the financial market crisis*, 2 J. DEV. AGRIC. ECON. 286 (2010).
[70] *Role of Proxy Advisory Firms in India*, INGOVERN, www.ingovern.com/2015/02/shareholder-activism-in-india/

leveraged balance sheet were raised by the proxy firms.[71] Various other transactions such as selling of wholly-owned subsidiary of Siemens AG and related parted transactions between United Spirits and Diageo PLC were also rejected by shareholders based on recommendations by PAFs.[72] Further, issues such as royalty payments to Holcim by Gujarat Ambuja and ACC, Pantaloon demerger due to par values of DVR shares with equity shares and opposing to restructuring of Escorts have been successfully undergone by PAFs in India.[73]

However, PAFs working involve various issues such as independence and impartiality of recommendations, profit earning through consultancy from companies, creation of a potential or actual conflict of interest and metrics errors.[74] SEBI has previously worked upon mitigating such issues.Regulation 2(i)(p) of Securities and Exchange Board Of India (Research Analysts) Regulations, 2014, defined a proxy advisor as: "proxy adviser means any person who provide advice, through any means, to institutional investor or shareholder of a company, in relation to exercise of their rights in the company including recommendations on public offer or voting

[71] *Id.*
[72] *Id.*
[73] Shriram Subramanian, *Role of Proxy Advisory Firms in India*, INGOVERN, http://www.ingovern.com/2013/06/role-of-proxy-advisory-firms/.
[74] Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887-926 (2007).

recommendation on agenda items".[75] Moreover, regulation 23[76] read with regulation 19[77] deals with disclosures to be made by PAF. These are further elaborated with two recent circulars by SEBI.[78] These regulations are incorporated for ensuring commitment[79] and for diminishing conflict of interest where such PAF represent both the shareholders and management and raising efficiency of corporate transactions such as M&As. Thus, within a given legal framework, PAFs can highly contribute towards efficiency of M&A transactions while promoting good governance practices.[80]

IV. COMPARATIVE MODELS OF SHAREHOLDER ACTIVISM

There is an abundant presence of academic research on the advantages and loopholes in shareholder activism.[81] Since, the activism of shareholders in M&A transactions is not limited to a

---

[75] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg. 2(i)(p).
[76] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg. 23.
[77] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg. 19.
[78] Procedural Guidelines for Proxy Advisors (Procedural Guidelines), 2020; 'Grievance Resolution between listed entities and proxy advisors' (Grievance Resolution Circular), 2020.
[79] Rose, *supra note* 65, at 62.
[80] Srivastava, *supra note* 33.
[81] Stephen M. Bainbridge, *Response, Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744–51 (2006); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 657–59 (2010); Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?,* HARV. BUS. REV. 49-51 (2012); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 821-824 (2006).

given jurisdiction, but is a global corporate governance affair, it is important to understand different models of interventions and legal regimes for a mature development of the phenomenon and crucial policy decisions.[82] Given to the nature of market in India, which is taken to be a hybrid of external dominated market systems such as US and UK, and insider dominated based systems of Germany and Japan,[83] following are respective models.

A. UNITED STATES

The financial institutions mark large equity holdings in corporate market in United States of America. Shareholder activism in U.S. therefore majorly involves Hedge fund activists who threaten portfolio companies, launch proxy fights,[84] or use legal remedies to seek injunctions against M&A proposals or request public declarations of the same.[85] However, since the core intention of such an activism lies only in maximizing their interests, hedge funds activism also accompanies the drawback of short term value

---

[82] Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157- 203 (2014).
[83] J. Sarkar& S. Sarker, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*, 1(3) INT. REV. FINANCIAL ANAL.161-194 (2000).
[84] John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds*, 14 J. ALT. INVEST. 17 (2012).
[85] William Alden, *Einhorn's Apple Suit Fits a History of Public Calls*, N.Y. TIMES DEALBOOK, Feb. 7, 2013, http://dealbook.nytimes.com/2013/02/07/taking-on-apple-einhorn-has-a-history-of-publiccalls.

extraction at cost of long-term plans such as mergers.[86] U.S. capital markets also exhibits activism by private equity funds that use extreme activism by involving in such M&A transactions to take the firms private and parachute their own managers for supervising the corporation.[87] They are however, long-term oriented as opposed to hedge fund activists.[88]

A collaborative model is used by traditional financial institutions in U.S. who informally interact with the management and influence its decisions.[89] They are more political driven actors rather than holding an economic interest.[90] Activism through social actors also marks their vital role in corporate governance of M&A transactions by proposing resolutions in voting[91] and using public relations and media to impact such transactions.[92] The efforts of Friends of the Earth to torpedo a merger of Exxon with Mobil by protesting at

---

[86] Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. OF ECON.655-664 (1989).
[87] Josh Lerner, Felda Hardymon & Ann Leamon, VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK (3rd ed. 2005).
[88] William W. Bratton, *Hedge Funds and Governance Targets* 1375–1433, ECGI Law Working Paper No. 80 (2007).
[89] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1072-1087 (2007).
[90] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).
[91] Miguel Rojas, *Bringing About Changes to Corporate Social Policy Through Shareholder Activism: Filers, Issues, Targets, and Success*, 114 BUS. & SOC'Y REV. 217, 231-32 (2009).
[92] *Id.* at 218.

latter's shareholder meetings marks one such instance.[93] Thus, U.S. marks a culmination of varied range of activists, with some interest in reducing managerial costs of such transactions while others for ripping short term gains.

B. UNITED KINGDOM

Similar to U.S., U.K. also has widely held public corporations, thus giving space for shareholder activism as a critical issue for corporate governance[94] and higher involvement of financial institutions for day-to-day governance with lesser restrictions and progressive approach of corporate laws in U.K. towards shareholder power.[95] However, as opposed to U.S., the social and minor actors have limited participation in M&A proposals due to higher solicitation costs and ownership requirements limits.[96] Thus, it leads to a greater day-to-day involvement in influencing managerial decisions.[97]

Governance of M&A transactions through shareholder activism in U.K. is similar to that of U.S. for most parts such as inclusion of

---

[93] Terrence Guay, *Non-Governmental Organizations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications*, 55 J. BUS. ETHICS 125, 134-35 (2004).
[94] John Armour, *Enforcement Strategies in U.K. Corporate Governance: A Roadmap and Empirical Assessment*, ECGI Working Paper No. 106 (2008).
[95] Bonnie Buchanan, *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AM. BUS L. J. 739, 800 (2012).
[96] *Id.*
[97] *Id.*

economic interests and voting rights, however it differs from the latter due its continual defensive activism[98] which involves coordination between several institutional investors. There is larger involvement of institutional investors as opposed to the involvement of unregulated players in the U.S. market. Thus, the combination governance laws and institutional players in M&A transactions marks a further divergent model of activism.

C. GERMANY

Germany's corporate ownership structure can be marked as family-owned similar to that of India. The German corporations with previously strong institutional influence of banks has seen decline in recent years with rise in foreign investors.[99] Despite this backdrop, the banks who act as dual agent (shareholder and debt holder) play a major role as activists in governing M&A transactions by use of voting powers and composition of board through their nominees.[100]

---

[98] Eric Berglöf & Ernst-Ludwig von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries*, Ann. World Bank Conf. on Dev. Econ., Wash. D.C., Conference Paper (1999).

[99] Patrick C. Leyens, *German Company Law: Recent Developments and Future Challenges*, 6 GERMAN L. J. 1415-1420 (2005).

[100] Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 EUR. CO. & FIN. L. REV. 135 (2004).

Rights of minority shareholders are also significant as they can add proposals to existing items[101] and call for new items or special meetings in such transactions upon reaching five percent threshold.[102] Shareholders with 1% shareholding can file suits against members of the board[103] while bearing the risk of litigation costs and prior requirement of succeeding in preliminary court proceedings for preventing abusive actions.[104] The German Code also allows for appointment of special representative (besonderer Vertreter) who can enforce claims against members of management (Vorstand), supervisory boards (Aufsichtsrat) and controlling shareholder.[105] This governance mechanism marks a high threshold of activism with rights vested in not only institutional investors, minority shareholders but also in employees and bondholders.[106]

D. JAPAN

Japan has witnessed significant corporate market reforms from historically concentrated ownership structure to a foreign and local

---

[101] Peter Cziraki, *Shareholder Activism Through Proxy Proposals: The European Perspective*, 16 EUR. FIN. MGMT. 738, 744 (2010).
[102] John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 J. FIN. & QUANT. ANALYSIS 499 (1998).
[103] Oberlandesgericht M¨unchen [Higher Regional Court of Munich] ZIP 2008, 73.
[104] Paul A. Carsten, *Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference*, 7 EUR. CO. & FIN.L.R. 98 (2010).
[105] Landgericht M¨unchen [Munich District Court I], ZIP, 1809 (2007).
[106] Kaal A. Wulf & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1472–73 (2011).

player fueled market.[107] Cross-ownership or Keiretsu, which previously stood as an antitakeover defense has seen a decline along with the banking sector losing their grips.[108] This was market with corporate governance reforms similar to that of U.S. with greater involvement of independent directors[109] and vesting rights amongst shareholders to put resolution on the company's agenda.[110] In recent times, the Japanese market marks with aggressive stock purchases and hostile takeovers[111] leading to self-imposing model of activism.

Relationship-based activism whereby the activist funds work with top management executives to improve governance operations also finds its place in influencing mergers.[112] Institutional investors such as Japan's Pension fund Association are major activists in the market by engaging in informal communication and cherry-picking firms with good governance practices[113] thus working on a constructive-activism model, and making these firms more likely to be acquirers in M&A transactions. This is in contrast to the

---

[107] Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13 CORP. GOVERNANCE: AN INT'L REV. 377 (2005).
[108] Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu*, 11 J. ECON. & MGMT STRATEGY 169 (2002).
[109] Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343 (2005);
[110] Seki, *supra note* 107, at 51.
[111] Yasushi Hamao, *U.S.-Style Investor Activism in Japan: The First 10 Years*, 6 Marshall School of Business Working Paper No. FBE 06-10, 8–10 (2010).
[112] *Id.*
[113] Bruce E. Aronson, *Japanese CalPERS or a New Model for Institutional Investor Activism? Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan*, 7 N.Y.U. J. L. & BUS.571-616 (2011).

confrontational activism model of United States and also reduces the burden on both retail investors and sophisticated investors for monitoring firms.

Japan sets a remarkable example for co-existence of heterogeneous models of activism under the umbrella of similar market conditions thus providing efficient system for governance of M&A transactions.

V. IMPLICATIONS AND WAY FORWARD

Although there are certain similarities in the above models and the corporate ecosystem in India, no appropriate reference point can be used for Indian regulators.[114] However, a broader understanding of these models can lead to various implications for better governance mechanisms while incorporating shareholder activism in essential transactions such as M&A.[115] Following are the implications that can be further incorporated by SEBI and Ministry of Corporate Affairs, India.

A. PRELIMINARY IMPLICATIONS

The preliminary implication of the above analysis suggests that various models can coexist under the same exogenous conditions

---

[114] Cyril Shroff, *Corporate Governance & Shareholder Activism*, INDIA CORPORATE LAW (Apr. 4, 2016), https://corporate.cyrilamarchandblogs.com/2016/04/corporate-governance-shareholder-activism/.
[115] Nili, *supra note* 82, at 195.

such as Japan and U.S. Thus, the presence of only one activism model can be both ineffective and detrimental to other stakeholders in the M&A transactions. While some shareholders look forward to shorter profit margins through rise in prices of shares post-mergers others are bend towards long term stability and profits by creation of greater entity through M&A transactions. Therefore, attempt must be made at balancing between two or more models. India can derive from notable models such as Japanese relationship-based activism model or U.S. social activism model, owing to its preliminary stage of shareholder activism. Incorporating these models would lead to effective M&A transactions while maintain higher governance standards.

B. POLICY IMPLICATIONS

Lawmakers should aim at direct regulation of controlling shareholders or promoters for giving leeway to the minority and institutional shareholders with their presence in the corporate landscape. Policy interventions must involve incentivizing and recognizing these activist shareholders for their contributions. Thus, this function should involve not only negative regulations which limit the damaging activism as in the case of controlling shareholders, but also on positive regulation by recognizing beneficial activism undertaken by retail shareholders and institutional shareholders. Furthering this argument, an incentive-

based reform can lead to monetary subsidization to beneficial activists while penalizing damaging activism. This would also limit the potential of alternate damaging activists to fill the void. In the long term, a shift from direct regulation towards incentive regulation would lead to greater changes in financial environment with gradual inclusion of shareholder activism in a controlled manner. Thus, rather than aiming towards band-aid solutions to specific concerns, lawmakers should take into consideration the above methods of regulations for being better equipped in the corporate regime.

C. PRACTICAL IMPLICATIONS

On practical aspects, there is a need for shifting focus from specific measures to broader procedural framework. This can involve various structures starting from enhancing the power of minority shareholders by vesting larger powers for appointment of independent directors to the board and prohibition on voting powers of controlling shareholders in related party transactions. German model can throw greater emphasis on minority shareholder inclusion. Regulation of Proxy Advisory Firms acts as another practical touchstone, while striking balance between the conflict of interests and independence of such firms, overregulation would diminish the very purpose of their existence. Additionally, opening the financial markets to foreign investors by reducing the regulations can also bring positive change in the activism. This would

collectively lead to increased effectiveness of corporate transactions such as M&A.

Thus, by analyzing the above models and the proposed framework for Indian market, a more nuance discourse can be promoted by market participants, regulators and academia.

VI. CONCLUSION

With the understanding that the major objective behind Indian corporate law is to improve governance and compliance, the ever-evolving nature of transactions in corporate landscape have taken a larger meaning than it used to before. In this regard, the advent of shareholder activism in M&A transactions marks a greater threshold for good governance and efficient transactions. However, despite the efforts of lawmakers there still exists a long way for realizing the full utility of activism in India with presence of controlling shareholders further cushioning this impact. The Indian landscape therefore, yearns for an enabling regime which would serve the shareholders with necessary incentives for activism and enhancing corporate governance. In today's environment sound principles of corporate governance act as a legal and commercial necessity not only for M&A transactions but for any corporation involved in capital markets while attracting mature and sound investments.

NATIONAL LAW UNIVERSITY
NH-65, Nagaur Road
Mandore
Jodhpur – 342304
Rajasthan (India)