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FOREWORD

DR. AKHIL PRASAD, *Evolving Dynamics of Governance*

ARTICLES

ABHIRUP GHOSH & NIVEDITA SHANKAR, *Checks and Balances on Related Party Transactions*

HIMANSHU CHANDRA & ANANYA KUMAR, *The Need for Whistle-Blowers' Legislation in India*

AYUSHI SINGHAL, *Whistle-Blower Protection Act, 2011- Does It Truly Protect the Unsung Heroes?*

DEBASIS PODDAR, *Introspection on Diversity in Boardroom from Governance Perspective*

ENAKSHI JHA & SHANTANU DEY, *RPT under Companies Act, 2013-Taking a Step Forward in Evolving a Regulatory Environment*

GARGI BOHRA & GARIMA TYAGI, *ESOPs and Independent Directors- The Unsettled Debate in Light of the Revised SEBI Norms*

THOMAS W. JOO, *Diversity and Deference- US Corporate Boards in Comparative Perspective*

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FOREWORD

EVOLVING DYNAMICS OF GOVERNANCE

"The things that will destroy us are: politics without principle; pleasure without conscience; wealth without work; knowledge without character; business without morality; science without humanity; and worship without sacrifice."

Mohandas K. Gandhi

I am delighted to know that the National Law University, Jodhpur is dedicating its annual journal on the subject "Evolving Dynamics of Governance" and it is my privilege to be able to contribute my thoughts for this very important topic.

The importance of Corporate Governance cannot be over emphasized and this has been a subject close to heart of all corporate lawyers in the country. I have been fortunate to be able to work for some esteemed organizations and learn globally acclaimed practices on Corporate Governance.

The Securities and Exchange Board of India ('SEBI') and the Companies Act 2013, ('the Act 2013') have put forth some real focus to enhance corporate governance practices among listed entities and some eligible public companies in India. In line with the provisions of the Act, SEBI aligned its provisions on corporate governance under Clause 49 of the listing agreement so that the provisions become applicable to all listed companies with effect from October 1, 2014. The except being to implementation of provisions pertaining to the constitution of a Risk Management Committee, which shall apply to the top 100 listed companies by market capitalization, as at the end of the immediate previous financial year.

I will make an attempt to explain in brief, the changes to the corporate governance regulations as proposed by SEBI under the following categories:

I. Diversity in Board Rooms

II. Whistle Blower Policy – Whether viable?

III. Independent Directors and pecuniary interests – the debate unsettled

IV. Succession Plan for Efficient Governance

V. Checks and balances for Related Party Transactions

For the purpose of elaboration below, I have relied upon literature and materials from leading accounting firms, law firms and information available on the SEBI's website and related sites.

I. DIVERSITY IN BOARD ROOMS

As per the provisions of Section 149 of the Act 2013 and consequent changes introduced by SEBI to the listing agreement to Clause 49(II)(A), by October 1, 2014 all listed companies and by April 1, 2015 certain eligible public companies, must hae at least one woman director on their Board of Directors. The requirement applies to any company which is:

(i) a listed company; or

(ii) a public company (that is a company other than a private company) where:

(a) the paid-up share capital is Rs100 crore (US$ 17 million) or more, or

(b) the topline is Rs300 crore (US$ 50 million) or more.

Any vacancy in the woman directorship should be filled in immediately but not later than the next immediate board meeting or within 3 months from the date of such vacancy, whichever is later. Private companies, irrespective of the paid-up share capital or top-line, are exempted from this requirement.

In reality, it appears that the appointment of women directors will be driven much on family considerations than on merits and is more likely to be a check in the box. At the moment, there are ground level challenges of capacity building - that is having a pool of women candidates with experience. Per August 2014 issue of Forbes India, 904 of 1,462 NSE-listed companies (62 percent) do not have women on their board of directors and all these companies need to appoint one by October 01, 2014. This would mean that these companies will have to gear up to have 10 appointments per day for next three months, including Sundays.

It is anticipated that these positions will be filled up by women belonging to the promoters group, which will cause a conflict of interest. A

women on the Board of Directors, per a report in the International Journal of Business Governance and Ethics, yields stronger corporate governance practices and better results. India Inc should work aggressively as India at 5.8% of women in board of directors lags behind UK (15%) and US (17%).

II. WHISTLE BLOWER POLICY – WHETHER VIABLE?

India has seen a fair share of issues on Whistle Blowing:

(i) In the year 2013, it was alleged that Infosys had reached a US$35 million settlement with US authorities for visa fraud. A whistleblower lawsuit against the company was filed by Jack Palmer, the then IT manager with the Indian outsourcing giant stating that Infosys was deliberately flouting the US visa rules to facilitate visits of its Indian employees on short-term B1 visas. Palmer also alleged that he was harassed, sidelined and victimized by the company because he refused an internal settlement offer. Even though the US federal court subsequently dismissed Palmer's lawsuit, but a federal investigation was conducted on the visa practices at Infosys and after hotly contesting the applications at first, Infosys did however agree to settle subsequently.

(ii) In February 2012, India's Supreme Court quashed 122 telecom licenses awarded to 16 Indian companies after it was found that a number of them had bribed senior government officials, including the then federal telecom minister to secure telecom licenses. Estimated to be worth US$ 27 billion, a number of senior officials from the government as well as private sector were jailed in the aftermath of the scam, which became widely known as the 2G-spectrum scam. Incidentally, the 2G spectrum scam was listed by the Time magazine among the top ten abuses of power just below the 'Watergate scandal'.

(iii) Similarly, allegations of corruption surfaced against several top Indian companies in 2012 over allocation of captive coal blocks to them by the government. It was alleged that the coal blocks, valued at billions of rupees, were given away almost free to a few private companies without any proper evaluation of their end use. Many companies are known to have simply sold the free coal in the open market earning windfall profits.

(iv) In 2003, SatyendraDubey, an engineer employed with National Highways Authority of India was murdered after he exposed

corruption in road projects under his watch.Two years later, an Indian Oil Corporation officer, ShanmugamManjunath, was shot dead for acting against petrol adulterers in the northern state of Uttar Pradesh.[1]

To prevent issues as above and to further strengthen the capability and provide protection, it was deliberated to have provisions under the Act 2013 and the listing agreement to tackle the menace of corruption and have robust provisions to safeguard the interests of Whistle Blowers.

The term "Whistle Blower" has not been defined under the Act 2013 but it makes it mandatory for some stated companies to set up a vigil mechanism. Clause 49(II) (F) of the listing agreement, as amended by SEBI in line with setting up of vigil mechanism under the Act 2013, requires that all listed entities should have a Whistle Blower Policy.

Section 177 of the Act 2013 requires every listed company and other companies which accept deposits from public and/or have borrowed money from banks and public financial institutions in excess of Rs. 50 crore (US$ 8 million), should establish a vigil mechanism for their directors and employees to be able to report genuine concerns or grievances. Further, it has been mandated that the Audit Committees of all listed companies and public companies with a paid up capital of Rs.10 crore (US$ 1.7 million) or more and/or having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs. 50 crore (US$ 8 million), shall oversee the vigil mechanism through such Audit Committee and if any of the members of the committee have a conflict of interest, they should recluse themselves and the others on the committee would deal with the matter on hand.

The vigil mechanism should provide for adequate safeguards against victimization of employees and directors who avail of the vigil mechanism and also provide for direct access to the Chairperson of the Audit Committee or the director nominated to play the role of Audit Committee, as the case may be. Vigil mechanism has to be included in Board's report to shareholders at every annual general meeting of the Company.

A whistle-blowing mechanism not only helps to detect fraud in organizations, but is also used as a corporate governance tool, which prevents

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[1]DeborshiChaki, *Whistleblowing and India's giant corporations*, ALJAZEERA, 10th January, 2014, Available at http://www.aljazeera.com/indepth/features/2014/01/whistleblowing-india-giant-corporations-201411092559554454.html

and deters fraudulent activity. Several companies, currently have whistle-blowing policies, however, these are not backed by adequate framework to make them effective tools in detecting and preventing fraud or misconduct. According to EY's India Fraud Survey 2012, 58% of the company's surveyed witnessed fraudulent activities in 2011, 62% of these indicated that whistle-blowing tips helped in detection of the fraudulent activities.

The regulations on Whistle Blowing, under the Act 2013 and Clause 49 of the listing agreement are in line with global practices such as The Public Interest Disclosure Act, 1998, in the UK (which protects whistle blowers from victimization and dismissal) and the Sarbanes Oxley Act, 2002 (which provides for the protection of whistle blowers and is applicable even to employees in public listed companies).

III. INDEPENDENT DIRECTORS AND PECUNIARY INTERESTS – THE DEBATE UNSETTLED

For years, Indian listed companies have been familiar with the concept of "independent directors" ("IDs") because of a mandatory requirement for such directors under the listing agreements with the stock exchanges. The test of "independence" in the listing agreement broadly was that the director is not associated with the "promoters" or with the management of the company. Companies Act 1956 did not have the concept of independent directors.

Act 2013 extends the concept of IDs to certain public companies. These are public companies:

(i) with paid-up share capital of Rs. 10 crore (US$ 1.7 million) or more; or

(ii) with topline of Rs. 100 crore (US$ 17 million) or more; or

(iii) which have in aggregate outstanding loans, debentures and deposits exceeding Rs. 50 crore (US$ 8.5mn).

Act 2013 provides an elaborate definition of an independent director. It states that such directors will have to be non-executive and should not be "nominees" of any person. "Nominee director" is one who is nominated by any financial institution in accordance with any applicable law, or of any agreement, or appointed by any government or any other person to represent its interests. Given this definition, imagine a case where a very large number of public shareholders propose appointment of a person of high repute as a director; will such director be deemed to be a "nominee" of such a large body

of shareholders? And in the context that every defined "independent director" also has to be appointed by the shareholders in a meeting – then how are the appointees different or how is one less or more "independent" than the other? Though this is a critical provision, but both the concept and the definition appear to be somewhat ambiguous. The drafting could have been simpler and more direct – that is a person "independent of" any conflict of interest with the company and "independent of" the promoters, the management, and their affiliated entities would be considered as an "independent director".

A "professional" would be considered "independent" even if he or his firm is providing services to the company so long as the revenue received from the company is less than 10% of the professional's total revenue. This is a rather ironic view of the concept of independence and conflict of interest. And then after such elaborate provisions for appointment of "independent director" – the shareholders have in any case the power to remove any director presumably including an "independent director".

Act 2013 casts extremely wide duties and responsibilities on independent directors. Besides being liable to comply with statutory duties of directors, they have to adhere to the code of professional conduct provided in the Act. It remains to be seen that with abundant duties and obligations and a curb on their remuneration (since now they will not be entitled to any stock options and only sitting fee and profit related commission is permissible, that too subject to shareholders' nod), will individuals be still willing to take up positions of IDs.

Though, the Act 2013 has been operationalized with effect from April 1, 2014, there are implementation issues on which various stakeholders sought clarifications from the Ministry of Corporate Affairs (MCA). The MCA vide general circular no. 14/2014 dated June 9, 2014 has provided clarifications, as under, on the matters relating to appointment and pecuniary relationships of IDs. These are as under[2]:

(i) Section 149(6)(c) of the Act 2013 requires that IDs should have no pecuniary relationship with a company, its holding, subsidiary or associate company, or their promoters, or directors, during the current and two preceding financial years. Clarification had been

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[2] KPMG, First Notes, Clarifications relating to independent directors, Available at http://www.kpmg.com/IN/en/IssuesAndInsights/first-notes/Documents/First%20Notes_12June14.pdf

sought as to whether a transaction entered into by an IDs with a company, which was at par with the general public and at the same price as was payable / paid by a member of public, would fall within the prohibition on 'pecuniary relationships' under the Act.

(ii) The MCA has clarified that Section 188 of the Act 2013 exempts those transactions that are in the 'ordinary course of business and are at an arm's length price' from the purview of the related party transactions. Therefore, an IDs would not be considered to have a pecuniary relationship under section 149(6)(c) of the Act 2013 for transactions with a company, its holding, subsidiary or associate company, or their promoters, or directors, provided such transactions are in the ordinary course of business and are at an arm's length.

(iii) Section 197(5) of the Act 2013 provides that a director may receive remuneration by way of fee (as may be prescribed in the relevant rules) for participating in Board and other meetings. Clarification has been sought on whether receipt of remuneration by IDs of a company would be considered as having pecuniary relationship, while considering his appointment in the holding, subsidiary or associate company of such company. After consulting SEBI, the MCA has clarified that a pecuniary relationship provided in the section 149(6)(c) of the Act 2013 does not include receipt of remuneration, from one or more companies, by way of fee as provided under section 197(5) of the Act 2013, reimbursement of expenses for participation in the Board and other meetings and profit related commission as approved by the members in accordance with the Act.

(iv) In line with the above, SEBI has accordingly, under Clause 49(II) (B) made appropriate recommendations on IDs and pecuniary relationships, which prohibits entitlement to any stock options as remuneration or otherwise.

IV. SUCCESSION PLAN FOR EFFICIENT GOVERNANCE

Per Section 179 of the Act 2013 the Board of Directors are required to look into succession planning (though the term has not been defined in the Act) and SEBI has consequently amended the Listing Agreement and introduced Clause 49((I) (D), which requires the Board of listed companies should satisfy themselves that plans are in place for orderly succession for appointments to the Board and senior management. This requirement will be applicable to all listed companies from October 1, 2014 and is likely to have

been triggered by some of the very public succession issues faced by India Inc in the recent past.

Section 179 of the Act 2013 also requires that appointment or changes to key managerial personnel and one level below, should be notified and approved at a meeting of the Board of Directors. For listed companies, this will also entail appropriate reporting to the regulators. Separation of ownership and management is a sensitive topic for family-run businesses in India and one most likely not discussed at length due to the tacit acceptance that the successor will be someone from the family. This assumes significance for stakeholders in such businesses in light of statistics that half the companies in the NIFTY index are family-owned and almost 75% of the top 500 companies are family-run.

Indian corporate culture has been criticized as being generally weak and myopic leading to the risk that the proposed amendment may become implemented more in form than in substance. However, considering that neither the old Companies Act, 1956 nor the new Act 2013 provide for succession planning, such regulatory initiative is essential to further the incorporation of global best practices in the running of Indian businesses[3] .

V. CHECKS AND BALANCES FOR RELATED PARTY TRANSACTIONS

A. Under Act 2013

Act 2013 broadly defines related party transaction (RPT) as being a transaction between the company with the counterparty being: a director or key managerial personnel or any relative of such person (collectively "connected person"); a partnership firm where a connected person is a partner; any other company in which a director or manager of a company are shareholders or directors; holding, subsidiary or associate companies and fellow (sister subsidiaries). With such a broad definition, many transactions will get covered by RPT provisions.

Companies Act 1956 provided that related party transactions would require board approval and additionally in certain cases Government approval but under the Act 2013, approval process is all internal and the Government has no role to play, which is a good move. Under Act 2013,

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[3]Nishih Desai Associates, Private Client Wrap, April 1st 2014, Available at http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/2320/html/1.html?no_cache=1

RPT is to be approved by audit committee (if a company is required to have such committee), Board of Directors and shareholders. In some cases, the shareholders' nod is by a special resolution (these are the cases where under Companies Act 1956 government approval would have been required).

Only disinterested shareholders and directors are permitted to vote on RPT. Importantly, an interested director cannot even attend the meeting when the RPT is being discussed and considered by the Board. Although this will strengthen corporate governance but it also runs the risk of being misused by disinterested shareholders. Therefore, the role of independent directors will be very crucial in a RPT. While the concept of disinterested vote is very significant, Act 2013 fails to contemplate all kinds of situations where it could become difficult for disinterested shareholders to exercise their vote. For instance, what will happen in a situation when there are only two shareholders (like in a private joint venture company) and one of them is interested, so the remaining disinterested shareholder being only one in number does not form quorum to approve RPT. Yet another situation which needs clarity is what will happen when a RPT is between two subsidiaries of the same parent. These are some unanswered questions which will surface and then solutions found – for example, it could be read down that approval of RPT by the disinterested shareholder achieves the intent of Act 2013 and therefore should be acceptable.

Transactions done in "ordinary course of business" and on an "arm's length basis" are exempted. While arm's length transaction is defined but there is no definition of "ordinary course of business". Arm's length transaction will mean transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest. So there will be gray, and thus contentious, areas. For instance, if a RPT is claimed to have been undertaken at arm's length basis relying on the transfer pricing report of an expert and subsequently the report is rejected in income tax proceedings? Will it also affect the RPT passed under the Act 2013?

Although, Act 2013 does not have an express provision in this regard but RPT entered in to before April 1, 2014 should not be affected but any modification or renewal of such RPT would trigger the provisions.

B. Under Clause 49 of Listing Agreement

Per Clause 49(VII) and (VIII) of the listing agreement, a RPT includes transaction whether or not a price is charged. Related parties include, besides covering the requirements of the Act 2013 and Accounting Standard 18, additional relationships – for example, person that has a joint

control or significant influence on the company and fellow joint ventures and associates.

The revised norms require all RPTs to be preapproved by the Audit Committee. Also, it requires approval of all material RPTs by shareholders through special resolution with related parties abstaining from voting. A transaction is considered material if the transaction / transactions to be entered into individually or taken together with previous transactions during a financial year, exceeds five (5) percent of the annual turnover or twenty (20) percent of the net worth of the company as per the last audited financial statements of the company, whichever is higher[4].

This clause shall be applicable to all prospective transactions. All existing material related party contracts or arrangements which are likely to continue beyond March 31, 2015 shall be placed for approval of the shareholders in the first general meeting subsequent to October 1, 2014. However, a company may choose to get such contracts approved by the shareholders even before October 1, 2014.

C. MCA Clarifications

The Ministry of Corporate Affairs, vide general circular no. 30/2014, dated July 17, 2014, has provided clarifications on matters relating to related party transactions under section 188 of the Act. The clarifications are as follows:

(i) *Related party abstention requirement on certain contracts*

The second proviso to section 188(1) requires a related party (who is a member) to abstain from voting on a special resolution of a company to approve a contract/arrangement entered into by the company. It was unclear whether such a member would be required to abstain from voting on every contract / arrangement entered into by the company. The MCA has clarified that a member would be considered as a related party only with reference to a contract / arrangement for which the 'said special resolution' is being passed.

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[4] KPMG, SEBI's amendments to corporate governance norms, 22 April 2014, Available at http://www.kpmg.com/IN/en/IssuesAndInsights/first-notes/Documents/FirstNotes_22April2014.pdf

(ii) *Compromises, arrangements, and amalgamations are outside the ambit of section 188 of the Act*

It was unclear whether section 188 also applied to transactions arising out compromises, arrangements, and amalgamations that are dealt with under the specific provisions of the Companies Act, 1956. The MCA has clarified that above transactions will not attract the requirements of section 188 of the Act.

(iii) *Transactions compliant with section 297 of the Companies Act, 1956, grandfathered*

As the Act does not provide any specific transitional provisions in section 188, it was unclear whether existing / continuing contracts (i.e., contracts that have been entered into by a company prior to the section 188 coming into force) would be grandfathered. The MCA has clarified that those contracts that were entered into by a company before April 1, 2014 (commencement date of section 188 of the Act) in compliance with section 297 of the Companies Act, 1956 will not require fresh approval under section 188 of the Act till the expiry of the original term of such contracts. If any modification is made in such contracts on or after April 1, 2014, then the requirements under section 188 of the Act would have to be complied with.

The MCA has provided some important clarifications on the practical challenges faced by companies while complying with section 188 of the Act. However, grandfathering provisions in particular may not prove to be beneficial to listed companies, especially for material transactions. This is because the amended Clause 49 of the Equity Listing Agreement, which is applicable from October 1, 2014, requires all existing material related party contracts / arrangements, which are likely to continue beyond March 31, 2015, to be placed for approval of the shareholders in the first general meeting subsequent to October 1, 2014. Also, certain aspects have not been addressed, such as situations where a transaction is considered to be a related party transaction under section 188 of the Act but was not covered under section 297 of the Companies Act, 1956.[5]

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[5] KPMG, Related party transactions: Certain clarifications by the MCA, 18th July 2014, Available at http://www.kpmg.com/IN/en/IssuesAndInsights/first-notes/Documents/FirstNotes_Related-Party-Clarification.pdf

VI. To Conclude

All aspects of Corporate Governance as covered above are extremely relevant to ensure transparency, effectiveness and trust building between a Company and its stakeholders:

(i) Our woman workforce is highly competent and most them are qualified, experienced and are managing global corporations: Indira Nooyi of Pepsico; ChandaKocchar of ICICI Bank; Kiran M Shaw of Biocon; ShobhanaBhartia – HT; Shikha Sharma – Axis Bank; NainaLalKidwai – HSBC; KalpanaMorparia – JP Morgan India, are some often quoted instances of women excellence but India needs many more.

(ii) Businesses need to be conducted ethically and with integrity for which employees need to speak up and show the way. It is every company, its promoter, directors and employee's responsibility to provide protection to those who blow the whistle. Indian needs an environment, which should facilitate growth and provide protection to stakeholders and not repeat instances like Satyam that would tarnish image of India Inc.

(iii) Independent Directors have a vital role to play in ensuring corporate governance. The Act 2013 and SEBI guidelines have outlined many ways how this is to be done. There are provisions of creation of various board committees on remuneration, audit, shareholders, etc. The Independent Director should be the person to whom these committees should report so they get enough ammunition to counter corporate greed and ensure protection to stakeholders. India Inc will see the relevance of professionally trained Independent Directors and the impact they would make to the image of a company and to its topline.

(iv) The role of succession planning is extremely vital for continuation of a company, which is an artificial person but needs guidance and control of an able and capable management. The Tata group have been an apt example of robust succession planning with a keen focus of "trusteeship" than "ownership". The Tata group has been able to be large, growing but with energy and passion of a start-up due to the professionalism in its management and succession planning. To manage a business group that has global capabilities from software development, defence, steel making, automobiles….it needs a

management which has a professional outlook and be able to find successors, who remain focused on value creation.

(v) The health of any business is based on the transactions that it does, so that returns to shareholders are maximized. The issue arises when the intention of the promoters is to manage their own interests over the interests of the stakeholders. There has to be a complete transparency and accurate record keeping on all transactions that a company engages in. After all there are no issues in dealing with related parties, provided the practices are universal to everyone and not aimed at a section of the beneficiaries.

The above are steps in the right direction and making India Inc at par or better than what international environment has to offer and am glad that the legal profession is playing a vital role to fulfil such initiatives.

Dr. Akhil Prasad
Country Counsel India
Boeing International Corporation

TABLE OF CONTENTS

Dr Akhil Prased, Evolving Dynamics of Governance

Abhirup Ghosh & Nivedita Shankar, *Checks and Balances on Related Party Transactions* 969

Himanshu Chandra & Ananya Kumar, *The Need for Whistle-blower's Legislation in India* 993

Ayushi Singhal, *Whistle-Blower Protection Act, 2011- Does it truly protect the unsung heroes?* 1004

Debasis Poddar, *Introspection on Diversity in Boardroom from Governance Perspective* 1015

Enakshi Jha & Shantanu Dey, *RPT under Companies Act, 2013- Taking a step forward in evolving a regulatory environment* 1026

Gargi Bohra & Garima Tyagi, *ESOPs and Independent Directors- Unsettled debate in light of the Revised SEBI Norms* 1060

Thomas W Joo, *Diversity and Deference: US Corporate Boards in Corporate Perspective* 1076

CHECKS AND BALANCES ON RELATED PARTY TRANSACTIONS

ABHIRUP GHOSH AND NIVEDITA SHANKAR

With the enactment of the Companies Act, 2013 ('Act, 2013'), Indian companies have been forced to sit up and take note of transactions with their related parties. The situation is graver for listed companies since the definition of 'related parties' is wider in the Equity Listing Agreement and so is the scope of transactions. With the recent incidence of scams in India and the effect of frauds on the revenues and goodwill of a company, companies cannot afford to take related party transaction easily anymore. Under the Companies Act, 1956, it was fairly easy to enter into such transactions since the definition of related parties and the scope of transactions was limited. The Act, 2013 has not only enlarged the definition of 'related parties' but has also widened the scope of transactions covered. In fact, under the Equity Listing Agreement, virtually any transaction with related parties is covered, whether financial or otherwise. The Article also discusses the regime of related parties in various parts of the world like United States, United Kingdom, Hong Kong, Singapore and Malaysia.

The Article further discusses the provisions pertaining to related parties under the provisions of Act, 2013 and compares the same with the provisions of Equity Listing Agreement which came into effect from October 1, 2014. Additionally, novel additions such as voting at general meetings, exemptions to transactions entered into on arm's length basis and in the ordinary course of business have also been discussed. Keeping the discussion in mind, we have concluded the Article with a detailed account of the many approvals required for undertaking a related party transaction.

CONTENTS

I. *Introduction*

II. *Who all are related parties to a company?*

III. *RPTs under the bygone regime*

IV. *Global Laws*

V. *How RPTs are to be governed under the new regime of the Act, 2013?*

VI. *The saviour*

VII. *Transactions covered by revised clause 49 of listing agreement*

VIII. *Certain transactions which require special resolution under the Act, 2013*

IX. *Voting at general meetings*

X. *Compliance requirements under the act, 2013 and revised clause 49*

XI. *Responsibilities to the audit committee and the independent directors*

XII. *Penal provisions for non compliance*

XIII. *How to ensure compliance while entering into RPTs*

I. INTRODUCTION

According to KPMG's survey on Fraud, Bribery and Corruption in Malaysia, 2013[1], potential frauds by way of Related Party Transactions ("RPT") ranked first in the category of 'financial reporting fraud' and its ability to affect the profits and losses was to the tune of 3% compared to that of other financial frauds in a company. Close to Rs 900 crore have been spent by MCX, the cash-cow of the FT group, in dealings with hundreds of related parties according to a PwC audit[2].

Since every related transaction has the potential to effect a company's operations majorly, it is obvious that one cannot take a discussion on this topic lightly. The OECD in its report titled "Guide on Fighting Abusive RPTs in Asia" rightly commented that:

Abusive RPTs have increasingly become a challenge to the integrity of Asian capital markets.

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[1]*Fraud. Bribery and Corruption Survey*, KPMG, Available at http://www.kpmg.com/MY/en/IssuesAndInsights/ArticlesPublications/Documents/2013/fraud-survey-report.pdf.

[2]Sugata Ghosh & Ram Sahgal, *MCX row: Around Rs 900 crore spent in transactions with hundreds of related parties, finds PwC audit,* THE ECON. TIMES, Feb. 24, 2014.

RPTs have always been a very sensitive area of discussion in corporate laws. Earlier, in India, the subject lacked proper legislative guidance but recently with the enforcement of the Act, 2013 and SEBI's move to amend Clause 49 of the Equity Listing Agreement, the topic of related party has received a whole new impetus. While the Act, 2013 aims to ensure that transactions are conducted in a transparent manner, SEBI's revised Clause 49 has simply expanded the scope. With strict penal provisions in place, every company will have to be extremely careful of its dealings with its related parties. It is understandable that transactions with related parties are by and large a common occurrence in any company. However, one inadvertent move can lead to a monetary penalty of upto Rs. 5 lakhs apart from imprisonment for a term of upto 1 year. In this paper we will take you through the various regulatory changes made with respect to RPTs and by the time we reach the end, we will be well aware of the "Dos and Don'ts" of RPTs.

VII. WHO ALL ARE 'RELATED PARTIES' TO A COMPANY?

Till date, the Companies Act, 1956 (Act, 1956) did not contain any provision which would have enabled the companies to identify its related parties. There is no denying that section 297 of the Act, 1956 came close to defining the related parties, yet there was a void. The only authoritative definition was derived from Accounting Standard 18 (AS-18). However, AS-18 operated for the limited scope of disclosure in the notes to the balance sheet of a company and did not put a bar on such transactions and neither did it regulate any RPT. The scope of applicability was also limited. But the Act, 2013 has brought in a whole new definition of related parties.

As per Section 2(76) of the Act, 2013 related parties mean the following –

(i) A director / Key Managerial Person (KMP) / their relatives;

(ii) A firm, in which a director / manager / their relative is a partner;

(iii) A private company, in which a director / manager is a member or director;

(iv) A public company, in which a director / manager is a director **and**[3]holds along with his relatives, more than 2% of its paid-up share capital;

(v) A body corporate, whose Board of Directors / managing director / manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager, other than in professional capacity;

(vi) Any person, on whose advice, directions or instructions a director or manager is accustomed to act, other than in professional capacity;

(vii) Any company, which is a holding / subsidiary / fellow subsidiary /associate company of the other company;

(viii) such other person as may be prescribed;

Further, Rule 3 of the Companies (Specification of definitions details) Rules, 2014 provides that *"a director, other than an independent director[4] or key managerial personnel of the holding company or his relative with reference to a company, shall be deemed to be a related party."*

The definitions of KMP and relatives have been derived from sections 2(51) and 2(77) of the Act, 2013.The same have been reproduced below:

Section 2(51) of the Act, 2013 – Definition of "Key Managerial Personnel" –

"Key managerial personnel", in relation to a company, means—

(i) the Chief Executive Officer or the managing director or the manager;

[3] The Companies 1st (Removal of Difficulties) Order, 2014 dated 28th March, 2014 changed the wording from 'or' to 'and'.

[4]Inserted by Companies (Specification of definitions details) Amendment Rules, 2014 (July 17, 2014), Available at http://www.mca.gov.in/Ministry/pdf/NCARules_17072014.pdf.

(ii) the company secretary;

(iii) the whole-time director;

(iv) the Chief Financial Officer; and such other officer as may be prescribed;

Section 2(77) of the Act, 2013 – Definition of "Relatives" –

"Relative", with reference to any person, means anyone who is related to another, if—

(i) they are members of a Hindu Undivided Family;

(ii) they are husband and wife; or

(iii) one person is related to the other in such manner as may be prescribed;

A detailed list of such persons who shall be deemed to be a 'relative' has been laid down in Rule 4 of the Companies (Specification of definition details) Rules, 2014. The same has been reproduced below:

Rule 4 of the Companies (Specification of definition details) Rules, 2014 – List of relatives in terms of section 2(77) –

A person shall be deemed to be the relative of another if he/she is related to another in the following manner:-

(i) Father, provided that the term "Father" includes the step-father,

(ii) Mother, provided that the term "Mother" includes the step-mother,

(iii) Son, provided that the term "Son" includes the step-son,

(iv) Son's wife,

(v) Daughter,

(vi) Daughter's husband,

(vii) Brother, provided that the term "Brother" includes the step-brother; and

(viii) Sister, provided that the term "Sister" includes the step-sister.

Besides the above, SEBI by way of its circular dated September 15, 2014 has laid down the list of 'related parties' for listed companies. Although the list has been pruned as compared to the list of related parties prescribed by way of SEBI's circular dated April 17, 2014, yet on further scrutiny it is clear that the pruning down of the list is only temporary. If one were to see the definition of related party as prescribed by SEBI's circular dated September 15, 2014, it reads as follows:

"For the purpose of Clause 49 (VII), an entity shall be considered as related to the company if:

(i) such entity is a related party under Section 2(76) of the Companies Act, 2013; or

(ii) such entity is a related party under the applicable accounting standards."

Since, currently, AS-18 is the relevant accounting standard for related parties, the list of related parties is significantly lesser than IAS-24. We provide below the list of related parties as per AS-18. This standard deals only with related party relationships described in (a) to (e) below:

a) enterprises that directly or indirectly, through one or more intermediaries, control or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

b) associates and joint ventures of the reporting enterprise and the investing party in respect of which the reporting enterprise is an associate or a joint venture;

c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise, that gives them control or significant influence over the enterprise, and relatives of any such individual;

d) key management personnel and relatives of such personnel; and

e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

Thus, it is clear that the definition of related party under the Act, 2013 differs from that under AS-18. After comparing both, we find that the following entities are not related parties as per AS– 18:

(i) Firm in which director, manager or his relative is a partner;

(ii) Private company in which director or manager is member or director;

(iii) Public company with common directors and director and relatives holding 2% of its paid up capital, unless the director can affect the policies.

On the other hand, AS-18 encompasses such entities as related parties which are owned by individuals who are its majority shareholders.

VIII. RPTS UNDER THE BYGONE REGIME

In order to understand the situation under the Act, 2013 better, we will have to first understand the situation under the Act, 1956.Though the Act, 1956 had no dedicated section for RPTs, bits and parts of various sections dealt with the same. Section 297 and section 314 of the Act, 1956 dealt with RPTs. In the upcoming paragraphs we will analyse the impact of these sections.

D. Section 297 of the Companies Act, 1956 - Board's sanction to be required for certain contracts in which particular directors are interested.

This section required prior consent of the board in order to enter into a contract of sale, purchase or supply of any goods, materials or services or for underwriting the shares or debentures of the company with the following person(s)/ entity(ies) –

(i) Director of the company,

(ii) Relative of the director of the company,

(iii) A firm in which the director or his relative is a partner,

(iv) Any partner of the firm in which the director or his relative is a partner,

(v) A private company in which the director of the company is a director or a member.

However, exemptions were provided to the transactions of the following nature –

(i) Transactions involving purchase or sale of goods and materials at prevailing market prices.

(ii) Transactions involving contracts entered into by either party for purchase or supply of any goods, materials or services, in its normal course of business, cost of which does not exceed an aggregate of five thousand rupees in a particular year.

(iii) Any transaction entered into by a banking company or an insurance company in its normal course of business.

E. Section 314 of the Companies Act, 1956 - Director, etc., not to hold office or place of profit.

This section required prior approval through special resolution for the appointing the following persons in any office or place of profit carrying

a total monthly remuneration (discussed in the subsequent paragraphs) in the company –

(i) Director of the company.

(ii) Relative of the director of the company.

(iii) A firm in which the director of the company or his relative is a partner.

(iv) Any partner of the firm in which the director of the company or his relative is a partner.

(v) A private company in which the director of the company is a director or member.

(vi) Any director or manager of a private company in which the director of the company is a director or member.

The section laid down some limits of total monthly remuneration which could be offered to the above-mentioned persons/ entities without passing a special resolution –

(i) For Directors – Any amount which the director accepts in excess of the amount received for holding the office of the director in the company.

(ii) For others – If such person has been offered an office or a place of profit with a monthly remuneration of not less than Rs. 50,000, then prior consent by special resolution was required and if the monthly remuneration exceeded Rs. 2,50,000, then additionally, the company would have required to obtain a prior approval of the central government also.

However, section 314(1) provided exemptions to the appointment of the above-mentioned person/ entities as managing director or manager or debenture trustee of the company or its subsidiary, provided that the remuneration received from such subsidiary company does not exceed that of the holding company.

IX. GLOBAL LAWS

RPTs have been an area of focus under different legislations across the world. We have tried to collate the governing principles of the different nations and the same have been shown below:

A. United States

Clause 314 of the NYSE Listed Company Manual deals with "RPTs"[5]. The Clause gives an inclusive definition of RPTs stating that "RPTs normally include transactions between officers, directors, principal shareholders and the company". The Exchange requires that all the RPTs need to be reviewed and evaluated by an appropriate group within the organization. Though the Exchange specifically does not name any committee with the company which should be given the responsibility to carry out the review and evaluation, it does suggest that the Audit Committee of a listed company should be capable enough to carry out this function. The proxy statements and other SEC filings with respect toRPTs are subject to review by the NYSE and where the situations continue year after year, the Exchange also evaluates whether such transactions should be permitted to continue.

Further, Item 404 of the Regulation S-K of U.S. Securities Law[6]also deals with RPTs. It lays down that public companies should disclose such transactions in which its related parties have direct or indirect interest of more than USD 120000 during a financial year.

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[5] The New York Stock Exchange Listed Company Manual, Section 3 Corporate Responsibility, Available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_14&manual=%2Flcm%2Fsections%2Flcm-sections%2F(last visited Oct.5, 2014).

[6] *Transactions with related persons*, LEGAL INFORMATION INSTITUTE, Available at http://www.law.cornell.edu/cfr/text/17/229.404

B. United Kingdom

The Financial Reporting Standard – 8[7] requires companies to make the following disclosures with respect to RPTs:

(i) Information regarding the transactions entered into by the reporting entity with its related parties; and

(ii) The name(s) of the party controlling the reporting entity, irrespective of whether or not any transactions between them have taken place.

The Companies Act, 2006[8] deals with related party disclosures, in detail, in sections 409, 410 and 413. Further, the Act also requires the companies to obtain approval of the members before entering into any transaction with the director or where its directors are connected in the transaction.

F. *Hong Kong*

Clause 14A of the Listing Rules9 of the exchange of Hong Kong regulates the connected transactions entered into by the listed companies or their subsidiaries. The clause also clarifies that any transaction between the listed issuer's group and the connected person shall be deemed to be a connected transaction. The clause requires the companies to obtain approval of the shareholders before it enters into any connected transaction. It also restrains a member, having material interest in the transaction, from voting in the resolution. It further lays down the requirement of appointing a financial adviser by the Independent Board Committee of the company to advise the

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[7] Available at https://frc.org.uk/Our-Work/Publications/ASB/FRS-8-Related-Party-Disclosures-File.pdf(last visited Oct.5, 2014).

[8]Companies Act 2006, Available at http://www.legislation.gov.uk/ukpga/2006/46/notes/contents(last visited Oct.5, 2014).

[9] Rules Governing The Listing Of Securities On The Stock Exchange Of Hong Kong Limited, Chapter 14,Available at https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_14a.pdf (last visited Oct.5, 2014).

company's shareholders on the terms of the connected party transactions and ensure that the transactions are being carried out in a fair and reasonable manner, ensuring best interest of the company and the shareholders as a whole.

G. Singapore

Chapter 9 of the Singapore Exchange Listing Manual[10]deals with the Interested Person Transactions. It requires the company to make immediate announcements where it enters into interested person transactions of a value equal to or more than 3% of the group's latest audited net tangible assets. However, relaxations have been provided to the transactions of value less than Singapore $ 100,000. It requires the companies to obtain prior approval of the members where the value of the transaction equals to or exceeds 5% of the last audited net tangible assets of the company. "Interested Person" has been defined to mean a director, CEO or controlling shareholder and an associate of any of these.

H. Malaysia

Rule 10.08 of Part E of the Bursa Malaysia Listing Agreement[11] requires companies to make immediate announcements with respect to transactions with related parties where the percentage ratio[12] of 0.25% is exceeded. However, for transactions of value less than RM 250,000/- or for transactions which are recurrent in nature, disclosures have to be given to the Stock Exchange. Where the percentage ratio of 5% is exceeded, approval of the shareholders in the general meeting is required. Further, an independent

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[10] *Interested Person Transaction*, SINGAPORE EXCHANGE, Available at http://rulebook.sgx.com/en/display/display_viewall.html?rbid=3271&element_id=5248&print=1(last visited Oct.5, 2014).

[11] *Listing Requirements of Bursa Malaysia Securities Berhad*, THE & LEE, Available at http://www.tehlee.com.my/updates/Listing_Requirement_MBSB.pdf (last visited Oct.5, 2014).

[12] Percentage ratio has been defined in Rule 10.2 (h) of Part B of the Bursa Malaysia Listing Agreement, Available at http://www.tehlee.com.my/updates/Listing_Requirement_Mesdaq.pdf (last visited Oct.5, 2014).

adviser, as approved by the commission, is to be appointed to comment on whether the RPTs are being carried out in a fair and reasonable manner ensuring best interest of the company and shareholders as a whole. Where the percentage ratio of 25% is exceeded, the issuer has to appoint a Principal Adviser, to ensure that such transaction are carried out on fair and reasonable terms and conditions and are not detrimental to the interests of the shareholders. The Rule also restrains the members, interested in the contract, from voting in the general meeting in which such transactions are been taken up.

X. HOW ARE RPTS TO BE GOVERNED UNDER THE NEW REGIME OF ACT, 2013?

As per Section 188 of the Act, 2013, a company, without passing a resolution at a meeting of the Board of Directors, is not allowed to enter into any contract or arrangement with a related party with respect to the following:

(i) sale, purchase or supply of any goods or materials;

(ii) selling or otherwise disposing of, or buying, property of any kind;

(iii) leasing of property of any kind;

(iv) availing or rendering of any services;

(v) appointment of any agent for purchase or sale of goods, materials, services or property;

(vi) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and

(vii) under-writing the subscription of any securities or derivatives thereof, of the company.

Further, as per the Companies (Meetings of Board and its Powers) Rules, 2014, where any director is interested in any of the aforesaid RPTs,

such director is barred from attending the meeting in which such discussions take place. The above requirement is peculiar in nature since it expects an interested director to sit out of a board meeting in which such a matter is taken up. Under the Act, 1956 interested directors by virtue of section 300 were not allowed to take part or vote on any matter involving RPTs, the reason being that such directors should not influence the other directors present. The Act, 2013 has seemingly taken this requirement forward by not allowing the presence of any interested director in the board meeting itself!

XI. THE SAVIOUR

The third proviso to section 188(1) comes as a relief for companies which are engaged in the businesses stated in section 188(1). However, in order to avail of the exemption from this section, the transaction has to be:

(i) in the ordinary course of business, and

(ii) on an arm's length basis.

Although, the term 'arm's length basis' has been defined rather vaguely, one needs to decipher the meaning behind the same. In common parlance, 'arm's length basis' means transactions entered into on such terms as with that of a third party. Where any company enters into a transaction with its related party on similar terms as it would with an unrelated party, then the terms of the transaction would be said to be on arm's length basis. The basis behind the same is to ensure that transactions with related parties are not prejudicial to the interests of the company. Although, any transaction with a related party is entered into with the basic presumption that the same is on favourable terms, yet, section 188 of the Act, 2013 seeks to mediate any such possibilities. Mere seeking of a certificate under section 92 of Income Tax Act, 1961 will not suffice i.e. arm's length basis is not limited to observing that the transaction with the related party is at arm's length price. It goes well beyond that to also include other terms and conditions of entering into a transaction with a related party like credit period, credibility of the other party *et al.* Thus, where say Company A does not enter into transactions with loss making companies, if it however makes an exception for its loss making subsidiary, then the same would not be on 'arm's length

basis', even if the same is on 'arm's length price'. Thus, the term 'arm's length basis' includes 'arm's length price' but is not limited to the same.

Such requirement although noble and intended to be in the best interests of a company, had the potential of making transactions difficult between a holding and subsidiary company. The MCA in its damage control mode stated in explanation (2) to Rule 15(3) of Companies (Meetings of Board and its Powers) Rules, 2014 that for transactions between a wholly owned subsidiary and a holding company, resolution passed by the holding company will suffice for the purpose of section 188(1). However, for other subsidiaries, matters continue to remain the same.

XII. TRANSACTIONS COVERED BY REVISED CLAUSE 49 OF LISTING AGREEMENT

In the Doing Business Report, 2014 of World Bank and IFC, India is ranked 134th out of a total of 189 economies, down from 131st in the year 2013. The revised clause 49 of the Listing Agreement adds to the existing difficulties of doing business by defining 'RPT' as follows:

> *a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.*

The definition is similar to the definition of RPT in Para 9 of IAS-24. By use of the phrase 'transfer of resources, services or obligations' with or without consideration, any transaction of a listed company with a related party will have to be carefully examined. One may also note that financial transactions (which were not covered by section 188) will be covered by the revised clause 49. In essence, the scope of the revised clause 49 of the listing agreement is wider and covers any transfer of resources, obligations or services. Therefore, loan transactions and guarantee transactions, not covered by section 188, will be covered by clause 49 of the Listing Agreement.

XIII. CERTAIN TRANSACTIONS WHICH REQUIRE SPECIAL RESOLUTION UNDER THE ACT, 2013

Though section 188(1) provides that the company can enter into specified transactions by passing a board resolution, but the first proviso to

section 188(1) read with the Companies (Meetings of Board and its Powers) Second Amendment Rules, 2014[13], states that, except with the prior approval of the members of the company by way of special resolution, companies shall not enter into any of the following contracts / arrangements:

(i) Contract or arrangements with respect to clauses (a) to (e) of sub-section (1) of section 188 with criteria, as mentioned below-

a) sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding 10% of the turnover or Rs. 100 crores, whichever is lower, as mentioned in clause (a) and (e) of section 188(1);

b) selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding 10% of net worth or Rs. 100 crores, whichever is lower, as mentioned in clause (b) and clause (e) section 188(1);

c) leasing of property of any kind exceeding 10% of the net worth or exceeding 10% of turnover or Rs. 100 crore, whichever is lower, as mentioned in clause (c) of section 188(1);

d) availing or rendering of any services directly or through appointment of agents exceeding 10% of the net worth or Rs. 50 crore, whichever is lower, as mentioned in clause (d) and clause (e) of section 188(1);

(ii) appointment of related parties to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs. 2.5 lakh as mentioned in clause (f) of section 188(1); or

[13] The Companies (Meetings of Board and its Powers) Second Amendment Rules, 2014 (Aug, 14, 2014), Available at http://www.mca.gov.in/Ministry/pdf/NCA_Rules_16082014.pdf.

(iii) remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of the net worth as mentioned in clause (g) of section 188(1).

Notably, threshold on the basis of paid-up capital has been done away with.

XIV. VOTING AT GENERAL MEETINGS

We also draw your attention to SEBI's circular dated September 19, 2014, wherein it has done a complete *volte-face* in relation to voting at general meeting of listed companies by related parties. MCA by its circular dated July 17, 2014 stated that only parties which are directly interested in the contract or arrangement should abstain from voting. This was done keeping in mind the impediment that the second proviso to section 188(1) of Act, 2013 posed. However, SEBI by way of its circular dated September 19, 2014 has done a complete turnaround and has put all listed companies back to square one. This is because the stated Circular also requires every related party to the contract or arrangement, whether directly related or not, to abstain from voting. Where on one hand, this comes as a major shock to all listed companies; it also exposes the ugly side of the disharmony amongst the different regulators in the country.

XV. COMPLIANCE REQUIREMENTS UNDER THE ACT, 2013 AND REVISED CLAUSE 49

Revised clause 49 of the listing agreement may have imbibed the definition of Act, 2013, however procedurally there are still certain differences which we have listed out below:

Particulars	Act, 2013	Revised clause 49
Approval of audit committee	Prior	Prior
Approval of board	Prior	Not clear. However, since section 188 of Act, 2013

		is applicable to all companies; prior approval of the board by all listed companies will anyways be required.
Approval of shareholders by special resolution	For transactions specified by the Central Government (as mentioned above) – Prior approval is required.	All 'material' RPTs require approval of the shareholders through special resolution. *A transaction shall be considered 'material' if the transaction / transactions to be entered into individually or taken together with previous transactions during a financial year, exceeds ten percent of the annual consolidated turnover of the company as per the last audited financial statements of the company.*
Disclosure	To be reported in the Board's report along with justification for entering into the same.	All RPTs are to be disclosed in the quarterly compliance report on corporate governance.

		The RPTs policy has to be disclosed on the website and also in the Annual Report.
Voting at general meeting	For the purpose of a particular RPT, the concerned related parties are abstained from voting in that particular resolution.[14]	For the purpose of a particular RPT, every related party to the contract or arrangement shall abstain from voting.

XVI. RESPONSIBILITIES OF THE AUDIT COMMITTEE AND THE INDEPENDENT DIRECTORS

The Act, 2013 also provides that the RPTs are subject to review of Audit Committee. As per Section 177(4)(iv), every Audit Committee shall approve, or shall carry out subsequent modification of, transactions of the company with the related parties.

Section 177(1) read with The Companies (Meetings of Board and its Powers) Rules, 2014, requires the following companies to constitute Audit Committee –

(i) listed companies,

(ii) public companies with paid up share capital of Rs. 10 crores or more,

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[14]Clarification on RPTs, MINISTRY OF CORPORATE AFFAIRS (July 17, 2014), Available at http://www.mca.gov.in/Ministry/pdf/Circular_No_30_17072014.pdf.

(iii) public companies with turnover of Rs. 100 crores or more, and

(iv) publiccompanies having loans and borrowings exceeding Rs. 50 crores or more.

Thus, given the fact that not every company needs to constitute an audit committee, but nevertheless section 188 is applicable to every type of company, the following scenarios arise:

Serial No	**Particulars**		**Remarks**
	Mandatory Provisions		
1	The RPT will first need to be approved by the Audit Committee, if any. In case the company does not have any Audit Committee, this provision will not apply.		
2	Once approved by the Audit Committee, if any, the Board of Directors of the Company will need to pass the resolution at a *meeting of the Board.*		Such resolutions cannot be passed by a resolution by circulation. Where the company is a listed company, then prior approval of board is also required.

		Companies covered by rule 15(3) of Companies (Meetings of Board and its Powers) Rules, 2014 or if the transaction is material in nature	
3	The RPT will additionally need to be passed by the shareholders of the company by way of a special resolution.		Members who are also related party to the company cannot vote on such resolutions. For clarity, the draft rules provide that for RPTs between wholly owned subsidiaries,the special resolution passed by the holding company would suffice.
		RPTs entered in ordinary course of business and on an arms' length basis	
4	None of the provisions u/s 188 will apply to such transactions. However, approval by Audit Committee, if any would still be applicable.		

It is pertinent to note here that section 177 of Act, 2013 does not require prior approval of the Audit Committee to be sought. On the other hand, Clause 49(VII)(D) of the revised Equity Listing Agreement, nevertheless requires prior approval of the Audit Committee to be sought.

In addition to the added responsibility to the Audit Committee, the Act, 2013 has also cast additional duty upon the Independent Directors. As per the code of conduct under Schedule IV of the Act, the Independent Directors are required to do the following –

(i) pay sufficient attention and ensure that adequate deliberations are held before approving RPTs; and

(ii) ensure that the same are in the interest of the company.

XVII. PENAL PROVISIONS FOR NON COMPLIANCE

As per section 188(3), any RPT entered into by a director or any other employee, without prior approval of the Board or passing of a special resolution by the shareholders, should be ratified by the necessary resolution within 3 months of entering into such a transaction. If the same is not obtained, the transaction shall become voidable at the option of the board, and where the transaction is entered into with a party related to the director of the company, the concerned director shall indemnify the company against any loss incurred by it due to the transaction.

Section 188 (4) also gives power to the company to proceed against a director or employee who has entered into contract or arrangement with the related party, on behalf of the company, in contravention of the provisions of section 188, and any loss has occurred due to such contract.

Section 188(5) further prescribes that any director or employee of the company who had entered into or authorized the contract or arrangement in violation of the provisions of this section shall:

(i) in case of listed company, be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not

be less than Rs. 25,000 but which may extend to Rs. 5,00,000, or with both; and

(ii) in case of any other company, be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5,00,000.

Accordingly directors or employees of only listed companies may face criminal liability in case they have been convicted for contravention of provisions of Section 188. As stated earlier in this document, Independent Directors of the company shall also be liable to the punishment under section 188(5), unless they are able to prove their innocence. However, the punishments prescribed are eligible for compounding.

If the punishment under section 188(5) is not enough, then we have section 164, which bars any person, who has been convicted of an offence relating to RPTs during the preceding 5 years, from becoming a director of any other company.

The listed companies also will have to take care of the penal provisions for the contravention of provisions of Revised Clause 49. As per section 23E of the Securities Contract (Regulation) Act, 1956, if a company fails to comply with the listing conditions or commits a breach thereof, it shall be liable to a penalty not exceeding twenty-five crore rupees.

XVIII. HOW TO ENSURE COMPLIANCE WHILE ENTERING INTO RPTS

So, to sum up whatever we have discussed so far in this work, in order to ensure compliance under the Act, 2013, the companies must enter into RPTs in the following manner:

(i) Prior approval by the Audit Committee of the company, if any.

(ii) Once approval is obtained from the Audit Committee, the same should be approved by the Board of Directors of the company. In case, the company is listed and the transaction is

material, then prior approval of Board of Directors of the company is to be sought.

(iii) Mention about any such transaction in the board's report in due compliance with section 188(2) of Act, 2013.

In addition the above, the listed companies will have to carry out the following in order to comply with the provisions of the Revised Clause 49:

(i) The company should frame a policy on material RPTs and the manner in which they are to be dealt.

(ii) In case of "material RPTs", special resolution has to be passed in the meeting of the shareholders, without the votes of related parties. However, no exemption is granted to companies entering into transactions in its ordinary course of business on an arm's length basis.

(iii) The transactions should be disclosed in the quarterly corporate governance compliance report.

THE NEED FOR WHISTLE-BLOWERS LEGISLATION IN INDIA

ANANYA KUMAR & HIMANSHU CHANDRA

In an ever increasing need for incorporation of corporate governance norms, the market regulators and the corporate world feel the desideratum for protecting the whistle blowers, to bring about better transparency and consequently improved market efficiency. The Report of the SEBI Committee on Corporate Governance Chaired by Mr. Narayana Murthy mooted the idea for a Whistle Blowers Policy as a mandatory requirement for all companies.

The SEBI took cognizance of the recommendation and made provision for Whistle blower policy under Clause 49 (IV) of the Listing Agreement. This present paper looks into the need for a comprehensive statute which would cater the need of the whistle blowing class and the pros and cons of such a statute at present.

CONTENTS

I. *Introduction*

II. *Whistle-blowing: What it Means*

III. *Whistleblowers' Legislation: The Indian Scenario*

IV. *What is the Course of Action?*

V. *Whether the Legislation should be Enacted Immediately?*

VI. *Other Factors to be Considered When Enacting the Legislation*

VII. *Conclusion*

XIX. INTRODUCTION

Corruption and frauds have become the byword of public life today. These viruses have paralyzed the working and functioning of a democracy

and are all set and ready to break the political structure.[1] The tricolour fluttering all over the country is black, red and scarlet – black money, red tape and scarlet corruption. We are in a condition of what the Great Jurist Shri. Nani A Palkhivala called a *State of Moral Decay*.[2] A shimmering portrayal of this is eloquently evidenced in the lifestyle of the rich and the wealthy. Institutions are also not far behind their *'Big Brothers'*. The disillusioned state of affairs is further goaded by the scams and frauds flooding the security markets and corporate houses. First Enron came down, only to be soon followed by Arthur Anderson. The Indian markets saw the UTI crash however Modi Xerox did not want them to be there all alone and they too joined them.

The recent spate of events should have made everyone of us proud Indians to bow our heads in shame. SatyendraDubey, an IIT Kanpur alumnus, who was the Deputy General Manager in the NHAIs Golden Quadrilateral Project, was shot dead for disclosing several irregularities in Aurangabad-Barachatti segment. The adverse impact of lack of probity in public life leading to a high degree of corruption is manifold.[3] The country once known for its testimony of tolerance and learning is being desiccated by this overt malady. The N N Vohra Committee bore eloquent testimony to a castrated political system existent in India. The picture depicted was very unpleasant.

XX. WHISTLE-BLOWING: WHAT IT MEANS

The term "whistleblower" is apparently derived from the act of English bobbies (policemen) blowing their whistles, upon becoming aware of

[1]*SeeState of M.P.* v. *Ram Singh* (2000) 5 SCC 88 "unless nipped in the bud at the earliest, it is likely to cause turbulence shaking the socio-economic political system, in an otherwise healthy, wealthy, effective and vibrant society."

[2]Nani A Palkhivala, *WE THE PEOPLE*(2003).

[3]*Association for Democratic Reforms* v. *Union of India*(2002) 5 SCC 294 ¶52.

the commission of a crime, to alert the general public and other law enforcement officials within the zone of danger about the criminal act.[4].

The term "whistleblower" carries more positive connotations than other terms assigned to people engaged in similar activities. Whistleblowers disclose information concerning wrongful, illegal, or dangerous activities or behaviour. The Oxford Dictionary defines a whistleblower as a person who informs people in authority or public that the company they work for is doing something wrong or illegal.[5] The UK Committee on Standards in Public Life defines *it as raising a concern about malpractice within an organisation or through an independent structure associated with it*.[6]

Whistle-blowing for the purposes herein (that is in the private sector) may be defined as an attempt by an employee of a corporation or business firm to disclose what he or she believes to be wrongdoing in or by the organization. "Wrongdoing" can entail not only conduct or conditions that the employee believes are illegal, but also behaviour that the employee considers to be immoral, as well as conduct that the employee believes is contrary to the public interest.[7]

The elastic demand for a Whistle Blowers Act has not popped out of the sky out of the blue. However, the social edifice we are surrounded has felt the need for a legislation to protect the 'disclosers'. Corruption and fraud are as old as the mountains and Mahabharata. (Shakuni tricked the Pandavas

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[4]*Winters* v. *Houston Chronicle Publishing Co.,* 795 S.W.2d 723, 727 (1990) (Tex.)."Modern day analogies to the whistleblower include: a referee blowing the whistle to enforce the rules of the game; a police officer blowing the whistle to direct traffic; a lifeguard blowing the whistle to direct swimmers."

[5]A S Hornby, *OXFORD ADVANCED LEARNER'S DICTIONARY OF CURRENT ENGLISH*1476 (2000).

[6]*See*AbhinavChandrachud,*Protection for Whistle-Blowers: Analyzing the Need for Legislations in India* 6 SCC (J) 91(2004).

[7] Frank J. Cavico, *Private Sector Whistle-blowing And The Employment-At-Will Doctrine: A Comparative Legal, Ethical, And Pragmatic Analysis*, 45 S. Tex. L. Rev. 543, 548.

to take their juristic property (Kingdom) in a game of dice.) Indira Gandhi, had once conceded that corruption is omnipresent. The matrix only seeks to have openness in democracy for attempting to cure cancerous growth of corruptions by few rays of light. The desideratum is to advance societal and public interests at large in order to strengthen the nation as a whole for what it stands for and what it has stood for throughout history.

The next chapter would look into the relevant provisions in the global context wherein Whistle Blower enactments have been passed by the respective legislatures and what we can learn from them.

XXI. WHISTLEBLOWERS' LEGISLATION: IN THE INDIAN SCENARIO

Having seen the whistleblowers' legislations in countries aforementioned it does seem that the desiderata at the top of our priority list is a Whistleblowers Act. However, can this be enacted immediately?

At the outset it is essential to know the present regulatory scheme. The need for a whistleblower scheme was first mooted in the Narayan Murthy Committee on Corporate Governance. [8] The committee recommended the following mandatory recommendation:[9]

> "-- *Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors.*
>
> *--Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc.*
>
> *--The employment and other personnel policies of the company shall contain provisions protecting "whistle blowers" from unfair termination and other unfair prejudicial employment practices.*

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[8] N.R. Narayan Murthy, SEBI COMMITTEE ON CORPORATE GOVERNANCE(2003).
[9] *Id* at ¶3.11.

--Companies shall annually affirm that they have not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that they have provided protection to "whistle blowers" from unfair termination and other unfair or prejudicial employment practices.

-- The appointment, removal and terms of remuneration of the chief internal auditor must be subject to review by the Audit Committee.

--Such affirmation shall form a part of the Board report on Corporate Governance that is required to be prepared and submitted together with the annual report."

The recommendation to approach the audit committee has been taken from the Sarbanes Oxley Act which provides for the same provision. Under the Sarbanes Oxley Act, Section 301 requires publicly traded corporations to establish audit committees. These committees are required, in turn, to "establish procedures" for accepting employee complaints (both anonymously and non-anonymously) concerning "questionable accounting or auditing matters." Under the whistleblower provisions, internal reports to such committees constitute fully protected activity.[10]

In pursuance of these recommendations SEBI has inserted Whistleblower policy into the Clause 49 of the Listing Agreement. The recommendations given by the Narayan Murthy Committee have been accepted by SEBI and it has found form in Clause 49 of the Listing Agreement. Further, the last recommendation has been implemented in Clause 49(IVA)(iv) of the Listing Agreement. Thus it is mandatory for every company to see to it that these measures are effectively implemented.

How effective would this be? The audit committee may comprise of independent directors who may not have any material interest in the company, but still there are certain loop holes. The audit committees are not functioning as was expected by the SEBI. In a recent article titled Audit

[10]*See* 18 U.S.C. 1514A(a)(1).

Committee: Prescription v. Practice[11], the audit committee of very few companies review high exposed areas and review risk management. In short the functioning of these committees is not as desired. Though the audit committee comprises of independent directors, they might require the help of one or more executive director during the meeting to sort out a problem. In this way, the management even if at fault, can rectify its mistake or it can influence the directors to agree to its decision. Furthermore, it leads to a leakage of the identity of the whistleblower and as a consequence he could face discrimination at the work place.

Also, the future might witness a rage of whistle-blowing complaints; in such a scenario the audit committee may not be able to do justice to the whistle-blowing complaints because of their extensive base of operation. Thus, it would be better to open a new agency, preferably an external one.

XXII. WHAT IS THE COURSE OF ACTION?

In the USA, the reason why audit committee is found instead of external agency is because there self regulating organizations and self regulation has become the order of the day. In addition in the United States, self-regulatory organizations always have played major roles in the examination and licensing of brokers and dealers in the securities industry and maintenance of the securities markets.[12] At the same time, the U.S. financial services industries have enjoyed diminishing government oversight over the past several decades, as the economy has grown stronger. This trend toward less government interference and less funding for regulation seems likely to continue. The Indian scenario has not reached that stage. The regulation could be much better if the regulation is from outside. The best option would be to have the disclosure of information to an external agency. Regulatory dependence upon the industry, exposes the public to market-

[11] P Krishna Prasanna ,*Audit Committee Prescription v. Practice*, Vol. III ICFAI Journal of Corporate Governance No.3 July 2004, 21.

[12] James Fisher et al., *Privatizing Regulation: Whistle-blowing and Bounty Hunting In the Financial Services Industries*, 19 Dick. J. Int'l L. 117, 119.

driven regulatory standards rather than standards defined by consumer protection. Dependence also increases the risk that industry participants will be able to conceal improper behaviour and practices from the regulators. When added to the inherent complexity and intricacy of the industry, active concealment and the ability of the industry participants to influence rule making will further diminish effective regulation.

Thus, we can have a select group to monitor a committee set up outside the company which would consider whistle-blowing claims. The SEBI being the monitoring body could start a body like the Ombudsman which is governed by the SEBI (Ombudsman) Regulations 2003. SEBI can set up these so called whistle-blowing cells in each and every city. These cells could be given the task of looking into whistle-blowing complaints. This helps in maintaining the confidentiality of the person making the complaint. However every complaint cannot be taken up by the cell. The person making the complaint would state the reasons as to why he reasonably thinks that the company is being mismanaged or managed prejudicial to interest of shareholders or in violation of some rule or law. Upon consideration of the complaint, the cell would then conduct the investigations and find out if there is any of the cause for concern. The decision of the cell should be made appealable before the SEBI.

In the alternative, companies could have a supervisory board like in China. In the Chinese corporate structure, there are supervisory boards which are supervising agencies for companies. The same structure could be adopted wherein the supervisory boards would not be part of the board but would be independent agencies operating from outside.

XXIII. WHETHER THE LEGISLATION SHOULD BE ENACTED IMMEDIATELY?

The Indian matrix has adopted the American situation, without adopting the rationale behind the American situation. In America the whistleblower provisions could be provided because of other supplementary statutes present. This is true even for the UK, where there are various allied statutes without which the functioning of whistleblower act or the provisions

there under would be an outright joke. In UK, the Whistle-blowers Act uses the enforcement procedures of the labour rights legislation to protect whistleblowers who allege retaliation for protected disclosures. The enforcement structure relies on labour tribunals. The decisions of these bodies may be appealed to the Court of Appeal. Thus, the Whistle-blowers Act links these protections to general employment legislation. Similar legislation prohibits employers from dismissing employees for disloyal acts such as reporting health and safety violations by their employers. In India these supplementary structures or statutes are not well developed and hence the inefficacy of the same would be end up being detrimental to the whistleblower.

Also, as the Indian committees and regulators are following the American model it is important to understand that there are inherent contradictions in the US Model too. On one hand in the Sarbanes Oxley Act, disclosure by any employee is sought to be made to an internal authority (audit committee) while at the same time gatekeepers like lawyers are being asked to disclose their information to external agencies.[13] Now why this distinction?

XXIV. OTHER FACTORS TO BE CONSIDERED WHEN ENACTING THE STATUTE

The foremost requirement is to state the law in clear and categorical terms. There is an imminent need to differentiate between protected and prohibited disclosures. It is equally important to clearly establish the scope of the legislation i.e. to whom the statute applies – whether it confers protection only to the employees or even a general member of the public is also protected. If it includes only employees then in that case an exhaustive definition needs to be provided. Further, not only should violation of law be protected i.e. non compliance of legal requirements but also any act of unlawful or unethical conduct. This is evidenced even in the Narayana

[13] *See* Rules under S.305 of Sarbanes Oxley Act 2002.

Murthy Committee Report where it is recommended that the Whistleblowers can report even against unethical practices in the company.

There should be a mandatory requirement for the complaint to be made in good faith and with the "absence of malice" and "honesty of intention." In determining this, the intention of the employee making the report should be scrutinized. The case of *Dalhbergv. Lutheran Soc. Serv. of N.D.*,[14] has succinctly summarized this point as follows: *in order to determine whether a report of a violation or suspected violation of law is made in good faith, we must look not only at the content of the report, but also at the reporter's purpose in making the report.* The central question is whether the reports were made for the purpose of blowing the whistle, i.e., to expose an illegality. In part, the rationale for looking at the reporter's purpose at the time the report is made is to ensure that the report that is claimed to constitute whistle-blowing was in fact a report made for the purpose of exposing an illegality and not a vehicle, identified after the fact, to support a belated whistle-blowing claim.

Whistle-blowing should be twofold. Firstly, wherein the person voluntary comes out with a piece of information and secondly, wherein a person comes out with a particular type of information for certain incentives in exchange. Neville Russell, chartered accountants, carried out a survey in 1998 of U.K. businesses with a turnover in excess of £10,000,000. They asked the finance directors to assess how their companies responded to fraud, what choices they made and why they made them. The report raised some interesting questions. In particular, the important issues highlighted were how to balance the risk of fraud against the appropriate strength and cost of internal controls; how fraud, once detected, should be investigated and reported to minimise further damage. The survey revealed that 69 per cent of finance directors indicated that they had come across material fraud or irregularity within the last five years. Departmental managers and internal personnel were regarded as being in the front line making them the obvious target when things went wrong. Nearly 70 per cent of detected fraud was picked up by internal sources and 12 per cent were detected by chance. This

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[14] 625 N.W.2d 241 at 254.

highlights the possibility that a lot of fraud is going undetected. Only 4 per cent of those surveyed had formal whistle-blowing procedures; 54 per cent thought it would be a good idea.[15] From this we can identify that the employees might not be willing to come out with information which they have and which they know would affect the company. In order to get these bits of information in the bigger scheme of corporate governance it is essential that we have the incentive based whistle-blowing scheme too.

Further, whistle-blowing should also be made mandatory for few cross sections of people working in the corporate world. For lawyers and other professionals such as CAs and ACSs, any information they have about the company which they think would be prejudicial to the shareholders should be intimated by them to the concerned authorities.

The whistle-blowing statutes in other states are devised on the social and corporate culture prevalent there; application of the same principles here without keeping in mind our social and corporate culture would be totally uncalled for. The Indian corporate structure is on the verge of moulding into a world class structure and hence the measures have to be provided keeping this in mind.

XXV. CONCLUSION

Whistleblower legislation is indubitably of imminent need; however in the haste of enacting the legislation the basic objective of protecting the whistleblowers should not be forgotten. At this juncture where there is an international movement towards incorporating corporate governance norms and where each state is coming out with its own legislation for the protection of whistleblowers, the legislators should not lose focus of its primary purpose. We understand that an ideal global approach may not exist but still the legislators should consider the experiences of others before adopting or revising the protection given to whistleblowers in India. However, the

[15]Susan Maynem, *Whistle-blowing - Protection At Last,* 10(11) *I.C.C.L.R.* 325, 327 (1999).

approach of others should not be applied directly in our social and corporate edifice and should be enacted in light of the matrix we are circumscribed by.

The desideratum is to enact a statute for protecting the whistleblowers but the prerequisites have to be kept in mind. It is about time that we enact the statute but the same should be done after analyzing the various pros and cons of the proposals presented above.

WHISTLE BLOWERS PROTECTION ACT, 2011: DOES IT TRULY PROTECT THE UNSUNG HEROES?

AYUSHI SINGHAL

Corruption is a huge impediment in the quest for transparency and accountability. However, the freedom of speech and expression strengthened by the right to information[1] *(hereinafter "RTI") provides an efficient mechanism to combat this corruption. In furtherance of the same, RTI asks for pro-active disclosure in order to make the citizens aware of all public transactions "in all its bearings",*[2] *which however is seldom practiced.*

As a deduction, there develops a need of disclosing information via means like 'whistle-blowing'. However, history is witness to the fact that once the whistle is blown, the blower is the persona non grata for most of his life time. Thus, provision of adequate safeguards to these trailblazers becomes a prerogative.[3] *In accordance to the same, the Whistle Blowers Protection Act, 2011 (Hereinafter "the act") has been finally given presidential assent. This essay in evaluating the efficiency of the act discusses whether this act provides realistic safeguards to the patriotic and brave whistle-blowers or is just symbolic politics.*

CONTENTS

I. *Introduction*

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[1] This Right to Information is also protected by the Universal Declaration of Human Rights, 1948, Art. 19 (2) of the Covenant on Civil and Political Rights and Art. 10 of the European Convention on Human Rights and Fundamental Freedoms subject to certain restrictions.

[2] State of UP v. Raj Narain&Ors., A.I.R. 1975 S.C. 865 (India); *See also*DR. JN BAROWALIA, COMMENTARY ON THE RTI ACT 177 (2006).

[3] The Whistle Blowers Protection Act, 2011, [Statement of Objects] (The idea of the Act dates back to a letter by Shri N. Vittal, former Chief Vigilance Commissioner to make a law to encourage honest persons to reveal corrupt practices); *See generally*DR. RK VERMA, RIGHT TO INFORMATION LAW AND PRACTICE, 1.228 (2006); PK DAS, HANDBOOK ON THE RIGHT TO INFORMATION ACT, 2005 12 (2005) (PK Das writes that the disclosure of certain type of information beneficial to public at large strengthens the "Rule of Law" and the "Public Information" aspects of whistle blowing).

II. *The Act – A True lifeline?*

III. *Conclusion*

I. INTRODUCTION

Protection for whistleblowers is one of the nine primary principles of any Freedom of Information Law across the world.[4] The task to implement the same in India was initiated by the Santhanam Committee in 1963 and reiterated by the Vohra Committee, the Law Commission[5] and the Second Administrative Reform Commission's report. These efforts came up keeping in spirit with the fact that the breach of the public trust, by virtue of which the public officials hold office, should not be brushed under the carpet, but should be dealt with according to the rule of law.[6] The people who espouse the same, shall be provided protection.

While many analysts doubt the very efficiency of such legislations across the world[7], others term it as a mere copy of the acts of other

[4]SUDHIRNAIB, THE RIGHT TO INFORMATION ACT 14 (2011); *See generally*TOBY MENDEL, FREEDOM OF INFORMATION: A COMPARATIVE LEGAL SURVEY 31-40 (2008); *See also*RODNEY D RYDER, RIGHT TO INFORMATION LAW-POLICY-PRACTICE 325 (2006) citing the Basic Principles of Freedom of Information Legislation developed by Article 19 (Global Campaign for free Expression) International Standard Series.

[5]The Law Commission of India, 179th Report on The Public Interest Disclosure and Protection of Informers, December 2001 (mentioned the necessity of a law for the whistleblowers. The Public Interest Disclosure and Protection of Informers Bill, 2002 was a result of its efforts); See also, PK DAS, HANDBOOK ON THE RIGHT TO INFORMATION ACT, 2005 10 (2005).

[6]VineetNarain v. Union of India, (1998) 1 S.C.C. 226 (India).

[7] Brian Martin, *Illusions of whistleblower protection*, 5 UTS Law Review 119-130 (2003); *See also*, Bruce D. Fisher, *The Whistleblower Protection Act Of 1989: A False Hope For Whistleblowers*, 43 Rutgers L. Rev. 355 (1990-1991).

countries[8], without any adaptation according to the Indian socio-economic condition.[9] However now that the bill has been passed, many questions regarding its capacity to protect arise. This essay will analyze the Act in the light of its preliminary objective of providing protection to whistle blowers, such protection, which they cannot ensure for themselves on their own. The essay is limited to the flaws which hamper the safety of the whistle blower, which are discussed in part II; even though there are considerable loopholes[10]

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[8] England (Public Interest Disclosure Act, 1998 based on the two reports of Nolan committee on "Standards of Public Life"), USA (Whistle blowers' Protection Act, 1989), Australia (the Australian Public Interest Disclosure Act, 1994) and New Zealand (the New Zealand Protected Disclosures Act, 2000).

[9]MeghaChandhiok, *Whistleblower Protection Bill in India: Who pays for it Anyway?*, 3 (1) International Journal of Management Excellence (April 2014).

[10] 1. The Act fails to cover complaints made against the High Court and Supreme Court Judges, despite of the judgments like that of Indirect Tax Practitioners' Assn. v. RK Jain, (2010) 8 SCC 281, where the SC accepted that a whistleblower can report to the media. For internal whistleblowers, it was of the view that the fellow employee should be reported to the superior in the company. In the case, the arbitrary behavior in the appointment of officials of CESTAT was disclosed in the respondent's law journal. It was held that the power of contempt cannot be used to silence criticism, (removing such conduct from the purview of the Contempt of Courts Act).

2. Lack of provision of penalties in case of victimization.

3. Non- admission of anonymous complaints. (UK, Canada and Australia have provisions to investigate anonymous complaints. *See generally*, S. N. P. N. Sinha, Drafting and Implementing Whistleblower Protection Laws 139, Available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN020662.pdf, (Last visited on July 25, 2014).

4. Lack of penalties for officials who victimize the whistleblower.

5. The high penalty imposed for frivolous or mala fide complaints, mala fide being very subjective. Take an example where there are redundancy removals in a Public Sector Unit. An employee in order to circumvent the removal process, discloses an irregularity, which he would not have disclosed in the ordinary course. It would be difficult to justify the removal of the complainant in this case. Will this be a mala fide complaint?

in the other provisions too. It is pertinent to note, that a majority of these loopholes are not only detrimental to the safety of these unsung heroes, but also to the investigation of the disclosure as a whole. Part III of the essay provides a summary of these escapes in the Act.

II. THE ACT- A TRUE LIFELINE?

The Act is well drafted in so much as it provides an appeal mechanism, provision of interim orders, shift in the burden of proof in case of a complaint of victimization etc. Yet there remain dodges including;

A. Non-existence of 'one' independent body

According to the present provisions of the act, there are different competent authorities for different public officials and authorities (for e.g., CM for the member of Council of Ministers).[11]This means that depending on the post of the person being complained against, different competent authority has to be approached. This is in variation to the interim provision of the Chief Vigilance Commission ("CVC") working as an independent body for all matters (although it covered lesser authorities). This multiplicity of competent authorities is the Achilles heel and might act as a mockery to the efforts of the whistleblowers. To understand how this argument unfolds, one needs to understand the characteristics of corruption in India.

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6. Although it provides for disclosure notwithstanding the provisions of the Official Secrets Act, yet there has been an exclusion of information affecting the security of the state, etc. The Parliamentary proceedings are also outside the purview of disclosure. There is no clarification as to the requirement of this exception, even when it is being disclosed to a competent authority. (*See generally*, DR. JN BAROWALIA, COMMENTARY ON THE RTI ACT 177 (2006)).

[11]§3(b), The Whistle Blowers Protection Act, 2011).

Mehbub-ul-Haq writes that a peculiar characteristic of corruption in India is that it occurs upstream instead of downstream[12], i.e. the decisions at the top affect the lower rungs in a considerable manner. It is contagious and if not controlled, "*spreads like a fire in a jungle … Unless nipped in the bud at the earliest.*"[13] More particularly, it is not the 'wonder' of one, but the art of many. The people involved generally have a silent understanding between them, which is the very reason of it prevailing over all efforts.[14] Considering this characteristic, it is difficult to catch the mastermind, even if some of the acting members in the scheme are caught. Conclusively, it means that the people at the lower levels in the chain are affected by the corrupt policies of the people at the upper level of the chain. The people at the top levels are more or less equally corrupt as the people at the bottom of the chain.

The present provisions of the Act in so much as they provide different competent authorities to complain about officials and members of the executive or the legislature, hamper the protection of the whistleblowers. Taking into note the above characteristic of the corruption persistent in India, there remain chances that the competent authority to whom complaint needs to be made, may already know about the corruption going on and might be acquiescing to it silently. The possibility of the 'political' competent authorities exercising the power under the act, also being the perpetrators of the crime in question can also not be denied. In case, the competent authority is involved, it can result in efforts to tamper with the documents which indict their fellow party members. The big fish, unless they belong to the opposition, will rarely fry. More particularly, there is a fear that the identity of the complainant be revealed in a manner that the victimization can be carried on, but can never be proven. Due to increased safeguards given to identity protection under the new Act, it will be difficult to prove that the reprisal is a result of the disclosure of the identity. The competent authority

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[12]JAGMOHAN, SOUL AND STRUCTURE OF GOVERNANCE IN INDIA 430, Note 69 (2005).
[13] State of MP v. Ram Singh, 2000 (5) S.C.C. 88 (India).
[14] Characteristics of corruption according to Laswell, *cited in*DR. MADABHUSHISHRIDHAR, RTI LAW AND PRACTICE 264 (2006).

can always prove the mandatory measures taken under the Act to protect the whistle blowers identity.

This information which is power, going in the hands of the wrong people, will lead to its misuse. They might use it to grind their own axe, leading to corruption within the investigation of corruption, a vicious circle. This will necessitate disclosures to external bodies like media, the disclosure via which is not protected under the act, making the legislation worth less.

The gruesome murder of SatyendraDubey who revealed the corruption in the Golden Quadrilateral Project Construction, is an example hitting the bull's eye. His letter to the Prime Minister is 'the' process he would have followed under the Act (provided we believe member of the Union Council of Ministers was involved in the case). His request for anonymity was however not heard, leading to his murder. It follows that in case Mr. Dubey would have revealed the records of corruption even after the legislation of the Act, he would have met the same fate, putting serious doubts on the legislation's strength and its ability to meet its objectives. Although it can be argued that Mr. Dubey's death was a result of a lack of formal mechanisms, and if the PM would have been formally designated to receive such complaints earlier, the identity wouldn't have leaked; yet the fact remains that such incidents are hard to avoid even in the present formal mechanism of the act. Both the cases involve(d) a request of anonymity, which might or might not be followed and in the latter case, its breach impossible to prove.

Consequentially, there arises a need of an independent body like CVC which might look over all disclosures. This will reduce the possibility of the above situation. Although this independence might come at the cost of ease in investigation, since the competent authorities designated under the present system have more information pertaining to the persons following under their jurisdiction, yet it should be a worthy deal, provided how the Indian system works. The Supreme Court also agrees to the idea of one nodal

agency, i.e. the CVC,[15] which is in accordance with the international best practice of a 'One stop shop';[16]i.e. one investigating body for all matters of corruption.

B. Other provisions

Ambiguities in an Act can be both, a shield to the dynamic nature of society and a dilution mechanism, depending on the interpretation given to the provision.[17]However, it is in interests of justice that in case clarity leads to better functioning, it be made. In the immediate context, the powers of the 'competent authority' need to be clarified. Under the present Act, the authority has a power to restore the status quo ante[18]of the whistleblower in case he/she is victimized in the forms of dismissal from job. However, whether the competent authority can order his/her transfer to a post of equal significance and rank in case of his/her victimization hasn't been mentioned in the Act. It is highly beneficial that this be expressly provided for in the Act to nip the bud of victimizing elements in case there are any.

Victimization hasn't been explained in the act, (which is good as the definition can be interpreted widely, yet some illustrative list here also can be beneficial, which can include victimization by the alleged corrupt or on their order) can take various forms.[19] Its possibility increases with the leak of identity of the complainant, which is easy under the present structure, as

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[15] TNN, *Raval: CVC must protect 'bravehearts'*, TIMES OF INDIA, Apr 13, 2004. Available at http://timesofindia.indiatimes.com/india/Raval-CVC-must-protect-bravehearts/articleshow/612920.cms.

[16] Paul Latimer &A J Brown, *Whistleblower Laws: International Best Practice*, 31 U.N.S.W.L.J. 766 2008;*See e.g.* Canada's Office of the Public Sector Integrity Commissioner.

[17]*See e.g.* The Basic Structure Doctrine of the Indian Constitutional Law.

[18]§11(4), The Whistle Blowers Protection Act, 2011(The power to restore status quo ante is not so beneficial in as much as the person might suffer emotional reprisals within the boundaries of the public authority).

[19]*See generally*AbhinavChandrachud, *Protection for whistleblowers: Analysing the need for legislation in India*, (2004) 6 S.C.C. J-9 (India).

explained earlier. In fact most of the times the boat of maladministration is not rocked[20] because of a fear of reprisals[21] like termination of employment[22] (equivalent to a ban on speech[23]) which is a serious sanction, making getting jobs elsewhere difficult[24]. Victimization may even extend to the family of the complainant, who is not protected under the Act. The risk of victimization becomes higher in case the investigation fails to prove the otherwise true complaint. In the light of this, there arises a need to specify the above power. This can of course be made subject to qualification, experience and a vacant equivalent post, akin to the US' and Australia's Acts.[25]

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[20]¶112, Nolan Committee Report *cited in*DR. MADABHUSHISHRIDHAR, RTI LAW AND PRACTICE 278 (2006).

[21]PK DAS, HANDBOOK ON THE RIGHT TO INFORMATION ACT, 2005 11 (2005).

[22]*See also*, International Labor Organization Convention 158 on Termination of Employment, Art.5(c) (says that disclosure cannot be a reason for dismissal); *See e.g.* Siberia treatment, the office's head secretary's contempt for the whistleblower manifesting itself by "forgetting" to put the whistleblower's name on the departmental monthly birthday cake, Job enlargement (giving more work than can be humanly done resulting in 'spread so thin'), technological advancement, removal for redundancy, the third party conduct, "Induce the whistleblower to commit a wrong and use this to blackmail the whistleblower into silence".

[23]Lingens v. Austria, 1986, 8 EHRR 407; *See also* Att. General v. Butterworth, 1963 (1), Q.B. 696 and Chapman v. Honing, 1963. 2. Q.B. 502. (cited in the 179th Law Commission report, the cases hold that a reprisal against a witness who has given evidence in legal proceedings may well amount to Contempt of Court)

[24] Vogt v. Germany, (1996) 21 EHRR 205. *See also*, Public Interest Disclosure Act, 1998 (UK) (protects reprisals from Co-workers and other employers who might refuse to give employment because of the employee's disclosure making tendencies).

[25]RODNEY D RYDER, RIGHT TO INFORMATION LAW-POLICY-PRACTICE 337 (2006)*c.f.* Martin H. Malin, *Protecting The Whistleblower From Retaliatory Discharge*, 16 U. Mich. J.L. Reform 277 1982-1983.

The Act also fails to address the protection of people who have exposed the facts to the media, [26] which becomes essential in some circumstances, as explained above. §5 (1)(b) in fact removes the requirement of concealing the identity[27] in case it has been disclosed to any other office or authority other than the competent. This can be construed to include approaching a wrong competent authority, say, the PM for a complaint against a public sector unit ("PSU") official; or approaching an authority which can help in tackling the situation within the PSU. It must be noticed that in these examples, even when the public or the alleged corrupt does not get to know the identity of the complainant; the competent authority is under no obligation to conceal it any further. Although this can be defended by presenting it as a method to force the complainant to obey the formal provisions of the Act and thus there arising no need for protecting informal disclosures; nevertheless, there remain situations where such disclosure would become inevitable.[28] Moreover the formal procedure is always not a viable option, especially the one provided by the Act in question.

The identity of the complainant further falls in crisis under §5(4). It mentions that in case the revelation of identity becomes necessary in order to further the inquiry, the same can be done with the prior permission of the complainant. In case the complainant refuses, the entire burden to provide 'all documentary evidence in support of' the complaint shifts to the complainant. As a consequence, the very objective of the act (mentioned

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[26] Virtually, only US protects the blowers to the media. In fact, it provides for three types of disclosures where protection can be granted, including the "wider disclosure" to the media and police.

[27]§5 (1)(b), The Whistle Blowers Protection Act, 2011.

[28]Art. 13, Principle 9, American Convention of Human Rights,
Available at http://www.cidh.oas.org/annualrep/99eng/Volume3e.htm (Last visited on September 12, 2014) "This would apply in situations where whistleblowers need protection from retaliation, where the problem is unlikely to be resolved through formal mechanisms, where there is an exceptionally serious reason for releasing the information…, a risk that evidence of wrongdoing will otherwise be concealed or destroyed."

earlier) becomes threatened in such a situation. The complainant is left with only two situations, either to disclose his/her identity or to gather all the material evidence by himself/herself, either of which ignores the very reason behind the legislation of such an Act, the protection of the whistleblowers and the expedient and unbiased investigation of the complaint of corruption.

Another shortcoming of the Act till recently was that it excluded private corporate entities from within its purview, despite Vohra Committee's finding that the root cause of corruption is the camaraderie among politicians, bureaucrats and industrialists.[29] The latest revelations about DLF, the coal scam and the 2C scam are all a testimony to this finding. This shortcoming however has been resolved to some extent [30] with the amendment to Clause 49 (II-F)[31] of the Equity Listing Agreement by SEBI (Securities and Exchange Board of India).[32] This clause is applicable to all companies which have their equity shares listed on a stock exchange recognized in the country. The clause mandates "the company [to] establish a vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's

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[29]Vohra Committee Report, 1993, Available at http://mahendra-agarwalonline.20m.com/PR_VohraCommitteeReport.htm (Last visited on October 20, 2014).

[30] Although the clause in the listing agreement provides for a mandatory mechanism to appreciate the requirement of whistle-blower's protection akin to the Act in question, yet it does not provide for the framework for it to be applicable. It has been left on the companies to design the same.

[31] It should be noticed that the clause is not an extension of the 2011 Act and is an independent provision under the Equity Listing Agreement for corporate entities.

[32]SEBI Circular No. CIR/CFD/POLICY CELL/2/2014, Available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1397734478112.pdf, with further amendments in SEBI Circular No. CIR/CFD/POLICY CELL/7/2014, Available at, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1410777212906.pdf (Last visited on October 20, 2014).

code of conduct or ethics policy" in confirmation with the best corporate governance practices in accordance with the new Companies Act, 2013.[33]

Although this is a laudable development, yet further reforms remain necessary in light of the limitations enumerated in the essay.

III. CONCLUSION

The robustness of any act is determined by its ability to stand in situations which are not normal to its applicability. The essay brings us to the conclusion that the statute under consideration is not infallible in its protection mechanism for the unsung heroes. The lack of an independent body for disclosure poses a serious threat to the health of the act. This is aggravated because of the risk to the identity of the complainant by virtue of §5(4) and §5 (1)(b) and the lack of clarity as to the ambit of the powers of the competent authority. Although the Act has been supplemented by the amendments in Clause 49 (II-F) of the Equity Listing Agreement by SEBI in as much as private corporate entities have also been brought within the ambit of the whistle-blower policy, a lot remains to be done to further the objectives of the Act. A former Special Counsel's advice to whistleblowers holds true in the present scenario, save the Act stands amended, "unless you're in a position to retire or are independently wealthy … Don't put your head up, because it will get blown off."[34]

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[33] P.V Shiju., *An Overview of the New Clause 49 of the Listing Agreement*, Available athttp://www.indialaw.in/overview-new-clause-49-listing-agreement/, (Last visited on October 20, 2014); *See also*http://www.sebi.gov.in/cms/sebi_data/attachdocs/1397734478112.pdf (Last visited on October 20, 2014).

[34]William O'Connor (Special Counsel) *cited in*Bruce D. Fisher, *The Whistleblower Protection Act Of 1989: A False Hope For Whistleblowers*, 43 Rutgers L. Rev. 355 1990-1991, Available at http://heinonline.org/HOL/Page?men_tab=srchresults&handle=hein.journals/rutlr43&id=426&size=2&collection=journals&terms=Off|off|blown|blown%20off&termtype=phrase&set_as_cursor (Last visited on September 12, 2014).

INTROSPECTION ON DIVERSITY IN BOARDROOM FROM GOVERNANCE PERSPECTIVE

DEBASIS PODDAR

A study of newly enacted statute on the company law in India and the first of its kind after the country took resort to the contentious economic agenda, liberalization-privatization-globalization, etc. the effort strives to decipher fault lines of the Companies Act, 2013 in general and of the boardroom under newer jurisprudence in particular with special reference to diversity. The author, with reasoning of his own, hereby advanced a set of argumentsto underscore simplistic solution sought for the not-so-simple economy and thereby identified few points for better statute in time ahead. Constructive in its essence, rather than demeaning otherwise jurisprudent craftsmanship of the Act, this effort is meant to facilitate the State accelerate its agenda and do away with populist politics from its efficient economics imperative to take a take-off toward globalization.

CONTENTS

I. *Introduction*
II. *From Bedroom to Boardroom: Her Ordeal Ahead*
III. *Diversity Jurisprudence: Much Ado About Nothing Global laws*
IV. *Marriage of Market Economic with Spatial Politics*
V. *Conclusion*

I. INTRODUCTION

Unlike earlier, while a(ny) Boardroom used to be filled in by hollow (wo)men stuffed by company promoters as body corporate under the Companies Act of 1956, a recent statute- the Companies Act of 2013 (hereinafter "Act")- introduced diversity in its top management forum-Board of Directors. The new legislative regime thereby strives to convert bored room of company as a doll's house of its promoters to *rostrum* as a democratic space meant for meeting of minds through dialogue among all representatives of divergent interests in technical sense of the term. Besides provision for independent directors, presence of at least one woman as a Director in Boardroom is provided for under Section 149 of the Act. Thus, for all listed companies and certain specified public companies,

inclusion of female independent Directors in their Boards stands as compulsory requirement to continue their entrepreneurship ahead.

Indeed there are other provisions as well to include concern for women, e.g. Section 135, read with Schedule VII, to take care of corporate social responsibility, Section 212 for investigation process into affairs of company by Serious Fraud Investigation Office, etc. These are but beneficial provisions either to distribute corporate justice or to save from the wrath of state intervention in cases of corporate injustice anyway. So far as empowerment is concerned, Section 149 deserves attention of readership and forthcoming effort is meant to explore subtle political economy of empowerment involved therein from diverse socio-legal perspectives.

Indeed diversity in Boardroom is seemingly a priority for the newly enacted statute, but,, whether and how far the same attained the object and purpose to offer democratic space from within the system is a moot point. For convenience of focus, the author hereby strives to explore a specific area of study- gender. Social inclusion, being a trendy approach since last few decades, is perceived as panacea to whatever disease there may be in given system of governance. The author advanced an argumentwith reasoning of his own that the same may not work in case of economic governancedriven by crude market force- the so called 'invisible hand'- as sensed by Adam Smith. Thus, accommodation of otherwise politically correct techniques of social inclusion may cost economically for corporate entities which are meant for economic development of its stakeholders. Inclusion of only one woman in Board of Directors may not serve either economics or politics.

II. FROM BEDROOM TO BOARDROOM: HER ORDEAL AHEAD

Since time immemorial, the way woman remains limited to her given *Lakshmanrekha*of private sphere left her away from public sphere in general and from power corridor in particular. For whatever the reason may be, without entering into gender polemics, workplace as a politicized public sphere is subject of domination and subordination, *inter alia* on the

basis of gender. With the passage of time, by initiative of the state, her access to power corridor emerged as part of a larger project, i.e. inclusive policymaking to facilitate justice- social economic and political- even otherwise declared basic features of the Constitution.[1]

After minute reading of the concerned legislative provision,[2] the readership is left with little clarity, if at all, about prudence behind the provision. Whether this is meant to increase economic efficiency or to decrease gendered character of the Boardroom, how far economics may walk hand-in-hand with politics, etc., together pose a series of moot points to this end. Such provision is *prima facie* meant for her empowerment rather than mere benefit as stakeholder of corporate world. The way the Bill was introduced by Shri Sachin Pilot in the floor of the House, it is clear that the economic efficiency cannot be the object.[3] In technical sense of the term, he mentioned such a provision as part of social inclusion, if not empowerment, of woman as one among vulnerable groups not represented in top hierarchy of the corporate world. Besides, his clear assurance is on record to extend the same to other vulnerable groups, e.g. backward classes, etc. In all counts, including the proceeding of relevant parliamentary debates, Section 149(1) resembles an instrument of woman empowerment and not concerned with economic efficiency of the Boardroom.

The cynic concern about intention of the Parliament (read Government) is on it's rise. The concern received voice through a question posed during question hour session where a woman member alleged- albeit under the (dis)guise of her parliamentary cloak- that the provision proves only to be a cosmetic step and the empowerment of

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[1]*KesavanandaBha*rati v. *State of Kerala* AIR 1973 SC 1461.

[2]Section 149(1), the Companies Act, 2013.

[3] Minister of State (independent charge) Ministry of Corporate Affairs, Shri Sachin Pilot's speech on the Companies Bill, 2012 (2013) in the *RajyaSabha* on August 8, 2013 (September 14, 2014), Available at http://www.youtube.com/watch?v=OwQCZLNWk6U.

women remains a distant dream as usual.[4] The reasoning behind her apprehension may be arranged thus: (i) one woman in a Boardroom of fifteen or beyond hardly matters as) decision is taken in terms of majority opinion; (ii) as per existing position of the statute, there is no additional weight on her opinion even if the matter is related to sexual harassment or similar matters which involves gender issues; (iii) despite an attempt by the State to create space, there is no capacity-building process for women in order to prepare them to handle cases of highhandedness, which their Boardroom colleagues may and do practisevis-a-vis business management, corporate governance, corporate social responsibility, and the like. Statistical database submitted by the Minister, which is otherwise correct, cannot thereby reflect upon women empowerment as such.

From another perspective, a concern raised by a member in the question-answer session exposed the poverty of prudence in given statutory position. The Companies Rules, 2014 makes the presence of at least one woman director mandatory only for listed company and public company with substantial annual paid-up share capital or turnover and thereby exclude others with a consequence that entrepreneurships with relatively smaller earning, which are more in number, possess no legal obligation to this end.[5] A point is thereby clear that even such allegedly cosmetic step is not pervasive enough to include woman as a member of Boardroom in every sundry entrepreneurship house. A derivative may not be too far to extend in favour of assumption that her inclusion may hardly matter in such elite powerhouse where she is most likely to be(come) part of the establishment and thereby devoid of her gender identity despite being a

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[4] RajyaSabhaunstarred question no. 332 answered on Monday, the 9th December, 2013, Representation of women executives in administrative positions of companies (September 7, 2014), Available at http://www.mca.gov.in/Ministry/pdf/Rajya_sabha_ques_W_2013_332.pdf.

[5] RajyaSabhaunstarred question no. 663 answered on Tuesday, the 15th July, 2014, Subject: Inclusion of women in Board of Directors of companies (September 7, 2014), Available at http://www.mca.gov.in/Ministry/pdf/RSQues663u_16072014.pdf.

woman by physical features. With its potential to accommodate women, patriarchy may well absorb such inclusion with marginal and thereby *de minimis* impact- if at all- upon its system of governance. Mere inclusion of individual woman cannot empower her fraternity.

Interestingly enough, except while raised during question hour session, the Ministry of Corporate Affairs otherwise conveys little concern to carry forward gender issues, e.g. effect of her participation after the enactment, monitoring empowerment through efficient participation on her part, and the like. For instance, in recent official circular, the Ministry offered clarifications on diverse issues of concern on Board of Directors while those related to woman director was set aside from such a document otherwise relevant to this end.[6] In post-enactment period, gender issues suffer from isolation- if not exclusion- as they did earlier. Under the (dis)guise of her empowerment, therefore, apprehension lies in likelihood of her presence being (ab)used in public sphere the way it happens in private sphere since time immemorial. Woman director reduced to ornamental identity sans efficacy before her male colleagues in Boardroom seems the game plan.

III. RPTs UNDER THE BYGONE REGIME

While this being the state of affairs in the affairs of state in general and of Indian Inc. in particular, the way the then Minister introduced the Companies Bill in *RajyaSabha*attracts attention on (juris)prudence in his policymaking. In course of his deliberation, Shri Pilot was accused of taking resort to semantics, which he indeed denied. But, whether to get rid of blunt resistance is a point apart, he indulged in a

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[6] Ministry of Corporate Affairs, General Circular No. 14/2014: Clarifications on Rules prescribed under the Companies Act, 2013- Matters relating to appointment and qualifications of directors and independent directors- reg. No. 1/22/2013-CL-V, dated 9th June, 2014 (September 13, 2014), Available at http://www.mca.gov.in/Ministry/pdf/ General_Circular_14_2014.pdf.

populist claim for inclusion of *dalit*, *adivasi*, etc. while briefing on inclusion of one woman director in Boardroom. This raises concern about his policymaking.[7] In the name of diversity in Boardroom, somehow the Minister thereby evoked a 'unity-in-diversity' sentiment which stands otiose for a(ny) company being a hardcore market-driven organization and run by hard-earned resources of its stakeholders. Despite economic organizations operating in public domain and thereby construed as "the State" under Article 12- read with Article 36- of the Constitution, these are meant for economic development of stakeholders and the same cannot reasonably be reduced to political organizations to the detriment of those who invested their hard-earned resources with profit motif for which a(ny) company is meant with endorsement of the State.

The way state demonstrates self-determination before the international community, as a juristic person with its shield as body corporate, company deserves right to self-determination before the national community. Subject to nuisance created by a state to gross detriment of international peace and security, International community cannot poke its nose within internal affairs of the state and thereby offend its sovereignty. Likewise, subject to nuisance created by a body corporate, national community cannot commit intervention within internal affairs of body corporate. With these arguments, a caveat is respectfully submitted to the Parliament for its appreciation that provision for diversity in Boardroom resembles provision on the part of UN Security Council for India to identify members of its Council of Ministers in the Central Government which stands anathema to national sovereignty. Within its domain, as juristic person, company does possess limited sovereignty which cannot be done away with unless and until there is reasoning with the concerned state for lifting its corporate veil. Indeed a welfare state by its Constitution, the State cannot usurp parental role for company while the same cannot take liability of its shareholders in case of any business failure for whatever reasons there may be. Thus, provision for intervention in composition of its Board of Directors stands as unwelcome

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[7] *Supra*, note 3.

provision despite enactment of the Bill into law of the land since it offends the heart and the soul of corporate jurisprudence. Also, after getting baptized into liberalization-privatization-globalization discourse, erstwhile parental state ought to get reduced to minimal state.

Indeed company jurisprudence may fall in deaf ears of empowerment lobby. Also, illustration of Norway seems on its way to demonstrate bright success story of quota for women in Boardroom- first country to introduce mandatory provision for women in Board of Directors which reached to forty percent (40%) as statutory requirement.[8] Before being carried away by Scandinavian precedent, a comparative database ought to be read to appreciate widespread gap vis-à-vis gender parity between two countries. Accordingly, as per current status report, Norway has already achieved gender parity in secondary education in 2008 while India is likely to achieve the same by 2015.[9]Without entering into merits of an encouraging wisdom, as spoke Mr. JaspalBindra,[10] this is hereby submitted that derivatives between two similarly situated target objects may facilitate arrive at a comparative study and the same is simply not the case here. Moreover, prevalent feudal culture and consequent character of the patriarchy here put South Asia in juxtaposition of liberal democratic political culture in Scandinavia. No wonder that Norway is not cited as best practice for India.

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[8]AagothStrovik and Mari Teigen, Women on Board: The Norwegian Experience, Friedrich Ebert Stiftung 3 (September 14, 2014), Available at http://library.fes.de/pdf-files/id/ipa/07309.pdf.

[9] Global Education Digest 2010, Comparing Education Statistics Across the World, UNESCO 22, TABLE 1 (September 14, 2014), Available at http://www.uis.unesco.org/Library/Documents/GED_2010_EN.pdf.

[10]"Once people see dollar and cent in the gender thrust, it will be much easier to promote women to top positions"- JaspalBindra, Member, Board of Directors, Standard Chartered PLC, Hong Kong, in Marie-Laurence Guy *et al* (ed.), Focus, Issue 9, Women on Boards: A Conservation with Male Directors 17 (September 14, 2014), Available at http://www.ifc.org/wps/wcm/connect/b51198804b07d3b2acabad77fcc2938e/Focus9_Women_on_Boards.pdf?MOD=AJPERES.

IV. GLOBAL LAWS

During parliamentary debates, to neutralize adverse impact of electoral politics and get the Companies Bill passed in the House, the then party in power was left with no other option but to allow interpolation of few populist ingredients in proposed draft and woman director thereby took entry in the corporate Boardroom while others, e.g. *dalit*, *adivasi*, etc., were promised by the Minister that entrepreneurs be encouraged to include them as well.[11] Indeed a western educated management expert like Pilot cannot be expected to believe in such queer ideological grandeur of social inclusion in hardcore business house. Perhaps, out of circumstantial compulsion, he synthesizedeconomic reform with Norwegian practice for an experiment which- at the same time- was instrumental to defuse dogmatic resistance from ideologues.

In principle, diversity in Boardroom is welcome to add value for its thought process. More there is diverse representation, e.g. religion, race, caste, sex, place of birth, etc. better there is likelihood of prudent policymaking. The *quota raj* in last six decades, albeit arguably, contributed to compromise with quality- as apprehended in the floor of the Constituent Assembly as well- and public administration paid heavy price through decline in its efficiency. Entrepreneurship being run by private administration, identity politics ought not to repeat the same until people with diverse background, e.g. religion, race, caste, sex, place of birth, etc. enter into Boardroom by default and not out of their politically correct identity card. Anyway Article 15 of the Constitutionis meant to facilitate inclusion while Article 16 limits the same to public employment. While inclusion is limited to public employment in express terms, a cardinal principle from interpretation of statutes suggests that the legislature (Constituent Assembly) intends not to apply the same elsewhere.

Thus marriage of market economics with spatial politics seems potentially voidable until woman director proves herself fitting into

[11] *Supra*, note 3.

Boardroom by default through quality of participation, leadership, and the like, rather than occupying her space- by courtesy- proviso to Section 149(1) of the Companies Act, 2013. The text of Norwegian law is written in context of her demonstrated strength to work with no less competence than her male counterpart even in top policymaking space like Boardroom. It is this background which validates marriage of market economics with spatial politics. Likewise synergy of economics and politics shares no necessarily adverse impact. If statutory text is in consonance with its context, as it did happen in case of Norway, result ought to emerge positive. In case of India, statutory text for woman director falls severely short to correspond with the given social context where gender parity is yet to be achieved in case of secondary education. Without homework beforehand, Boardroom experience is bound to invite misadventure for her sisterhood fraternity. On other side of the coin, her misadventure at top policymaking space like Boardroom is bound to cost too dear to bear with for India Inc. as well.

Meanwhile a silver line appears in the corporate horizon to prepare her participation. A corporate entrepreneurship, perhaps first of its kind in South-Asian subcontinent, has initiated a series of workshops for potential women directors to facilitate them preparing Boardroom participation, developing leadership skill, handling issues and challenges they may and do grapple with in and out of corporate Boardroom in generaland as women director in particular.[12] From within the corporate world, statutory text initiated to contextualize itself- an encouraging development perhaps not anticipated even by Shri Baghel, M.P., who initially mooted the proposal.

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[12] The EY event news on WOMEN ON BOARD: BOARD READINESS WORKSHOP FOR WOMEN (September 14, 2014), Available at http://www.ey.com/IN/en/Issues/EY-board-readiness-for-women-workshop.

V. CONCLUSION

Without questioning inclusion of woman director in Boardroom in terms of its merit as part of a larger political project, named social inclusion, a concluding observation may be submitted for her preparation to prove such otherwise progressive provision worthy of economic development of the country. Besides initiative through workshop, etc., gender parity in a larger context seems imperative to bring in better relevance in favour of the statutory text for her inclusion. Formal education in general, and quality education in particular, is a need of the hour for her elevation as female counterpart in a top policymaking space like Boardroom. Rather than spatial politics, a similar suggestion may be offered for elevation of other marginalized groups, e.g. *dalits*, etc., to facilitate their participation in Boardroom without jeopardy to market economics so that the same may be acceptable proposition to shareholders whose hard-earned resource input runs the company as a locomotive for economic development of the country. Inclusion of *adivasis* in Boardroom seems rhetoric, as mooted by Shri Pilot, in course of his speech on the floor of RajyaSabha. An *adivasi* remains so since (s)he declines to join mainstream civilization. Inclusion of this person to Boardroom seems oxymoron and thereby suffers from acute fallacy. A moot point, indeed yet to be settled under law of the land, lies on the methodology- if any- of settlement while two fundamental rights are at loggerheads. Here the right to equality vis-à-vis status and opportunity of women under Article 14, read with Article 15(3), collides with right of promoters and shareholders vis-à-vis their freedom of occupation with special reference to choice of members for the Board of

Directors in company- a pure commercial establishment run by their own hard-earned resources with the legal status of 'body corporate'- under Article 19(1)(g) of the Constitution though the private entity operates in public domain. The Court will have to gapple with this situation under Article 141 of the Constitution, if a(ny) writ petition would be filed under Article 32/ Article 266 from promoters/shareholders. Last but not least, indeed these duly qualified women directors may bring in diversity in Boardroom. However, whether or how far such elite group represent their sisterhood fraternity in parochial patriarchal society poses a

moot point. Thus, even though the participation of woman director in Boardroom is perceived by emancipation movement as its victory, hard fact may prove otherwise. A creamy layer, as the group is identified in course of identity politics for Scheduled Caste and Scheduled Tribe, is scheduled to emerge out of such otherwise progressive movement with little loyalty for the movement which placed them high in power arrangement. Thus, very purpose of the movement to get women highly placed by statutory provision may get defeated out of their class character- a politically charged variable with the potential to topple such dicey chessboard upside down; yet so often than not ignored to gross detriment of the movement despite its voice heard in the Parliament.

RELATED PARTY TRANSACTIONS UNDER THE COMPANIES ACT 2013: TAKING A STEP FORWARD IN AN ADAPTING REGULATORY ENVIRONMENT

ENAKSHI JHA & SHANTANU DEY

Related Party Transactions (RPT) in the recent past have proven to be an instrument finding centrality in major corporate scams which has fuelled the debate surrounding the imposition of a stricter regulatory regime governing the corporate sector. Assuming primacy within the policy-making discourse, through this paper the authors examine the approach endorsed by the Indian Legislature towards such transactions under the Companies Act 2013. Beginning with a trace-back analysis, the paper begins with a critical analysis of the provisions governing RPTs under Companies Act 1956 exposing the countable apertures in the legal framework circumscribing its operation. Using such legislative flaws to justify the inception of the 2013 act reflecting an illiberal approach towards the employment of RPTs, the authors dissect the governing laws into the definitional, disclosure-centric, punitive and auditing dimension. However, recognizing the fallouts often governing such laudable legislative activism, the paper in its concluding section attempts to cull out the several inadequacies continuing to plague the RPT legal framework in the Indian Context. Utilizing the observations in the previous sections, the authors in the penultimate chapter have thrown light over the consequences of the gradually transforming regulatory framework governing Related Party Transactions on the different sectors of the economy namely- Automobile, Infrastructure and Financing. Thus, the scope of study of this paper seeks to further the argument that the regulatory provisions vis-à-vis RPTs under the Companies Act 2013 though exemplifying a marked change in the scheme of affairs suggests that there continues to be a long way to go.

CONTENTS

I. *Introduction: Juxtaposition of Related Party Transactions within the Idea of Effective Corporate Governance*

II. *Tracing the Statutory Origins of the Concept within the Contours of the Companies Act 1956*

III. *Companies Act 2013- Exemplifying a Marked Transformation in Approach*

IV. *Plugging The Leaks through an Illustrative and Comparative Analysis*

V. *Engaging in Consequential Analysis of RPT Regulations*

VI. *Conclusion: Paving Way Towards Efficacy in Corporate Governance*

I. INTRODUCTION: JUXTAPOSITION OF RELATED PARTY TRANSACTIONS WITHIN THE IDEA OF EFFECTIVE CORPORATE GOVERNANCE

Demonstrating cognizance to the fundamentality of legal instruments within the realm of corporate governance, the idea of Related Party Transactions has assumed prominence within the contemporary Indian Legislative Setup compelling an expansive discourse surrounding the same through this paper.

Sensitive to the advent of corporate frauds in the recent past involving major corporates such as Satyam, Enron and Tyco[1], the Indian Legislative Landscape has espoused for efficient and effective corporate governance. Such a state-initiated strategy pushing for the promotion integrity and reliability aims at generating greater sense of security amongst the primary stakeholders namely employees, shareholders, customers and banks.[2]

Within the ambit of such an expanding idea of corporate governance, the idea of a Related Party Transaction assumes prominence. A Related-Party Transaction ("RPT") as defined by the Ministry of Corporate Affairs is referred to as *a transfer of resources or obligations between related parties, regardless of*

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[1]PadminiSrinivisan, ANALYSIS OF RELATED PARTY TRANSACTIONS IN INDIA(June 24, 2014), which can be read at http://www.iimb.ernet.in/research/sites/default/files/WP%20No.%20402_0.pdf,.

[2] OECD, IMPROVING BUSINESS BEHAVIOUR: WHY NEED CORPORATE GOVERNANCE?(June 24, 2014), which can be read at http://www.oecd.org/daf/ca/corporategovernanceprinciples/improvingbusinessbehaviour whyweneedcorporategovernance.htm.

whether or not a price is charged.[3]The parties involved on the two sides of the deal could be a parent company and its subsidiaries or affiliates, the employees, the principal owners, the directors or the management of the company and the subsidiaries, or members of their immediate families.[4]

The pertinence of RPTs within the corporate governance discourse can be traced to its potential to subvert minority shareholder protection and on the other hand ability to exist as a value-enhancing instrument. Subsequently, through this paper, the authors have attempted to highlight the legislative approach adopted towards the idea of RPTs as a means to legislate upon the virtue of corporate governance under the Companies Act 1956 and 2013.

II. TRACING THE STATUTORY ORIGINS OF THE CONCEPT WITHIN THE CONTOURS OF THE COMPANIES ACT 1956

In this section, the authors have taken an objective approach in scrutinizing the operation of RPTs and tracing the law regulating the same under the 1956 Act. The critique of this Act has been presented below to advocate and welcome the much-needed changes envisaged in the Companies Act of 2013. The theme of Section 297 to Section 302 has been briefly discussed while culling out its drawbacks in entrenching transparency and leaving scope for sidestepping the law. The authors have further examined judgments that reiterate the same critique in justifying the need for a new and comprehensive set of laws.

Scrutinizing the Companies Act of 1956 unravels the fallacies and gaping holes in the Legislature, which the New Companies Act has attempted to sew together. The first instance of such fallacies is reflected in Section 297 of the 1956 Companies Act, which mandates the Board's approval before entering into any transaction with a related party. However such transactions

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[3] Ministry of Corporate Affairs, ACCOUNTING STANDARD 18: RELATED PARTY DISCLOSURES274-275 (June 25, 2014), Which can be read at http://www.mca.gov.in/Ministry/notification/pdf/AS_18.pdf.

[4]PADMINI, *Supra* n. 2, at 5.

were limited in number and the section only included transactions pertaining to restricted areas such as sale/purchase of goods.[5]

Further, Companies needed the Central Government's approval when the capital paid was more than Rs. 1 crore, which was subject to the exceptions provided for under Section 297(2).While this mechanism was designed to maintain a Governmental scrutiny over the fundamental intentions of contracts to ensure the Companies' best interest, it did not serve its logical purpose as it covered only contracts between private parties and did not apply to public companies.[6]

This criticism of Section 297 has been elucidated by the Company Law Board in its decision in *YashovardhanSaboo v Groz-BeckertSaboo Ltd*[7], where the inter relation between Section 297, 299 and 300 was established while recognizing its inapplicability to contracts between public companies, thereby reducing vigilance on such RPTs. This criticism of the 1956 Act is vital as often public companies do not serve a public interest and are merely family controlled.[8]

Section 299 of the 1956 Act imposes a duty on Directors to disclose any personal interests while entering a contract with related parties in the form of a "general notice" and Section 300 demands that such Directors

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[5]A. RAMAIYA, GUIDE TO THE COMPANIES ACT: PART 2, 2968-2969, (16th ed., 2005)

[6]Anil Khicha, AUDIT AND ASSURANCE: RELATED PARTY TRANSACTIONS(August 21, 2014), Which can be read at http://www.manupatrafast.com/articles/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch=Subject:%20Corporate.

[7]1995 83 CompCase 371 CLB.

[8]The family members usually own a substantial stake wielding overwhelming influence over such enterprises, *See* DR. SWAMI PARTHASARATHY, CORPORATE GOVERNANCE: PRINCIPLES, MECHANISM AND PRACTICE, 31-32, (2006).

abstain from voting on the contract in question however, the enactment of such laws is relaxed.[9]

The relaxed approach endorsed by Section 299 inhibits the disclosure of greater details regarding the nature of the Director's pecuniary interests and the limited language of the section provides for loopholes that exempt many transactions in situations where the Director owns less than two percent of the shares of the related party (other party).[10] This was noted in *Naini Oxygen & Acetylene Gas Ltd. v. Bisheshwar Nat* [11], when the Court held that such non-disclosure would not make the contract void, thereby reiterating the voluntary nature of the director's disclosure of his pecuniary interest.

Furthermore, Section 300 reflects similar shortcomings as in Section 299 and a violation of these two sections amounts to a meager penalty of Rs. 50, 000. [12] This paucity represented by the non-default statutory characterization of these transactions and a pitiful penalization renders this section to be merely formalistic in nature devoid of any considerable retributive effect.[13]

In light of the several loopholes plaguing the corporate governance structure instituted through the 1956 Act, the emergence of Companies Act 2013 into the scheme of affairs assumed inevitability providing a welcome change in approach discussed in the subsequent chapter.

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[9] PK PADHI, LEGAL ASPECTS OF BUSINESS, 527-528, (2012); *Also see* DH Law Associates, RELATED PARTY TRANSACTIONS: THE LEGAL FRAMEWORK IN INDIA, (August 9, 2014), Which can be read at http://www.dhlawassociates.com/assets/newsletters/2013/ january-2013.html.

[10] H.K. SAHARAY, COMPANY LAW, 308-309, (5th ed. 2008).

[11] (1986) 60 Com Cases 990 (All).

[12] Ami Galani and Nathan Renn, *Related Party Transactions: Empowering Boards and Minority Shareholders and to Prevent Abuses*, National Law School of India Review, Volume 22(2), 36-37, (2010).

[13] Ministry of Corporate Affairs, REPORT OF THE EXPERT COMMITTEE ON COMPANY LAW(August 10, 2014) http://www.mca.gov.in/MinistryV2_hn/chapter5.html.

III. COMPANIES ACT 2013- EXEMPLIFYING A MARKED TRANSFORMATION IN APPROACH

Cognizant of the urgent need to revolutionize the statutory framework governing the functioning of the Indian Corporate Sector witness to several scandals such as the Satyam Scandal and companies like Usha Rectifier, Bindal Agro ignoring investor protection, the Companies Act 2013 has proved to be a landmark effort in the right direction. Corporate Governance Reforms sought to be one of the pillars of this legislative milestone has been subjected to constant critical analysis compelling the authors to discuss the changes brought about within the realm of RPTs in a critical light in this section.

The ambit of RPTs as a concept has been covered under Sections 2(49), 2(76), 2(77), 134, 177, 184, 188 and 189 of the Companies Act 2013 of which all have been notified till date[14]read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014.Primarily espousing for principles of self-regulation, e-governance and investigative and penalising provisions, the approach towards the phenomenon of RPT has been progressive and sought to idealize the twin concepts of Transparency and Compliance.

A. *Definitional Analysis*

Firstly, the definition of "related party" has been provided under Section 2(76) covering directors and key managerial personnel relating to the company concerned[15] additionally specifying the 2 percent paid-up share capital criteria for public companies. Furthermore, the inclusion of a holding, subsidiary or an associate company of such company and a subsidiary of a holding company to which it is also a subsidiary has contributed towards the

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[14] Ministry of Corporate Affairs, TABLE CONTAINING PROVISIONS OF COMPANIES ACT 2013 NOTIFIED UP TO DATE, (June 28, 2014), Which can be read at http://www.mca.gov.in/Ministry/pdf/ProvisionsTable_CompAct.pdf.

[15] Section 2(76), Companies Act 2013.

complexity of the RPT legal regime potentially impacting transactions between group companies.[16]

The sub-section however excludes advice/recommendations in a professional capacity thereby making a distinction from the nature of advice given in a managerial capacity which renders it an element of authoritative influence.[17]The legislative construction vis-à-vis the related party definitional clause exemplifies the move towards legal determinacy in the realm of corporate governance sought to be achieved yet preventing an aggressive move towards laying down the boundaries to the idea of a related party.

The conception of Related Party as envisaged by the new act is reflective of one of the fundamental principles of corporate governance revolving around "Board Responsibilities". The principle recognized by the Organization for Economic Co-operation and Development ("OECD") places responsibility upon the board comprising of the directors as the decision-making body for monitoring effectiveness of governance and smoothening process of disclosure and communication.[18]

The definition provides a marked improvement from the state of affairs under the 1956 Act which failed to incorporate this crucial element disabling the legislative instrument from effectuating an appreciable degree of restraint on the abuse of RPTs. Conclusively, by doing so it illustrates an elemental perspective of corporate governance identified as, "Controlling Authority" effectively bringing out the shareholder perspective ensuring

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[16] OECD, IMPROVING CORPORATE GOVERNANCE IN INDIA: RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER PROTECTION, 20-21, (OECD PUBLISHING, 2014).

[17] PricewaterhouseCoopers, MANAGING NEW REQUIREMENTS UNDER NEW COMPANIES ACT AND SEBI NORMS(June 27, 2014), Which can be read at http://www.pwc.in/en_IN/in/assets/pdfs/india-services/transfer-pricing/related-party-transactions-managing-new-requirements.pdf.

[18] VASUDHA JOSHI, CORPORATE GOVERNANCE: THE INDIAN SCENARIO, 10-11, (2004).

castigation of defaulting individuals complemented by statutorily backed accountability.[19]

Moving on to the definition of "relative" as specified under Section 2(77), guarding against excessive statutory constraints, the definition covers eight relations as opposed to fifteen in the draft rules.[20] Significantly improving upon the superfluous list of relatives specified under Schedule IA of Companies Act 1956 including even third generation of relatives, the new companies law seeking to make amends prevents inclusion of people criticized to be far and remote under the previous legislation.[21]

Lastly, Section 2(49) is yet another demonstration of legislative novation infused within the 2013 Act with the introduction of the concept of "interested director". The explanation of an interested is reflective of the ideology as conceptualized under the *Resource Dependence Theory of Corporate Governance* recognizing the criticality of the Board in resource maximization and preventing exploitation of any form of relation at the cost of the numerous stakeholders involved.[22]

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[19]*Id.*,at 58-59.

[20]It is necessary to later taken into account while dealing with disclosures of interest by directors, the legislature does not envisaged disclosure of relatives by directors. *See* Deloitte, A SERIES ON COMPANIES ACT 2013 3-4 (June 29, 2014), Which can be read at http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/D%20Prism/DPrism_Issue3_Related%20parties.pdf.

[21]KPMG, COMPANIES ACT 2013- RULES NOW NOTIFIED(June 28, 2014), Which can be read athttp://www.kpmg.com/IN/en/Documents/Companies-Act_Final-Rules-Notified.pdf.

[22]Madhu T. Rao, Carol V. Brown and William C. Perkins*, Host Country Resource Availability and Information System Control Mechanisms in Multinational Corporations: An Empirical Test of Resource Dependence Theory*, Journal of Management Information Systems, Volume 23, No. 4, 13-14, (Spring, 2007); The theory has been deemed to be instrumental in enabling focussing of power to controlling resource allocation as key to organizational survival and managing resource dependencies through tactics such as co-optation, reducing uncertainty in flow of resources involving crucial decision-making by the board. *See* TizianaCasciaro and Mikolaj Jan, POWER IMBALANCE AND INTER-ORGANIZATIONAL RELATIONS: RESOURCE

The Act as per the proviso to Section 188mandates approval by special resolution in case of RPTs of a specific nature as specified under Rule 15(3) of the Companies Board Meeting Rules 2014. Furthermore, the section prevents the interested director from such voting thereby guarding against the rule of majority and espousing the objectives of minority shareholder protection especially in light of the shareholder approval requirement via special resolution in such material RPTs.[23]

Such a statutory approach culling out the interests of the minority shareholders vis-à-vis RPT regulations can also be found in the German Law on groups of companies provides for the *disclosure of transactions between the company and its affiliated companies in an annual report that must be controlled and verified by an independent auditor and furthermore the controlling shareholders also owe duties of loyalty to the minority shareholders.*[24]Examining through an international lens, the Consob Regulation on RPTs forming a crucial element of the Italian Company Law Reform mandates procedures of two kinds to approve such transactions with the materiality forming the basis for the classification.[25]

B. Examining the Scope of RPT and Creating Exceptions

The nature of transactions requiring consent of the Board through a resolution at a meeting as mandated by Section 188 of Companies Act 2013

INDEPENDENCE THEORY: REVISITED 3-4 (June 21, 2014), Which can be read athttp://web.mit.edu/sloan/osg-seminar/f03_docs/RDRevisited.pdf.

[23] TAXMANN'S, COMPANIES ACT 2013 WITH RULES, 2.327-2.348, Volume 1, (2014)

[24] Joseph A. Mccahery and Erik Vermeulen, CORPORATE GOVERNANCE CRISES AND RELATED PARTY TRANSACTIONS: A POST-PARMALAT AGENDA237-238(June 28, 2014), Which can be read at

http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf.

[25] A general procedure applies to any RPT other than small transactions, while further requirements are to be followed when a RPT is material. *See* M. Bianchi, A. Ciavarella, L. Enriques, V. Novembre and R. Signoretti, REGULATION AND SELF-REGULATION OF RELATED PARTY TRANSACTIONS IN ITALY3-4 (July 31, 2014), Which can be read at:www.consob.it/documenti/quaderni/qdf75.pdf.

has been divided into seven categories thereby causing a significant departure from the disparaging and unorganized state of affairs under the 1956 Act. With Section 188 specifically dedicated towards the concept of RPTs clearly enunciating the kind of transactions, the scope for abuse of power and bypassing the legal regulations has significantly reduced.

The transactions requiring such consent range from sale/purchase of goods and materials, leasing of property and appointment of an agent to underwriting of the subscription of any securities or derivatives thereof, of the company.[26] Evidently, the legislative effort has been to broaden the scope of statutorily backed transparency and accountability measures vis-à-vis the impugned transactions with a related party.

The statutory move culls out the nodal position of corporate governance within the plethora of company-centric rules and regulations highlighting the ethical and moral dimensions[27] and justifying a move towards the stakeholder model of corporate governance.[28]

The legislative construction of the scope of RPTs and its treatment under Section 188 demonstrates similarity to the Hong Kong Approach as the Stock Exchange of the country, which terms such transactions as "connected transactions". The Listing Rule 14A of the Stock Exchange of Hong Kong defines such transactions and subsequently subjects the range of transactions to disclosure requirements and shareholder approval depending upon the volume the concerned transactions.[29]The Rule broadly defines the

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[26]Section 188, Companies Act 2013.

[27] Kevin T. Jackson, *Rethinking Economic Governance: A Naturalistic Cosmopolitan Jurisprudence*, Boston College International and Comparative Law Review, Volume 36 Issue 1, 102-103, (2014).

[28] Stakeholder Theory refers to, "A theory about how specific stakeholder groups should exercise oversight and control over management", *See* Joseph Heath and Wayne Norman, Stakeholder Theory, *Corporate Governance and Public Management: What can the history of state-run enterprises teach us in the post-Enron era?*, Journal of Business Ethics, Volume 53, 251-252, (2004).

[29] GALANI, *Supra* n. 13, at 43-44.

statutory conception of transaction thereby, exhibiting similarity to the expansive regulatory regime as propounded under the Companies Act 2013 involving RPTs as a fundamental element of corporate governance.

However, it is essential to recognize that the director still does not lose the ordinary right of an individual to enter into a contract with such related party and the prohibition under Section 188 operates only with respect to the contractual capacity of the company. The exception to such a proposition as laid down in *SM Ramakrishna v Bangalore Race Club*[30] has been when there is a direct conflict of interest between his duty as a director and interest as an individual.

The range of transactions encompassed by the scope of Section 188 is critical to the examination of the idea of RPTs as covered under this act as they throw light upon the legislative perception of such transactions in light of the absence of a specific definition. Improving upon its predecessor, the statutory provision delimiting the legal conception of RPTs includes property within its scope as well effectively including sale/purchase/lease of immoveable property, which was considered to be outside the scope of Section 297 under the 1956 Act.[31]

Furthermore, the 2013 Act taking into account the expansive list of RPTs under the impugned provision is a legislative experiment demonstrating the lessons learned from the past as Section 188(1)(f) makes an explicit mention with respect to a related party's appointment. The ambiguity vis-à-vis the mere use of the word "services" in the 1956 legislation created doubts regarding the inclusion of contracts of employment involving personal services within its ambit as expressed by authors such as A. Ramaiya thereby necessitating an express reference to such employment contracts via the use of the word, "appointments".[32]

In light of the statutory construction of Section 188 endorsing a stringent standard for controlling RPT-induced corporate crimes, it is

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[30] [1970] 40 Comp. Cas. 674 (Mys.)

[31] RAMAIYA, *Supra* n. 6, at 2968-2969.

[32] *Id.*, at 2970.

necessary to clarify that the new Companies Act includes transactions between two independent companies comprising of family relatives making a distinction from the manner in which RPTs have been defined under Accounting Standards-18 necessitating a need for bringing about a sense of semblance in the legislative approach.[33]

Drawing a comparative example, the Financial Reporting Standard 8 Related Party Disclosures in the UK deals with such commonality on a more non-familial level as it does not bring transactions between two entities involving common key management personnel within the ambit of RPTs endorsing a less stringent approach as in the case of the Accounting Standards 18 in India.[34]

Ultimately, Section 188 of the Companies Act 2013 creates an exception with respect to transactions on arm's length basis carried out in the ordinary course of business. The flexibility adduced to such creation of exception is evident from the employment of the phrase, "ordinary course of business" which hasn't been defined necessarily involving a case-by-case analysis infusing the essentiality of adjudicative mechanisms. Arms' length transactions have been defined as, "*a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest*"[35], which by its very nature requires a subjective assessment and consequently, the inclusion of a transaction within its definitional ambit involves consideration of various parameters[36] as the Act by itself does not provide the manner in which the "arm's length principles" would need to be applied.

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[33]TAXMANN. *Supra* n. 24, at 1.170.*Also See* Ministry of Corporate Affairs, ACCOUNTING STANDARD 18: RELATED PARTY DISCLOSURES272-274 (July 17, 2014), Which can be read at http://www.mca.gov.in/Ministry/notification/pdf/AS_18.pdf.

[34] DAVID KERSHAW, COMPANY LAW IN CONTEXT: TEXTS AND MATERIALS, 507-508, (2012)

[35]Section 188, Companies Act 2013.

[36]A. BULLEN, ARMS LENGTH TRANSACTION STRUCTURES, 43-44, (2010).

The concept of arm's length transactions also finds a place of centrality in the Indian tax legislation vis-à-vis taxation of cross-border transactions between associated enterprise enabling companies to utilize taxation principles to determine whether their transactions fall within the legally prescribed exception under Section 188.[37]

Therefore, the creation of exception and the subjectivity associated to its application has been a product of the past when the words of the Financial Accounting Standards No. 57 stating that- "*Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated*"[38] were reproduced in the 2000 Enron Financial Statement which witnessed a major corporate governance lapse in 2001.[39]

C. *Delving into the Essentiality of Disclosure*

The idea of self-disclosure has gained primacy within the scheme of affairs as has been mentioned before and will be adequately evidenced in this

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[37] Ernst and Young, INDIA'S NEW COMPANY LAW SEEKS TO INTRODUCE ARM'S LENGTH CONCEPT FOR RELATED PARTY TRANSACTIONS3-4, (June 28, 2014), Which can be read athttp://www.ey.com/Publication/vwLUAssets/TP_Alert_new_company_law_seeks_introduce_arm%E2%80%99slength_concept/$FILE/TP_Alert_new_company_law_seeks_introduce_arm%E2%80%99s_length_concept.pdf.

[38] FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS BOARD NO. 57: RELATED PARTY DISCLOSURES(July 1, 2014), Which can be read at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820909171&blobheader=application%2Fpdf&blobheadername2=ContentLength&blobheadername1=ContentDisposition&blobheadervalue2=145875&blobheadervalue1=filename%3Dfas57.pdf&blobcol=urldata&blobtable=MungoBlobs.

[39] THE SCANDAL INVOLVED THE USE OF RELATED-PARTY PARTNERSHIPS TO MANIPULATE ENRONS' EARNINGS. *SEE* NANCY B. RAPOPORT, JEFFREY D. VAN NIEL AND BALA G. DHARAN, ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER, 181-182, (2009)

chapter via emphasis upon Section 134, 184 and 189 of the Companies Act 2013 which seek to justify the argument.

Firstly, in pursuance to the provisions of Section 134(h), the company is statutorily obliged to disclose the particulars of contracts or arrangements with related parties referred to insub-section (1) of section 188 in the Board of Director's report.[40] It is interesting to note that such disclosure was not required under the 1956 Act, thereby reflective of a change in approach in contrast to the idea of "government approval" regime as enshrined under Section 295(1) of Companies Act 1956.[41]

Furthermore, as per section 184(1) every director is required to disclose his interest in other Companies, firms and also to disclose his shareholding above 2% in such company in form MBP-1. Such an approach is a reflection of the legislative cognizance of the tremendous potential of the efficacy of Institutional Self-Regulation as a concept within the corporate governance paradigm. The emergence of Corporate Self-Regulation as a code of conduct has largely been deemed to be inefficient however the statutory backing for such good governance practices renders effectiveness to the matter in hand.[42]The emphasis upon the director is similar to the approach followed in a number of common law countries such as Malaysia, Hong Kong and Singapore, which identify the director as a crucial entity in relation to such conflict of interest transactions.[43]

Such a statutory move has also been reflected in the Italian Company Legislative Framework which was plagued with the issue of possessing a lax

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[40]Section 134(h), Companies Act 2013.

[41] Deloitte, COMPLIANCE FOR RELATED PARTY TRANSACTIONS (July 1, 2014), Which can be read at http://www.deloitte.com/assets/Dcom- India/Local%20Assets/Documents/Thoughtware/2014/RPT_under_2013_Act_N_TP.pdf.

[42] Rhys Jenkins, *Self-Regulation in a Global Economy,* Technology, Business and Society Programme Paper Number 2, United Nations Research Institute for Social Development, 7-8, (April 2001).

[43]AimanNarima, *Responding to Concentrated Ownership- The Related-Party Transaction Provisions of Some Asian Countries*, Corporate Governance Law Review, Volume 3 No. 1, 73-74, (2007).

statutory policy regulating RPTs. Subsequently, the 2003 reform in the Italian company law regime has rendered primacy to the requirement of the director to disclose his/her interest in a company's transaction to the other board members thereby, endorsing such self-disclosure within the corporate governance paradigm.[44]

Section 184 makes the disclosure involving concern or interest in any company/companies or bodies' corporate firms, or other association of individuals including the shareholding and the disclosure of concern/interest in contract or arrangement as distinct requirements in contrast to the mere requirement of a general notice under the 1956 Act.[45]

While applauding the exemplification of such contended legislative proactivity in the corporate governance paradigm, the authors find the construction of Section 184(2) to be slightly problematic. Reading the impugned provision along with Section 2(76) reflects the considerable difference in the statutory conception of "related" with respect to a private limited company and a public limited company. The qualification of two-percent shareholding with respect to public limited companies measured against the absence of any such qualification vis-à-vis private limited companies renders validity to the problematic idea that a single shareholding by a director in another private limited company is covered by the ambit of related party.[46]

Trotting along the lines of such self-disclosure, Section 188(2) pushes forth the idea of imposition of stringent disclosure compliances involving RPTs requiring every contract or arrangement entered into under Section 188(1) to be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement.[47] Such a statutory requirement transcending beyond the inadequately objective

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[44]BIANCHI, *Supra* n. 26, at 5.

[45] TAXMANN, A COMPARATIVE STUDY OF COMPANIES ACT 1956 AND COMPANIES ACT 2013, 2.114-2.115, (2013).

[46]*Id.*

[47]Section 188(2), Companies Act 2013.

requirement of a mere disclosure is similar to the approach taken by the United States Corporation Law of the State of Delaware which requires a comprehensive disclosure of the director's interest and the transaction.[48]

The idea of full disclosure complemented by such self-disclosure is a reflection of the *Concession Theory* within the contours of the law-making process as the RPT Disclosure Requirements under Companies Act 2013 compel the enhancement of a sense of responsibility and the accountability towards the stakeholders. The Theory views existence and operation of company as a concession by state granting the corporate world to trade with limited liability necessitating development of a social conscience.[49]

Ultimately, Section 189 requiring details of RPTs to be filed with Registrar of Companies represents a marked distinction from its Companies Act 1956 counterpart under Section 301which exempted from entry in the register of contracts/arrangements involving director's interest not exceeding ₹ 1000. The Indian Legislature subscribing to the belief that law exists as a dynamic organism thereby demonstrating sensitivity to the abysmally low limit setup under the previous legislation increasing it to ₹ 5, 00,000 in this 2013 Act.[50]

Section 189 under Companies Act 2013 further requires that the register to be kept shall also be produced at the commencement of every annual general meeting of the company and shall remain open and accessible during the continuance of the meeting to any person having the right to attend the meeting which is a new unprecedented statutory obligation.[51]

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[48]GALANI, *Supra* n. 13, at 42.

[49] JANET DINE, THE GOVERNANCE OF CORPORTE GROUPS, 21-23, (Cambridge Publications, 2000ed.). *Also see* G. Mark, *The Personification of Business Corporation in American Law,* University of Chicago Law Review, 1441, (1987) discusses the link between the idea of corporate existence and state sponsorship.

[50]TAXMANN, *Supra* n. 24, at 2.121.

[51]*Id.*., at 2.121-2.122.

The opinions of academicians such as Jonathan Charkham and Anne Simpson find imminence in such legislative construction as they emphasise upon disclosure relating to the four P's- Performance, position, people and prospects for future performance.[52]The enforced self-regulation as is the evident theme of the disclosure requirements discussed under the new company law find place within the *Coase Theorem* which espouses for organization of firms and production at cheaper goods through internal contracting (as is the case here involving disclosure-centric regulatory functions).[53]

Therefore, the self-disclosure framework as established thus, engenders cooperation and provides greater depth within company culling out a hands-off approach free of bureaucratic barriers negating the adversities of outside regulation.

D. Auditing Committees assuming Centrality within the Legislative Discourse

The Companies Act 2013 prescribing audit committee approvals vis-à-vis related party transactions and any subsequent modifications demonstrates the numerous safeguards put in place involving the legislative clutches upon the practice of RPTs. Section 177 of the Act enunciating upon the statutory provisions regulating the functioning of audit committees culls out the monitoring function central to its existence as Section 177(4)(iv) establishes the role played by auditors with respect to RPTs.

The legally prescribed role marks a differentiated approach from the 1956 regime wherein the audit committee was statutorily mandated to review RPTs at periodic intervals under Section 292-A contributing towards the highly formalistic yet ineffective intervention.[54] Furthermore, the generic

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[52] VASUDHA, *Supra* n. 19, at 35.The theory has been discussed in much detail in-JONATHAN CHARKHAN AND ANNE SIMPSON, FAIR SHARES; THE FUTURE OF SHAREHOLDER POWER AND RESPONSIBILITY, (1999).

[53] JANET, *Supra* n. 50, at 131-132.*Also see* AYRES AND BRAITHWAITE, RESPONSIVE REGULATION, 101, (1995).

[54]JAYATI SARKAR, CORPORATE GOVERNANCE IN INDIA, 97-98, (2012).

reference to the auditor's responsibility to review such contentious transactions central to the corporate governance practices as legislated under Section 227(3)(d) of the 1956 Act reflected the gaping loopholes plaguing the efficacy of the legislation.[55]

A brief overview of the provisions of the Companies Act 2013 leads to a logical inference that within the changing scheme of affairs, the Audit Committee is now expected to approve all RPTs and furthermore, also any subsequent modification of transactions of the company with such related parties regardless of the value involved.[56]

The proactivity laying the foundation for the legislative agenda governing the inception of Companies Act 2013 vis-à-vis the value attributed to the contribution of auditing committees in monitoring the unscrupulous engagement in RPTs is a lesson learnt from the *Enron Scandal* which forms one of the biggest corporate frauds of the 21st Century. The scandal exposed the laxity of the audit committee in enabling Chief Financial Officer Andrew Fasto and other executives mislead them as well the board of directors' vis-à-vis high risk accounting practices.[57] The oblivious attitude of the audit committee to the admission of criminal offences by the senior management and the infrequent meetings concretized the impression that the monitoring authority had been a part of the process[58]

Therefore, the inclusion of penalties comprising of both monetary and imprisonment punitive mechanisms under Sections 147, 447 and 448 of the Companies Act 2013 with the specific legislative construction involving use of words such as, "fraud", "misstatement" and "willfully deceiving" traces its justification from such events culling out the need for such state-initiated legislative transformation.

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[55]*Id.*

[56] Section 177(4)(iv), Companies Act 2013.

[57] Paul M. Healy and Krishna Palepu, *The Fall of Enron,* Journal of Economic Perspectives , Volume 17, No. 2, 7-8, (2006).

[58]JOHN ARMOUR AND JOSEPH MCAHERY, AFTER ENRON, 3-4, (2008)

Such reliance upon the auditing committees as instruments of institutionalization of the system of checks and balances has also been reflected in the Australian Legislative Framework with its Auditing and Assurance Standards Board (AUASB) issuing the Auditing Standard ASA 550 (Related Parties).The focus of ASA 550 has been strikingly similar to the statutory approach to the auditor responsibilities vis-à-vis RPTs under the 2013 Act as it prescribes mandatory auditor responsibilities involving regulation and monitoring of RPTs via risk identification, risk assessment and responses to such assessed risks.[59]

Such statutory emphasis upon the unprecedented role played by auditing committees backed by adequate penalties for laxity in approach is also demonstrative of the normative approach of the New York Stock Exchange which attributes prominence to the idea of auditing committees for the purposes of reviewing RPTs.[60] Conclusively, endorsing a theoretical approach to such a legislative route placing importance on statutorily backed monitoring inducing accountability has culled out the utopian characterization of auditors as guardians of public interest in the realm of corporate governance.[61] The presence of auditors as a watchdog evidences the state-approval of such link drawn between public interests and monitoring authorities.

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[59] Auditing and Assurance Standards Board: Australian Government, EXPLANATORY STATEMENT ASA 550: RELATED PARTIES(August 3, 2014), Which can be read athttp://www.auasb.gov.au/admin/file/content102/c3/ES_ASA_550_27-10-09.pdf.

[60] GALANI, *Supra* n. 10, at 43.*Also See New York Stock Exchange Listed Company Manual* Section 314 which states that- "While the Exchange does not specify who should review related party transactions, the Exchange believes that the Audit Committee or another comparable body might be considered as an appropriate forum for this task. Following the review, the company should determine whether or not a particular relationship serves the best interest of the company and its shareholders and whether the relationship should be continued or eliminated."

[61]The role of auditors comes up in light of the growing realization that shareholders no longer form an effective governance mechanism specifically where guardianship of their own interests is the issue. *See* JANET, *Supra* n. 50, at. 30.

E. Enforcement via Sanctions

Concluding the discourse surrounding the critical analysis of the legislative changes as envisaged under the Companies Act 2013, the imposition of stricter penalties has been the concretization of the unprecedented stress upon the idea of regulating RPTs within the corporate governance paradigm. Section 188 of the act forms the central provision dealing with the punitive measures prescribed by the 2013 Act and represents a marked shift from the mere Rs. 50, 000 penalty provided for under the 1956 Act.

The penalizing provisions under the Act can be primarily divided into four categories namely-

(i) Voidability- As provided under Section 188(3), any contract or arrangement entered into by a director or any other employee, without obtaining the consent of the Board or approval by a special resolution in the general meeting under Section 188(1) and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board.

(ii) Disqualification- As a consequence of Section 164(1)(g), if any person has been convicted of the offence dealing with related party transactions at any time during the last preceding five years, he becomes ineligible to be appointed as director.

(iii) Indemnity- In cases when the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it[62] [Section 188(3)]

(iv) Recovery- Despite the mechanisms provided above, Section 188 provides an independent solution for the company and its

[62]Section 188(3), Companies Act 2013.

shareholders to proceed against the concerned parties in order to recover losses for entering into such unauthorized transactions[63]

(v) Penalty- Ultimately, Section 188 lays down punishments of the nature of fine of 25,000 – 5,00,000 and/or imprisonment for a term up to 1 year[64]

Reflecting upon the lessons learnt during the *Satyam Scandal* and creating a state-sanctioned deterrent force counteracting unethical corporate practices, the shift towards a stricter approach towards RPTs can be linked to a simulation of the Belgian Penal Framework.[65]

The need for stricter punishments is embedded within the call for effective enforcement thereby, moving beyond mere regulatory provisions as present in the Companies Act 1956 of India, Belgian Company Law warrants the prejudiced parties to turn over the file to the courts and that can lead to civil sanctions in the form of annulments of irregular transactions, the attribution of compensatory damages to the prejudiced company or other victims of wrongdoing, and/or the penal sentencing of wrongdoers in the form of fines or prison.[66] Such promotion of strictness inducing compliance within the corporate realm is an indicator of promotion of minority shareholder interests[67], which has been the underlying tone of the 2013 Act.

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[63]Section 188(4), Companies Act 2013.

[64]Section 188(5), Companies Act 2013.

[65] OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS (July 25, 2014), Which can be read athttp://www.oecd.org/daf/ca/50089215.pdf.

[66]*Id*, at 49-50.

[67]LeoraKlapper, Luc Laeven and Inessa Love, *Corporate governance provisions and firm ownership: Firm-level evidence from Eastern Europe*, Journal of International Money and Finance, Volume 25, 430-431,(2006). The controlling shareholders and their nexus with the board of directors can often adversely impact the minority shareholders in light of a mere conflict of interest necessitating the law to step in. *See* ALESSIO PACCES, RETHINKING CORPORATE GOVERNANCE: THE LAW AND ECONOMICS OF CONTROL POWERS, 272, (2013 ed.)

Furthermore, as envisaged by the proviso to Section 188, the financial penalty is common to the listed and unlisted company though such commonality is not present vis-à-vis imprisonment, which is specific to the listed companies.[68] The rationale governing such legislative distinction can be linked to the principles of corporate governance circumscribing the functioning of unlisted enterprises and the structural differences persisting between the listed and unlisted companies.

Commenting upon such contrast justifying the penal differentiation, unlisted enterprises are characteristically owned and controlled by single individuals and families, consequently contextualizing corporate governance in terms of establishment of transparent framework of company process adding to its value than concerning itself with the relationship between boards and external shareholders (as in listed companies).[69]

F. *Scrutinising the Subsequent Enforcement Circulars and Clarifications: Clearing the Air or Losing its Way?*

On the 17th of July 2014, the Ministry of Corporate Affairs issued clarifications to clear the air around the status of Related Party Transactions under the New Companies Act of 2013. The Circular dated No. 30/2014 attempted to draw light upon the second proviso of Section 188 (1) of the 2013 Act that prohibits any member who is a related party from voting in matters with respect to the contract or arrangement at hand for which a special resolution is being passed. This Circular clarifies that the term "related party" only meant that which is related to the contract or agreement in question (in whose furtherance a special resolution is being passed) and not to any other transaction[70]. Under Section 2 (76), a related party in the "context of an agreement or contract" has not been envisaged or defined

[68]TAXMANN, *Supra* n. 24, at 1.171.

[69] Deloitte, CORPORATE GOVERNANCE GUIDANCE FOR UNLISTED COMPANIES(July 26, 2014), Which can be read athttp://press.iod.com/2010/11/22/corporate-governance-guidance-for-unlisted-companies-launched-by-iod/.

[70]TAXMANN, *Supra* n. 24, at 3.119.

anywhere in the 2013 Act. The ambiguous language of the Circular and its inability to clarify the meaning of this term leaves scope for further interpretation. Big corporates are now free to interpret this term to mean interested parties, thereby diluting the purpose of this clarification and enabling shareholders who are not "related" parties, but have an interest in the contract or agreement in casting a vote to their share. This can be seen to be the dilution of the majority of minority Rule under Section 188 of the Companies Act 2013.

Any party, which forms a related party in the said transaction, is refrained from voting in the special resolution, leaving the decision making upon the shareholders who are not related parties. In case, a single shareholder forms a majority of this voting nexus, the future of the company is left solely in his hands, if this circular is to be honored. To escape this situation companies may now further dilute this majority for minority rule by contracting only with such related parties that have a limited shareholding in the company[71]. Further, ambiguity remains with regard to small companies whose directors and shareholders are often the same and also form the "related party" in transactions mentioned above. In light of their plight it is necessary for the MCA to relax this circular to protect smaller companies.

Further in attempting to clarify and covering the loopholes in the 2013 Act, Circular No. 30/2014 amended Clause v of Section 2 (76) replacing the word "and" with the word "or" thereby widening the spectrum of relatives that fall within the scope of related parties. While this circular is launched from an objective and ethical intention, it has made business in India cumbersome as any company which wishes to do business with another private company in which a director's relative is on the board will be considered a related party transaction and will necessarily need the approval of the Audit Company as mandated for in the New Act. [72] Further transactions which do not from the ordinary course of business and are not

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[71] TAXMANN, MASTER GUIDE TO COMPANIES ACT 2013 AND COMPANY RULES, 3.116, (2014).

[72] *Id.*, at 3.119.

being done on an arms-length basis will need the Board's Approval making matters take longer than they should have, thereby hindering business advancements and economic growth.[73]

IV. PLUGGING THE LEAKS THROUGH AN ILLUSTRATIVE AND COMPARATIVE ANALYSIS

While the Author's commend the Legislature's initiative in drafting the Companies Act, 2013 and the move towards modern corporate governance, it is imperative to note the loopholes and implementation challenges in the Act. At the very periphery of this section lies the stumbling block of some of the Rules of the New Act overriding the Sections of the Act. This is explicated in the instance of Section 185, which prohibits a company from giving a loan to its subsidiary if a Director of the parent company is interested in the subsidiary but the Rules allow for such loans to be granted, proving to be in contradiction[74] with the Act

Following these periphery challenges, the authors wish to elucidate upon the accompanying problem of excessive litigation. As per the 2013 Act, all related party transactions need to be passed by a majority (75%) from minority shareholders and this procedure has also been extended to decisions on royalty and mergers. However, multinational parent companies are interdicted from participating in this voting process, opening the gates for excessive litigation especially in the form of class action suits regarding jurisdiction, increased costs of compliance, complexity of regulations and disclosures and approvals required by the Act.[75]

Moving to the substantive challenges to the 2013 Act, it is crucial to recognize the absence of a differentiation between related parties and

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[73]*Id.*, at 3.120.

[74]TAXMANN, *Supra* n. 72, at 3.121.

[75] PricewaterhouseCoopers, RELATED PARTY TRANSACTIONS: NAVIGATING THROUGH CHALLENGES(September 2, 2014), Which can be read athttp://www.pwc.in/en_IN/in/assets/pdfs/india-services/transfer-pricing/related-party-transactions-navigating-through-challenges.pdf.

interested parties. This differentiation is crucial in the Indian Context as the New Act necessitates clearance of all special resolutions by shareholders and further prohibits related parties from participating in this voting process.[76]

Unfortunately, the law has not differentiated between interested and related parties, as not all related parties may be interested parties in the said transaction. This poses a serious challenge to Indian companies that are closely held or are smaller in size because in such scenarios the shareholders are mostly related parties too and are therefore abstained from voting by the new law.[77]

Analysing the much applauded reduction in the number of relatives in the comparing list, the Authors express their reservations as the shortened list is subject to pragmatic problems. The new Act has classified daughter's husband and stepfather as "relative" but has left daughter's son, sister's husband and brother's wife of this ambit.[78] Further, the continuation of brothers and sisters on the Board continues to pose a problem as this could lead to an evasion of responsibility by the Board and reduce accountability, as it is difficult to control such corporate relationships closely intertwined with personal limitations. The Act has turned a blind eye to the conception of financially dependent[79] relatives who have not been covered under the ambit of "relatives" with respect to related party transactions.

Sections 177 and 188 both mandate approval by the board and the audit committee leading us to a procedural question sprouting from which body would thereafter yield greater power, especially in the context of a disagreement between the two. Secondly, shareholder approval is necessary

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[76] OECD, GUIDE ON FIGHTING CORPORATE GOVERNANCE IN ABUSIVE RPTS IN ASIA(September 2, 2014), Which can be read athttp://www.pwc.in/en_IN/in/assets/pdfs/india-services/transfer-pricing/related-party-transactions-navigating-through-challenges.pdf.

[77] DELOITTE, *Supra* n. 42, at 7-8.

[78]TAXMANN, *Supra* n. 72, at 3.1222.

[79]SaiVenkateshwaran, COMPANIES ACT RULES 2013 NOW NOTIFIED (August 6, 2014), Which can be read athttp://www.kpmg.com/IN/en/Documents/Companies-Act_Final-Rules-Notified.pdf.

in transactions made by companies whose paid up share capital amounts to Rs.1 crore. This threshold is very low and has the potential of dangerously imposing elaborate procedural requirement on companies that lie at the margin of this threshold.[80]

In a nutshell, at the present point of time, it is appropriate to argue that the corporate governance structure envisaged under the Companies Act of 2013 symbolizes a small step in the right direction accompanied by its fair share of fallacies necessitating subsequent legislative dynamism.

V. ENGAGING IN A CONSEQUENTIAL ANALYSIS OF RPT REGULATIONS

The authors initiated the discourse surrounding RPTs in light of their characterization as a double-edged instrument thereby necessitating an inquiry into the manner in which legislations such as the Companies Act 2013 seeking to regulate such transactions impact the corporate affairs. The related party transaction regulatory paradigm has often assumed centrality as a legislative instrument to counter the conflict of interest hypothesis incentivizing acquisition of assets at inflated prices or disposal of company's assets at paltry rates exemplifying gross violation of shareholder rights.[81] Thus, the intended impact of pro-transparency legislations such as Companies Act 2013 restructuring the RPT regulatory environment is to ensure objectivity vis-à-vis the transactions engaged in by the company.[82]

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[80]DELOITTE, *Supra* n. 13.

[81] Elizabeth Gordon, Elaine Henry and Darius Palia, RELATED PARTY TRANSACTIONS: ASSOCIATIONS WITH CORPORATE GOVERNANCE AND FIRM VALUE, AFA 2006 Boston Meetings Paper2-3 (August 30, 2014), Which can be read at http://carecob.nd.edu/Workshops/04-05%20Workshops/Gordon.pdf.

[82]See *British Racing Drivers' Club v. Hextall Erskine & Co* [1997] 1 BCLC 182, where Carnwarth J discussed the rationale governing Section 320 of the UK Companies Act 1985, "The thinking behind the section is that if directors enter into substantial commercial transactions with one of their numbers, there is danger that their judgment may be distorted by conflicts of interest and loyalties, even in cases where there is no actual dishonesty. The section is

However, not all related party transactions in this industry are objectionable, thereby it is inevitable to scrutinise the efficient transaction hypothesis[83] which discusses the ability of related party transactions to fulfill the company's economic needs contributing towards shareholder interests. In such a situation, the impact of RPT regulations is more on the lines of a balancing act as it seeks to harmonise the objectives of corporate governance mechanisms with the legitimate economic objectives of the company.[84]

In the subsequent sub-sections, the authors moving on from such a generic examination of the effect of RPT laws and regulations on the corporate scheme of affairs engage in an illustrative examination of the manner in which the statutory treatment of such an elemental aspect of corporate governance has on industries namely- *Infrastructure, Financing and Automobile.*

A. Infrastructure Sector

The problematic aspect of infrastructure industry attributing primacy to RPT regulations arises from the concentration of ownership in a few hands referred to as promoters who are closely involved in the infrastructure projects. Such close involvement of promoters enjoying a bulk of the ownership along with the tendency of infrastructure projects to be carried out in a structural manner involving a group of companies performing different roles magnifies the potential for engaging in abusive RPTs.[85]

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designed to protect a company against such distortions. It enables members to provide a check."

[83]ELIZABETH, *Supra* n. 82, at 2.

[84] PratipKar, FIGHTING ABUSIVE RELATED PARTY TRANSACTIONS IN ASIA, ASIA ROUNDTABLE ON CORPORATE GOVERNANCE 3-4 (August 30, 2014), Which can be read at http://www.ifc.org/wps/wcm/connect/ec745f0048a7e74daaf7ef6060ad5911/46435512.pdf?MOD=AJPERES.

[85] Bernard Black, ReinierKraakman& Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, Stanford Law Review, Volume 52, 1731-1732, (2000).

Such innate ability of the infrastructure industry's functional aspect to breed the utilization of RPTs creates a theoretical foundation for stringent RPT regulations countering the ability of promoters as controlling shareholders to adversely affect the outside investors. The network of promoters operating in such a group-structure often creates barriers to transparency and thus, the RPT regulations impact the sector by urging companies in this sector to draft and execute internal RPT policies and subject themselves to third-party review involving an audit acting performing a gate-keeping function[86] as also mandated by Section 177(4) of the 2013 Act discussed before.

Another aspect of infrastructure projects and related party transactions lies in the pivotal role-played by "patient capital". Patient Capital is an alternative asset that is characterized by its long gestation period for capitalization and is a long-term investment commitment due to the long period taken by infrastructure projects. This is a flexible form of capital that takes into account the delays and hurdles faced in the infrastructure sector, lack of manpower and delays in attaining government licenses and permits to name a few.[87]

More importantly, this form of capital does not let the customer suffer and hence puts shareholders of infrastructure companies second to the proper completion of projects, ensuring customers are satisfied. On the other hand it remains appealing to investors both individual shareholders and private equity funds who aid infrastructure projects due to accountability. Hence patient capital investors may have a lower yield of financial returns vis-à-vis other forms of investment. In light of this investment, related party

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[86]The Scottish Government, Financial Partnerships Unit, Financial Directorate, BRIEFING NOTE 3: BENCHMARKING AND MARKET TESTING(August 29, 2014), Which can be read athttp://scotland.gov.uk/Resource/Doc/923/0054675.doc.

[87] V. Umakanth, *Corporate Governance in India's Infrastructure Sector: Issues and Perspectives,* 2-4,IDFC Law Reporter, 3rd Anniversary Issue, (2011).

transactions play a pivotal role due to the significance of maintaining a higher financial yield on the investor's initial commitment.[88]

In the context of shareholders who invest infrastructure companies, a strict RPT regime as the one intended by the Companies Act 2013 provides good news with the focus on auditing and protection of minority shareholder interests through disclosure and approval statutory mandates. The impact of such regulations acquires prominence in the infrastructure industry on the lines of ensuring transparency and allowing minority shareholders to monitor their patient capital over the long time duration limiting the scope of misuse between related parties in usurping this initial investment that shareholders bring to the table. In the case of a misuse of power, shareholders have much more to lose as they not only receive a fraction of their initial investment but also have to wait longer time duration due to the very nature of patient capital, making the impact of RPT laws even more crucial.[89]

However, the nature of infrastructure sector involving the need to control project risk and meeting time-based targets makes the RPT regulations in some cases a barrier than a facilitator incentivising evasion of an excessively stringent scheme.[90] The self-disclosure and shareholder-approval requirements as also endorsed by the Companies Act 2013 can often prove to be a lengthy process for an RPT to be executed and such a scheme could incentivise corporate crimes in order to attain timely completion of infrastructure projects. Hence, the authors contend that the infrastructure industry constitutes a base for the nation's economic foundation involving a broader social purpose impacted by the corporate governance regime the state espouses for and thus, the RPT regulations need to strike a balance between facilitating legitimate business interests

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[88]*Id.*, at 3.

[89] OECD, THE ROLE OF BANKS, EQUITY MARKETS AND INSTITUTIONAL INVESTORS IN LONG-TERM FINANCING FOR GROWTH AND DEVELOPMENT, Report for G20 Leaders, 5-6 (August 25, 2014), Which can be read at http://www.oecd.org/daf/fin/private-pensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf.

[90]UMAKANTH, *Supra* n. 88, at 8.

perpetuating larger interests of the public and promoting a transparent process in an inherently close-functioning industry.[91]

B. Financing Sector

Financial companies are often considered to be analogous to banks however it is essential to draw a distinction between financial companies and banks. While banks transact loans and provide banking services, finance companies focus on portfolio and investment management, providing service by guiding the flow and investment of capital. While banks today also engage in certain functions of financial services, we attempt to focus only on financial services divorcing any banking transaction in this section. [92]

Related Party Transactions that are not at an arm's length basis in financial firms and companies have the potential to wreck non-banking financial sectors due to the enormous net sum of money that is in their hands. Excessive lending between financial companies in the absence of sufficient securities that are proportional to the sum borrowed is the primary culprit for the 2008 Economic Crisis and has been catalyzed by the existence of unregulated related party transactions.[93]

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[91]Asian Corporate Governance Association, WHITE PAPER ON CORPORATE GOVERNANCE IN INDIA(September 2, 2014), Which can be read athttp://www.acga-asia.org/public/files/ACGA_India_White_Paper_Final_Jan19_2010.pdf.

[92]European Commission, NON-BANK FINANCIAL INSTITUTIONS: ASSESSMENT OF THEIR IMPACT ON THE STABILITY OF THE FINANCIAL SYSTEM 8-9 (September 4, 2014), Which can be read at http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp472_en.pdf.

[93]Xiaojing Wu and Sue Malthus, THE ROLE OF RELATED PARTY TRANSACTIONS IN THE FAILURE OF NEW ZEALAND FINANCE COMPANIES, Nelson Marlborough Institute of Technology: Working Paper Series, (August 2012) 9-10 (September 3, 2014), Which can be read at http://www.nmit.ac.nz/assets/Uploads/About-NMIT/pdfs/Research/RoleOfRelatedPartyTransactionsInTheFailureofNZFinanceCompanies-WuMalthus-Aug12.pdf.

Countering such RPT-induced adversities, the role of an efficient regulatory regime assumes importance as Schedule III of this 2013 legislation mandating disclosure of loans and advances from related parties in the Company Balance Sheet thereby effectively seeking to prevent such financing companies from entering into loan-based transactions with related parties in a non-transparent manner without analyzing the securities[94].

The declaration of bankruptcy by financing companies triggering economic crises and the inquiry into account revealing loans given to related parties being depicted as unrelated parties revealed the auditing farce existing in this sector. Therefore, the RPT regulations as endorsed by the New York Stock Exchange and Australian Auditing and Assurance Board emphasizing upon the role of audit-based review enjoys criticality as the natural impact of such legislations has been the statutory recognition of the need to maintain higher auditing standards and treating lapses in such audit-based review equivalent to misconduct subject to penalties[95] (as also proposed by the Companies Act 2013 discussed before).

Adding to this plight is the problem of Directors of Financial companies being majority shareholders in the related parties (companies) that such loans were given to or were acquaintances with the Director thereby painting the perfect picture of bad loan management and exploitative related party transactions. In such a problematic scheme of affairs, the RPT laws have often being viewed as a messiah by the investors compelling financing companies to make such lending public to all shareholders and bring such transactions to the notice of regulatory watchdogs and cautious investors endorsing the cause of respecting shareholder rights.[96]

C. Automobile Sector

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[94]PADMINI, *Supra* n. 2.

[95]XIOJING, *Supra* n. 94, at 8.

[96]Henry, Elaine and Gordon, Elizabeth A. and Reed, Brad and Louwers, Timothy, The Role of Related Party Transactions in Fraudulent Financial Reporting, Journal of Forensic & Investigative Accounting, Vol. 4, No. 1, 2012, 188-189, (2012).

Lastly, the authors discuss the repercussions of related party transaction laws on the automobile industry. The automobile industry is a complex industry in which production of goods and products comes from different sources (often subsidiaries and alliances) and has the potential of facing the impact of unregulated related party transactions. While this section is only a glimpse into the auto industry, the scope of related party transactions is wide and can broadly be categorized into the following to name a few, the initial investment into the automobile entity, transportation of raw products to the sole agent by his principal suppliers, technology transfer and training, loans between automobile corporates and the transfer of administrative training and functions.[97]

Analyzing the transfer of technology and training along with the transportation of raw products to the industries exposes the close nexus between related party transactions and taxation. Such transfer mostly occurs between subsidiaries or partners in different nations and jurisdictions, making the tax implications vary. In the absence of a uniform tax code and custom duty, related party transactions in this industry allow the tax burden to shift to countries with a lower taxation rate.[98]

Related party transactions in this plane involve the sale of goods and services that together help in creating the end product (an automobile), by the sale of a raw product at a much higher cost than the market rate or the sale on the books of record of the company of any service or product at a much lower rate than in the market to evade cross-country taxation.[99] Easing

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[97]Roger Y.M. Tang, *The automakers and their related party transactions in Indonesia,* Asia Pacific Journal of Management, Volume 7 Issue 2, 73-74, (1990).

[98] KPMG, CHINA TAX PLANNING FOR CROSS-BORDER TRANSACTIONS OF CHINA'S AUTO INDUSTRY*,* Issue 1, (2013) (September 5, 2014),Which can be read athttps://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-Tax-for-the-Auto-Industry/documents/China-Tax-for-the-Auto-Industry-1307-01-cross-border-transactions.pdf.

[99] ALAN PAISEY AND JIAN LI, A DIAGRAMMATIC AND CASE STUDY INTRODUCTION WITH SPECIAL REFERENCE TO CHINA, 134-138, (2012).

this scenario the Indian Accounting Standard (AS) 18 establishes the mandate to disclose any related party transaction and is read with the Income Tax Act of 1961 to enable taxation of related party transaction laws under the companies Act.[100]

Further, in the scenario of inter corporate loans between automobile companies and their subsidiaries, all forms of contribution to equity are presented in the form of a loan or a debt to enable profit shifting back to the company from the subsidiary. In this related party transaction, the equity contribution disguised in the form of a debt paves the path for profits to be returned from subsidiary to the parent company in the form of repayment of debt along with its due interest.[101]

This related party transaction has repercussions of the final pricing of the product as well as the tax implications of profit shifting, thereby affecting the value to shares ultimately. SEBI Clause 49 mandates shareholder approval in instances of any RPT, including those occurring at arm's length in the ordinary course of business and they all also need the approval of the audit committee under the Clause. This complements the objectives of the Companies Act 2013 in ensuring transparency. Further the SEBI Equity Listings Agreement includes transfer of services and products between related parties irrespective of the price charged, thereby covering all such transactions in its ambit.[102]This enables transparency in this complex industry giving shareholders of automobile companies a right to analyze and understand the multinational transactions and helps the government in tax collection and regulation of RPT's.

VI. CONCLUSION: PAVING WAY TOWARDS EFFICACY IN CORPORATE GOVERNANCE

Companies Act 2013 represents the gradually transforming attitude towards the conception of corporate governance within the commercial

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100 PWC, *Supra* n. 13, at 4-5.

101PRATIP, *Supra* n. 85, at 12.

102PWC, *Supra* n. 13, at 2.

scheme of affairs. The corporate sector subject to constant changes has necessitate legislative transformation justifying the landmark change in the statutory provisions governing the existence of Related Party Transactions as a critical element of the corporate regulatory structure.

With the government excluding amalgamation and mergers from the scope of Section 188 and disabling only related party interested in the particular transaction put to voting from making a decision, the relaxation of the regulatory norms is apparent.[103] It is in context of such cautious application of stringency that the state needs to draw a balance between furthering business interests against the promotion of ethical conduct and restraints on suspicious corporate practice.

The approach under the 2013 Act lays the foundation for a much needed uncompromising statutory regime circumscribing the scope of Related Party Transactions as a transactional instrument often subjected to planned abuse thereby necessitating the stringency envisaged by this latest legislative product.

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[103]Ministry of Corporate Affairs, CLARIFICATIONS ON MATTERS RELATING TO RELATED PARTY TRANSACTIONS, General Circular No, 3O/2O14, (August 13, 2014), Which can be read athttp://www.mca.gov.in/Ministry/pdf/Circular_No_30_17072014.pdf.

ESOPS AND INDEPENDENT DIRECTORS: THE UNSETTLED DEBATE IN LIGHT OF THE REVISED SEBI NORMS

GARGI BOHRA & GARIMA TYAGI

The Companies Act, 2013 ['2013 Act'] has ushered in a new regime of corporate governance based on the twin objectives of greater accountability and transparency. One of the most significant aspects of the 2013 Act is the increased role of independent directors. It has been mandated in the 2013 Act that in case of a company with an executive chairman, half the Board of Directors ['Board'] should comprise of independent directors. In case of a non-executive chairman, one third of the Board should comprise of independent directors. Keeping in mind the increased involvement of independent directors, the drafters of the 2013 Act also took steps to ensure that the independence and impartiality of independent directors is not compromised.

One of the steps taken by the legislature is with regards to the remuneration paid to the independent directors. During the previous regime of the Companies Act, 1956 ['1956 Act'], one of the ways of remunerating independent directors was by allocation of stock options. This was an incentive offered by companies to attract and retain independent directors. Even the SEB I(Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999['1999 Guidelines'], which governed Employee Stock Option Plans ['ESOPs'], permitted issuance of stock options to independent directors. But with the advent of the 2013 Act, this scenario changed completely. The drafters of the 2013 Act believed that a share in the company by way of stock option can compromise the independence of directors. Hence, Section 197(7) read with Section 149(9) of the 2013 Act expressly prohibit issuance of stock options to independent directors. To avoid any conflict with the 2013 Act, SEBI has also revised Clause 49 of the Listing Agreement on 17th April, 2014. As per the revised SEBI norms, issuance of stock option to independent directors is prohibited.

The purpose of this research paper is to analyse whether the prohibition on issuance of stock options to independent directors is necessary to secure their independence. Firstly, the paper will deal with the meaning and working of ESOPs. Secondly, the position of the law as per the 1956 Act and the 1999 Guidelines will be examined. Thirdly, the change from the old position of law will be traced by the examination of provisions of the 2013 Act as well as the revised Clause 49 of the Listing Agreement. Fourthly, the corporate governance norms in United States and United Kingdom with regards to stock options to independent

directors will be examined. Finally, a conclusion will be drawn on the viability of issuing stock options to independent directors.

CONTENTS

I. *ESOPs: Definition, Meaning and Process*

II. *Independent Directors: Meaning and Definition*

III. *ESOPs and Independent Directors: Position of law prior to the 2013 Act*

IV. *ESOPs and Independent Directors: The transition of law under the 2013 Act and Revised Clause 49 of the Listing Agreement*

V. *Position in United Kingdom*

VI. *Position in United States of America*

VII. *Should Independent directors be entitled to stock options? Is the prohibition really required?*

VIII. *Conclusion and Recommendations*

I. ESOPS: DEFINITION, MEANING AND PROCESS

ESOPs stand for Employee Stock Option Plans. They were the brainchild of a visionary economist Louis Kelso, who remarked "*that for capitalism to survive, there needed to be more capitalists."* ESOPs are unique employee *benefit plans* and are fast replacing cash incentives as a method to reward and retain employees. The spirit of ESOP is that they provide the employees a share in the wealth of the company and inculcate a sense of ownership and hence loyalty. This helps in retaining talented and skilled employees, especially in today's scenario when the employee turnover is high. It also improves the productivity and performance of the employees.

An employee stock option is defined under the 1999 Guidelines as "a right but not an obligation granted to an employee in pursuance of the

employee stock option scheme to apply for shares of the company at a pre-determined price"[1].

To put it simply, an ESOP works in the following manner:

(i) An option is granted to an employee of a company in the form of an incentive.

(ii) This option can be converted to shares if the holder of the option fulfils certain conditions. These conditions are the "vesting criteria" and can be either number of years of continued service after receiving the option, satisfaction of some performance goals by the option holder, or both. After the vesting criteria is satisfied, the options are said to be "vested."[2]

(iii) A vested option gives the option holder a right to "exercise" the option and be allotted shares of the company. Exercise of an option is the process by which a vested option is converted into shares by the payment of the exercise price. The exercise price is normally determined at the time the option is granted to the employee.

(iv) After the allotment of shares, the employee can sell the shares if he wishes to do so.

II. INDEPENDENT DIRECTORS: MEANING AND DEFINITION

The term 'independent director' was first defined and enunciated in the K. K. Birla Committee Report. In the report it was agreed that "*material*

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[1] Clause 2A, Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

[2]Vesting is defined in section 2.1(15) of the 1999 Guidelines as *the process by which the employee is given the right to apply for shares of the company against the options granted to him in pursuance of the employee stock option scheme.*

pecuniary relationship which affects independence of a director" should be the *litmus test* of independence and the Board would exercise sufficient degree of maturity when left to itself, to determine whether a director is independent or not.[3] Clause 49 of the Listing Agreement, which was inspired from the Birla Committee Report, defines Independent Directors as *a non-executive Director of the company who as far as shareholding is concerned, is not a substantial shareholder of the company, i.e. owning two percent (2%) or more of the block of voting shares.*[4]

Considering that lack of pecuniary interest in the company is the *sine qua non* for an independent director, the question which arises is whether by issuance of stock options and thereby greater shareholding in the company, will the independence of an independent director be compromised? Before answering this question, it is essential to trace the law in India with regards to grant of stock option to independent directors.

III. ESOPS AND INDEPENDENT DIRECTORS: POSITION OF LAW PRIOR TO THE 2013 ACT

In this section, we will examine the position of law under the 1956 Act and the 1999 Guidelines. By an analysis of the above, the change which has occurred after the advent of the 2013 Act will be contrasted.

A. Position under the 1999 Guidelines

Under the 1999 Guidelines, ESOPs are stock options that are granted to "employees", as defined in the 1999 Guidelines. An "employee" *inter alia* means *a permanent employee of the company working in India or out of India; or a director of the company, whether a whole time director or not.*[5] While determining whether independent directors are allowed stock options under the 1999 Guidelines, an informal circular issued by SEBI in 2008 ought to be

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[3]Securities Exchange Board of India, *Report of the Kumar Mangalam Birla Committee on Corporate Governance,* May 7, 1999, *at* <http://web.sebi. gov.in/commreport/corpgov.html.>

[4]Explanation(i)(f) to Clause 1.A, Clause 49 of the Listing Agreement.

[5]Clause 2.1(1), SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999

considered. In the year 2008, a company contemplating an ESOP in accordance with the 1999 Guidelines proposed to form an employee welfare trust to grant options to eligible employees and desired to appoint its independent directors as trustees of the trust. Further, it also wanted to grant options to those directors. When a clarification was sought from SEBI whether such options could be issued to independent directors, it stated that "*the following persons are not eligible to participate in the ESOP:*

a) an employee who is the promoter or belongs to the promoter group[6]*; and*

b) a director who either by himself or through his relative or any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company[7]*.*

Thus it is clear that the company is not specifically prohibited from allocating options to the independent directors of the issuing company who are acting as Trustees of the Trust." [8] For the purposes of the 1999 Guidelines, an Independent Director means a director of the company, not being a whole time director and who is neither a promoter nor belongs to the promoter group.[9]

From a combined reading of the above provisions, it can be seen that as per the 1999 Guidelines, an independent director who is not a whole time director, a promoter or belongs to the promoter group and who neither by himself nor through his relative or any body corporate, directly or indirectly holds more than 10% of the outstanding equity shares of the company,

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[6]Clause 4.2, SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

[7]Clause 4.3, SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

[8]SEBI's Reply on 29th august 2008 under Request for Informal Guidance under the SEBI (Informal Guidance) Scheme, 2003, at <http://www.sebi.gov.in/informalguide/ nucleus.pdf>

[9]Clause 2.1(9), SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

maybe entitled to stock options of the Company. Thus, the 1999 Guidelines allow grant of stock options to independent directors albeit subject to certain stringent conditions.

The 1956 Act did not specifically deal with grant of ESOPs to independent directors. Hence, the only regulation which seems to clarify the position prior to the 2013 Act are the 1999 Guidelines which allow ESOPs to independent directors.

IV. ESOPs and Independent Directors: The Transition of Law under the 2013 Act and Revised Clause 49 of the Listing Agreement

With the advent of the 2013 Act, the position of law with regards to grant of ESOP to independent directors has changed drastically.

An independent director under the 2013 Act, in case of both a listed and an unlisted company is not eligible for such options. The 2013 Act provides for a further issue of capital to employees under an employee stock option plan subject to a special resolution passed by the company and further conditions as may be prescribed under section 62(1)(b) of the 2013 Act.[10] The Companies (Share Capital and Debenture) Rules, 2014[11] while providing for a definition of 'employees' for the purposes of Section 62(1)(b) states that[12]-

For the purposes of clause (b) of sub-section (1) of section 62 and this rule "Employee" means-

[10]Section 62(1)(b), Companies Act, 2013.

[11]Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 prescribes additional conditions which will need to be satisfied by private companies and unlisted public companies. However, additional conditions for issue of ESOP's by listed companies will continue to be regulated by the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

[12]Explanation , Rule 12(1), Companies (Share Capital and Debenture) Rules, 2014.

(a)_…

(b) a director of the company, whether a whole time director or not but excluding an independent director; or ……..

Therefore, an option under an ESOP cannot be given to an independent director. This change in position is reflective of the recommendation made by the Report of the Standing Committee on Finance that had proposed to disallow the granting of options under ESOPs to independent directors.[13] At the same time it suggested that a higher sitting fee may be prescribed. Further, Section 197(7) of the 2013 Act clearly provides that an independent director cannot be given stock options.

An independent director can be paid remuneration by way of an attendance fee, reimbursement of expenses and profit related commissions.[14] The remuneration payable to independent directors can at no point of time exceed one percent of the net profits of the company, if there is a managing director or a whole time director or manager; and three percent in any other case.[15] This remuneration by way of a percentage of net profit will be exclusive of the fees paid to the independent directors for attending the meetings of the Board or a Committee.[16]

This change was brought about to ensure the independence of judgment of the independent directors serving on the Board. In order to eliminate any pecuniary relationship between the company or its performance and the independent directors, the granting of stock options to independent directors has been prohibited under the 2013 Act.

In light of the above provision and to avoid any conflict with the 2013 Act, the SEBI has recently revised Clause 49 of its Listing Agreement

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[13]Standing Committee on Finance (2011-12), The Companies Bill, 2012, 57th Report at pg 22.

[14]Section 197(7), the Companies Act, 2013.

[15]Section 197(1)(ii), the Companies Act, 2013.

[16]Section 197(2), the Companies Act, 2013.

on 17th April, 2014. According to the revised SEBI norms, independent directors shall not be entitled to any stock option.[17]

There can be no sure shot formula to ensure independence. It is precisely for this reason that the remuneration structures for independent directors vary across jurisdictions. A few countries like Netherlands and France follow a 'no stock option' policy for independent directors. At the same time the New York Stock Exchange[18] and the Hong Kong Stock Exchange[19] do not prohibit granting of stock option to independent directors and their determination of independence is not solely based on ownership of shares and generally the ownership of shares is capped. The Securities and Exchange Commission of the Republic of Philippines while deciding on the validity of the prohibition of granting of stock options to independent directors recognized the effect of economic rewards on the impartiality and objectivity of independent directors but at the same time held that there was no need for a prohibition on such grants and the purpose could also be achieved by placing a restriction, which in that case was 2%.[20]

V. POSITION IN UNITED KINGDOM

In U.K., the enforcement of corporate governance norms laid down by the U.K. Corporate Governance Code ('Code') is based on the principle of 'comply or explain'. As per Rule 9.8.6(6) of the Listing Agreement of the

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[17]Clause 49(II)(C), SEBI Circular CIR/CFD/POLICY CELL/2/2014, April 17, 2014, *Corporate Governance in listed entities - Amendments to Clauses 35B and 49 of the Equity Listing Agreement, at* <http://www.sebi.gov.in/cms/sebi_data/attachdocs/1397734478112.pdf>

[18]Section 303A, Corporate Governance Rules, New York Stock Exchange, as amended on 3 November, 2004, at<http://www.nyse.com/pdfs/section303A_final_rules.pdf>; *see also* NYSE Manual, section 303A.02(a).

[19]Hong Kong Stock Exchange Mani Board Listing Rules.

[20]*Artemio V. Panganiban* v. *Corporation Finance Department of the Securities and Exchange Commission*, SEC EnBanc Case No. 08-11-242, 5 July, 2012.

London Stock Exchange, listed companies incorporated in the U.K. have to include the following in its annual financial report:

(6) a statement as to whether the listed company has:

a) complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code; or

b) not complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code and if so, setting out:

i. those provisions, if any it has not complied with;

ii. in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and

iii. the company's reasons for non-compliance

This approach is popularly known as the 'comply or explain' approach that requires the company to either follow the norms laid down in Code or to state the reasons for its departure from the norms. Such an approach is adopted to ensure a dual benefit of making the investors and shareholders aware of the actions of the company so that they can make an informed choice and at the same time allowing the company to adopt an approach that suits its needs.

The Code lays down the legislative framework for the determination of the remuneration payable to a non-executive or an independent director.[21] It provides that the remuneration of a non-executive director should be linked to his time commitment and responsibilities. With regards to stock options, the Code lays down a prohibition on providing non-executive directors' remuneration in the form of share options or other performance related elements. However, in case share options are provided to non-

[21]D.1.3, Section D: Remuneration, U.K. Corporate Governance Code, September 2012.

executive directors, the shareholders should approve such a grant and the non-executive directors should hold the shares for a period of at least 1 year after their resignation or dismissal from the Board.[22] Also, participation in share options or a performance related pay scheme is presumed to create circumstances by which the independence of an independent director may be affected. Consequently, in cases of participation in share options by independent directors, reasons should be stated to prove how the independence of the director is not affected despite holding shares in the company.[23]

In U.K., despite the lack of a prohibition or a mandatory law against granting of stock options to independent directors, remuneration to independent directors in the forms of stock options can only be said to be an exception. Further, the rules for applying such an exception are very onerous to the extent that they presume lack of independence. The present Indian law regarding prohibition on granting of ESOPs to independent directors is in line with the U.K. approach. The difference only exists theoretically, and that too because of a difference in approach towards corporate governance in general i.e. U.K.'s 'comply or explain' approach and India's mandatory approach under the 2013 Act. The principle in both countries is against the granting of stock options to independent directors.

VI. POSITION IN UNITED STATES OF AMERICA

The Corporate Governance regime in the United States of America is largely covered by the Sarbanes Oxley Act ['SOA'] and the listing requirements of its two stock exchanges - the New York Stock Exchange ['NYSE']and NASDAQ -all of the which have certain requirements which determine the independence of a director and these requirements shed light on the approach which the United States Corporate Governance regime has on grant of stock options to independent directors.

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[22]*Id.*

[23]B.1.1, Section B: Effectiveness, U.K. Corporate Governance Code, September 2012.

As per section 301 of the SOA, an independent director in the audit committee should not be an "*affiliated person*" of the company. The SOA does not itself define an affiliated person and relies on the meaning given to the term by the Investment Company Act ['ICA']. The ICA defines an affiliated person as someone who owns 5% or more of the securities of the company.[24] But even the ICA exempts such persons from the definition of affiliated persons who are only included in the definition by virtue of their stock ownership in the firm.[25] Thus the outlook of the US Congress, while drafting the SOA, with respect to stock options and independent directors is unclear. On one hand, the SOA states that independent directors should not be affiliated persons who own more than 5% securities of the company. But, on the other hand, the very statute which defines affiliated persons for the purpose of SOA (ie. The ICA), *does not see stock ownership as a bar to independence of a director.*[26]

The NYSE requires an independent director on its audit committee. But it imposes no limit on their shareholding in the company.[27] In fact according to the NYSE, ownership should be viewed as desirable, and with regards to independence from management, even ownership of a significant amount of stock, by itself, does not compromise the independence of a director.[28] Thus, unlike the provisions of SOA, the listing requirements of NYSE unequivocally support stock ownership of independent directors.

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[24]Section 2(a)(3), Investment Companies Act, 1940.

[25]The ICA uses the definition of "affiliated person" in its own definition of the term "interested director" (i.e., directors who do not meet the ICA's standards of independence), butspecifically exempts those who fall within the definition of "affiliated person" solely by virtue oftheir stock ownership. *See* 15 U.S.C. section 80a-2(a)(3), (19)(A) (2000).

[26]Donald C. Clarke, *Three Concepts of the Independent Director*, 32 Del. J. Corp. L. 73 (2007).

[27]Section 303A, N.Y. Stock Exch., Listed Company Manual, (2003), *available at*http://www.nyse.com/listed [hereinafter NYSE Manual].

[28] Section 303A, Corporate Governance Rules, New York Stock Exchange, as amended on 3 November, 2004 <http://www1.nyse.com/pdfs/section303A_final_rules.pdf>; *see also* NYSE Manual, section 303A.02(a).

Therefore, it can be stated that although the provisions of SOA in the USA do not permit payment of a profit-related commission to independent directors, yet, the overall corporate governance regime, including the SOA, does not prohibit stock options to independent directors.[29]

VII. SHOULD INDEPENDENT DIRECTORS BE ENTITLED TO STOCK OPTIONS? IS THE PROHIBITION REALLY REQUIRED?

The role of independent directors was overhauled after the Satyam fiasco and their involvement was increased to counter corruption in management. Along with an increase in their involvement, there has also been an increase in measures to ensure their accountability and impartiality. One of the key steps taken towards fulfilment of this objective is to prohibit grant of stock options to these directors. The need and viability of such a prohibition has received two divergent views.

The first view argues against the prohibition on granting of stock options to independent directors. The argument is that keeping in mind the increased liability and involvement of independent directors with the advent of the 2013 Act, prohibition of ESOPs will make it very difficult for companies to attract and retain independent directors in their Board. This is so because stock options are deemed to be an incentive and a very profitable form of remuneration to independent directors. With the current limits on remuneration under the 2013 Act, most independent directors would not want to continue their directorships.[30]Also, ownership of significant amount of stock in the company by the independent directors aligns their interest with that of the shareholders. In other words, an independent director is

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[29] KPMG and the Associated Chambers of Commerce and Industry of India, *Role of Independent Directors-Issues and Challenges*, 2011, *at* <http://www.kpmg.com/IN/en/.../ Role_of_Independent_Directors.pdf.>

[30]Shubham Batra, *New stringent law for independent directors makes posts unattractive*, E. Times, March 3, 2014, at
<http://articles.economictimes.indiatimes.com/2014-03-03/news/47859329_1_independent-directors-seven-listed-companies-new-companies-act>

more likely to act in the interest of the shareholders if he owns shares in the company and thereby relates to the shareholders' situation in the company.[31]

The proponents of the contrary view argue that increased shareholding in the company will unequivocally affect the independence of independent directors. Hence, if the company wants to reward the independent directors for their skills, experience and service to the company, it ought to increase their sitting fees instead of granting them stock options.[32] This view can be traced back to the Cadbury Committee report. The report did not prohibit grant of stock options to independent director but stated that in *order to safeguard their independent position, it was good practice for non-executive directors not to participate in share option schemes.* Further, proponents of this view disagree that a prohibition would act as a dis-incentive for independent directors. In their view independent directors in private sector companies are already paid enough remuneration.[33] The huge private sector corporations who want to utilise the experience, domain knowledge and networking skills of these directors are already willing to offer them high commissions. Thus, even a prohibition on grant of stock options will not act as a dis-incentive for such directors. However, it is also true that in the absence of ESOPs, small/medium sized companies and public-sector companies might find it difficult to attract and retain independent directors since they cannot offer them high remuneration as private sector companies.[34]The new SEBI norms

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[31]Robert Charles Clark, *Corporate Governance Changes In The Wake Of The Sarbanes-Oxley Act: A Morality Tale For Policymakers Too*, The Harvard John M. Olin Discussion Paper Series at < http://www.law.harvard.edu/programs/olin_center/>

[32]*Should independent directors receive ESOPs?* August 8, 2009 <http://thefirm.moneycontrol.com/story_page.php?autono=410366>

[33]Independent directors on the boards of Nifty 50 companies on average make Rs 21.13 lakh a year; some companies pay Rs 75 lakh per annum. Ranbaxy Laboratories paid four of its independent directors Rs. 1 crore each as commission apart from sitting fees. Software Giants Infosys and Tata Consultancy Services pay their independent directors close to Rs. 82 lakh on average per annum.

[34]Nitin Srivastav, *Most independent directors manage to rake it in even without stock options plans*, F.E, February 22, 2014

would impact people whose business is to become independent directors and treat this as a profession.[35]

In the authors' opinion, although the object of the 2013 Act was to *minimize* situations which may result in a lack of independence for independent directors, the fulfilment of this object has posed a few difficulties. The first is in relation to the difficulty that has been pointed out by the proponents of the first view, i.e.an increase in the responsibilities and liabilities of independent directors and a subsequent decrease in their remuneration may result in the unwillingness of qualified personnel to act as independent directors. An increase in the liability of independent directors coupled with a reduced remuneration does not work very well in the favour of the Indian corporate governance scenario. In light of the changes, the need to bring in risk-return parity to the post of an independent director was also recognized by the SEBI.[36] We have already witnessed a mass resignation of independent directors after the Satyam episode where 620 independent directors resigned their office.[37] A similar situation may occur due to an apprehended increased liability under the 2013 Act and a parallel reduction in remuneration due to a restriction on granting of stock options to independent directors.

Secondly, there exist other performance related remuneration mechanisms which can affect the independence of independent directors as much as ESOPs under the current regime. The commission fee given to independent directors is directly related to the net profit of the company.

<http://www.financialexpress.com/news/most-independent-directors-manage-to-rake-it-in-even-without-stock-options-plans/1228255>

[35]M. Saraswathy, *SEBI may make independent director post unattractive*, B.S, January 13, 2013 <http://www.business-standard.com/article/companies/sebi-may-make-independent-director-post-unattractive-113011300071_1.html>

[36]Consultative Paper On Review Of Corporate Governance Norms In India Para 11.9; <http://www.sebi.gov.in/cms/sebi_data/attachdocs/1357290354602.pdf>

[37]Vikramaditya Khanna & Shaun Matthew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer*, Vol 22(1), NLS L.R., p. 36 (2010).

Although the amount of commission payable has been capped to a limit of 1% of the net profit of the company, this 1% of the net profit in itself constitutes a hefty amount of money. As statistics show, the independent directors of quite a few Nifty 50 companies have been earning a commission ranging between Rs. 20 lakhs to Rs. 80 lakhs a year apart from their sitting fees.[38] The problem associated with commission fee is not about the hefty amount that is being paid to independent directors but it is about it being a performance-related remuneration just like ESOPs. It is important to note that both in the United States and the United Kingdom, independent directors are not allowed to be remunerated by way of a profit-related commission.[39]

VIII. CONCLUSION AND RECOMMENDATIONS

The effect of providing remuneration in the form stock options is debated across jurisdictions. As has been pointed out earlier, wherein a few countries provide for a prohibition on granting of stock options, others allow for the same with strict regulation. It cannot be denied that the 'independence of judgment' of an independent director is of great importance but at the same time it is also important to ensure that this crucial role is played by those qualified for it. The prohibition on granting of stock options coupled with the deterrent of an increased liability may lead to situation where companies are left looking for well-qualified independent directors.

After an analysis of the pros and cons of granting stock options to independent directors, following are the recommendations suggested by the authors.

Firstly, considering the increased popularity of stock options as a form of remuneration, a complete ban on grant of such options to independent directors does not seem viable. Rather, restrictions ought to be placed on the

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[38] *Supra* note 34.
[39] U.S.-Sarbanes Oxley Act; U.K.- Corporate Governance Code.

total amount of options granted or the manner in which these options are exercised. For eg., stock options exercised and converted to shares by an independent director may not be sold for a certain pre-determined period after exiting from the Board.[40] Also, only a *significant* stock ownership affects the independence of directors. Hence, there ought to be a limit on the total options that can be granted to an independent director rather than a total ban on the same.

Secondly, the major proportion of a directors' remuneration ought to be by way of fixed compensation for certain assigned responsibilities. Under this, the sitting fees paid to independent directors for attending board meetings ought to be increased. This form of remuneration should be given preference over stock options. Also, shareholder approval ought to be taken when deciding the fees as they should be involved in the remuneration of directors of their company. At the same time, the amount of money paid to independent directors in the form of a commission fee which is directly proportional to the performance of the company should also be regulated.

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[40] *Supra* note 29.

DIVERSITY AND DEFERENCE: U.S. CORPORATE BOARDS IN COMPARATIVE PERSPECTIVE

THOMAS W. JOO

The boards of directors in business corporations worldwide are notoriously lacking in gender and racial diversity. This paper asks what the United States can learn from reform efforts in other nations. A number of countries, including India and many European countries have legislated quotas requiring specified percentages of female directors. The United Kingdom has resisted the trend toward quotas. Instead, the law has mandated only disclosure about the gender composition of boards. In addition, U.K. companies have adopted a number of voluntary reforms in recent years.

In the U.S., quota laws based on gender (or race) are politically unrealistic and would probably violate the Constitution. The U.S. Constitution generally prohibits the government from imposing gender and racial classifications, even when they are intended to assist a historically disadvantaged gender or race. Thus the U.K.'s combination of disclosure and voluntary action provides the best model for reform in the U.S.

U.S. law imposes few substantive legal mandates on corporate governance. Instead, it gives a great deal of deference to the "business judgment" of corporate boards. U.S. boards therefore have the opportunity (should they choose to use it) to pursue voluntary reforms to increase board diversity. Advocates of board diversity often argue that it benefits corporations by increasing profits. In fact, however, it is unclear whether this is true. But U.S. corporate law and culture are so deferential to directors' "business judgment" that boards need not prove any such benefits. In sum, U.S. law is likely to permit voluntary reforms to increase board diversity, but it will be up to corporate boards to take the initiative. Disclosure requirements and political, social and shareholder pressure may be influential in this process.

CONTENTS

I. *Introduction*

II. *Quotas and the U.S. Constitution*

III. *Therapeutic Disclosure*

IV. *Voluntary Reform and Title VII*

V. *Voluntary Reform and Internal Corporate Governance: The Role of Shareholders*

VI. *Voluntary Reform and Judicial Deference to Directors*

I. INTRODUCTION

The boards of directors in business corporations worldwide are notoriously lacking in gender and racial diversity. Many countries have addressed gender imbalance with laws requiring corporate boards to include specified percentages of women.[1] (None appear to have addressed racial imbalances, however.) In 2003, Norway led the way with a law requiring its listed companies to have boards comprised of 40% women by 2008.[2] Spain and France are phasing in 40% quotas over the next few years.[3] The European Parliament recently approved a Directive that would require publicly listed corporations to meet a 40% quota for their non-executive board positions by the year 2020.[4] Pursuant to a recent revision of the Companies Act, India passed a rule in 2014 requiring listed companies to include at least one woman director.[5] In the United States, women held only 12% of the board seats in the S&P 1500 companies as of 2008, and people of

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[1]Some countries also mandate minimum representation of women among elected political officials. *See* Darren Rosenblum, *Parity/Disparity: Electoral Gender Inequality on the Tightrope of Liberal Constitutional Traditions*, 39 U.C. DAVIS L. REV. 1119 (2006).

[2]*See* Douglas M. Branson, *Initiatives to Place Women on Boards of Directors: A Global Snapshot,* 37 J. CORP. L. 793, 803 (2012).

[3]*See Id.* at 803-04.

[4]*See* European Commission Press Release, *Gender equality: EU action triggers steady progress* (April 14, 2014), Available athttp://europa.eu/rapId/press-release_IP-14-423_en.htm. As of April 2014, the Directive awaited approval by the EU Council. *Id.*

[5]*See* Companies Act 2013 § 149(1)("such class or classes of companies as may be prescribed, shall have at least one woman director"), Available at http://www.mca.gov.in/Searchable Acts/Section149.htm; Government of India, Ministry of Corporate Affairs, Companies (Appointment and Qualification of Directors) Rules, 2014, Rule 3 (stating that all listed companies and all public companies above a certain size shall have at least one woman director). http://www.mca.gov.in/Ministry/pdf/NCARules_Chapter11.pdf.

color held only 10%.[6] Women of color accounted for only 3.2%.[7] This paper asks what the U.S. can learn from reform efforts in other nations.

In the U.S., gender or racial quota laws are not only politically unrealistic, but probably illegal: the former are probably unconstitutional and the latter almost certainly so. American law and public discourse in recent decades have come to avoid—and in many contexts, to prohibit—directly addressing race and gender inequities. Over the same period, American law and politics have come to disfavor business regulation, further reducing the likelihood of strong legal requirements regarding the gender or racial composition of boards. These challenges suggest that diversity on corporate boards will depend on voluntary affirmative action by corporations, like that being adopted in the UK. Relative to most other countries, the U.S. (like the U.K.) tends to have a stronger faith in market solutions. Thus American doctrine and rhetoric about corporate reform tend to emphasize profit-based justifications over social-justice reasons. They do not subject those justifications to much scrutiny, however, because U.S. law concentrates decision-making authority in the board and hesitates to interfere with board discretion. Thus boards do not need to prove profit-based justifications for taking steps to increase board diversity. As a result, corporate boards hold considerable power and discretion over whether and how to address diversity on boards.

II. QUOTAS AND THE U.S. CONSTITUTION

In the United States, racial diversity is at least as much of a concern as gender diversity. Statutory quotas are not a viable approach to increasing racial diversity, however. The U.S. Supreme Court has held that all government-sponsored racial classifications (even those with "benign" intent) are subject to strict judicial scrutiny under the Constitution's guarantees of Equal Protection.[8] Under strict scrutiny, such classifications are permissible

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[6] *See* Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?,* 89 N.C. L. REV. 855, 867-68 (2011).

[7] *See Id.*

[8] *See* Richmond v. J.A. Croson, 488 U.S. 469 (1989); Adarand Constructors v. Pena, 515 U.S. 200 (1995).

"only if they are narrowly tailored measures that further compelling governmental interests."[9]

While the Court has not categorically ruled out quotas, it has been hostile to them, even where the government has established a compelling interest, on the grounds that quotas are not narrowly tailored to serve that interest.[10] The Court has rejected the argument that racial quotas are justified by "societal discrimination" against racial minorities, as well as the argument that racial quotas are necessary to achieve diversity.[11] The Court has thus struck down quotas in government contracting and university admissions.[12] A regulation imposing race-based quotas for corporate directors would almost surely be found unconstitutional on similar grounds.

Statutory quotas for women directors are also likely to be found unconstitutional. The Supreme Court has not specifically addressed quotas or other affirmative action for women in employment. The only Supreme Court case addressing an affirmative-action plan for women in public employment was decided under the Title VII antidiscrimination statute, not the Constitution.[13] In upholding the plan, the Court noted with approval that it did not employ quotas.

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[9] *Adarand,* 515 U.S. at 227.

[10] According to the Court's seminal affirmative action case, even if the state had a compelling interest in "diversity" in the student body of a public medical school, diversity includes factors other than race, and thus "the assignment of a fixed number of places to a minority group is not a necessary means to that end." Regents of the University of California v. Bakke, 438 U.S. at 316.

One of the few examples of a racial quota to survive such scrutiny was a court-ordered hiring quota imposed on a police department that had intentionally excluded all African-Americans from its ranks for its entire history, and had failed to diversify itself after a decade of court orders to do so. United States v. Paradise, 480 U.S. 149 (1987).

Even in that egregious case, the Court approved the plan only by a narrow margin of five votes to four.

[11] *See* Regents of Univ. of Calif. v. Bakke, 438 U.S. 265 (1978).

[12] *See Bakke, supra; Croson, supra.*

[13] Johnson v. Transportation Agency 480 U.S. 616 (1987).

Gender classifications are nominally subject to only "intermediate" scrutiny under the Constitution.[14] But the Court has only addressed gender-based classifications in government benefits and education; it has never directly addressed the constitutional status of gender-based governmental affirmative action in the employment context. The Sixth Circuit and Federal Circuit Courts of Appeal have expressly adopted strict scrutiny for gender-based classifications in public employment.[15] Furthermore, despite its precedent establishing intermediate scrutiny, the Supreme Court stated in a more recent public-education case that a governmental gender classification must have an "exceedingly persuasive justification" to survive a constitutional challenge.[16] Justice Scalia, in dissent, argued that this formulation imposes a standard akin to strict scrutiny.[17] The nominal distinction between "intermediate" and "strict" scrutiny, then, may be illusory—or at least porous.[18]

Affirmative-action laws without quotas would have somewhat better chances of surviving constitutional challenge, but would remain susceptible to strict scrutiny. In *Grutter v. Bollinger,* affirmative action in a public law school's admission policies survived strict scrutiny when the Supreme Court decided to "defer" to the school's "educational judgment that [racial] diversity is essential to its educational mission."[19] U.S. courts are unlikely to award such deference to a statute mandating affirmative action. Just as the *Grutter*Court presumed that a university has superior judgment with respect to education, U.S. courts have a strong tradition of deference to a board's decisions with respect to *corporate* affairs. A statute requiring affirmative

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[14]*See* Califano v. Webster, 430 U.S. 313 (1977).
[15]*See* Brunet v. City of Columbus, 1 F.3d 390, 404 (6th Cir. 1993); Berkley v. United States, 287 F.3d 1076, 1085 (Fed. Cir. 2002).
[16] U.S. v. Virginia, 518 U.S. 515, 533-34 (1996)(striking down Virginia Military Institute's men-only admissions policy).
[17] *See Id.* at 571-72.
[18]*See*AshutoshBhagwat, *Affirmative Action and Compelling Interests: Equal Protection Jurisprudence at the Crossroads*, 4 U. PENN. J. CONST. L. 260, 263 (2002)(arguing that the Supreme Court's "strict" and "intermediate" scrutiny jurisprudence lacks "any examination or explication of what those tiers of review mean in practice.").
[19]Grutter v. Bollinger 539 U.S. 306, 328 (2003).

action with respect to board nominations, however, would constitute a *legislature's* judgment about corporate policy.

The "business judgment rule" is emblematic of the legal deference to corporate boards. Courts will not recognize shareholders' legal challenges to the decisions of executives or boards unless they can prove, despite strong presumptions to the contrary, that management did not act in good faith, on an informed basis, or in the best interests of the corporation.[20] The business judgment rule reflects the deep-seated notion that the board is the institution best suited to determine how to serve shareholders and the corporation. A legislature's decision to require affirmative action in the corporate context would not receive the same kind of deference; indeed, it would probably be met with considerable skepticism.

In any case, non-quota affirmative action mandates would be difficult to craft in any meaningful way, and are thus likely to have limited effect on diversity. Effective government-sponsored affirmative action has tended to involve government agencies that *want* to practice affirmative action, rather than government rules that impose affirmative action requirements on unwilling private parties. *Grutter,* for example, involved the University of Michigan Law School plan to increase racial diversity through the setting of "target" numbers.[21] The active and effective pursuit of diversity in *Grutter*(and in other public university settings) did not result from government compulsion of private parties, but from the policy decisions of public (university) officials. A law mandating non-quota affirmative action by private parties can only prescribe procedures; it cannot compel results—or even sincere attempts.[22] For example, under rules requiring corporations to consider gender as a factor in nominations, a corporation could comply with the letter of the law even without actually nominating any women directors. That is, successful non-quota affirmative action requires sincere commitments to diversity on the part of the affected institutions—in which case statutory mandates would be unnecessary.

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[20] *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 278-79 (2000).

[21] *Supra* note 19 at 318.

[22] A statute might in theory require "good faith efforts," but such standards are of course difficult to enforce.

III. THERAPEUTIC DISCLOSURE

"Therapeutic disclosure" is an approach that lies somewhere between legal mandates and purely voluntary private action. In the United States, federal securities regulation consists mainly of disclosure requirements. Congress has given the Securities Exchange Commission enormously broad authority to define the specific requirements. Under the Securities Exchange Act, for example, an application for the registration of a security must include "[s]uch information....as the Commission may...require, as necessary or appropriate in the public interest or for the protection of investors."[23] Similarly, when a corporation or other person solicits proxies (the equivalent of absentee votes in a corporate election), it must comply with "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[24]

The SEC has long used this broad authority to craft so-called "therapeutic" disclosure requirements; that is, to use disclosure mandates "as means of altering conduct, rather than...as a means of informing investors."[25] Critics have argued that using disclosure rules in this way is an improper use of the SEC's statutory authority.[26] But this critique seems willfully naïve, if not disingenuous. Disclosure requirements by their nature have some "therapeutic" effect. Required reporting along any metric can encourage conduct that affects the reported metric; as regulators well know, "You manage what you measure." This is as true of disclosures about annual earnings or indebtedness as it is of more "political" disclosures, such as those related to diversity. The question, then, is not whether to influence corporate conduct via disclosure, but rather what areas of conduct are appropriate targets of SEC influence. The statutory references to "the public interest" suggest little in the way of statutory limits; the limits would instead appear to be determined by politics (and perhaps the First Amendment, as will be addressed below).

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[23] Securities Exchange Act § 12(b)(1), 15 U.S.C. § 78*l*(b)(1).

[24] Securities Exchange Act § 14(a)(1), 15 U.S.C. §78n(a)(1).

[25] A.A. Sommer, Jr., *Therapeutic Disclosure,* 4 SEC. REG. L. J. 263, 270 (1976).

[26] *See Id.*

In 2009, the SEC made regulatory amendments regarding disclosures related to "diversity" in director nominations.[27] Because its requirements are so vague and easily satisfied, however, the rule change will probably have minimal "therapeutic" impact on racial or gender diversity on boards. Regulation S-K sets forth the reporting requirements for corporations that issue securities to the public, or "issuers" in regulatory parlance. As amended, the regulation requires issuers to state "whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director." [28] Despite requiring disclosures about the consideration of "diversity," however, the SEC declined to define the term.[29] Instead, it explicitly left it up to corporations to define the concept: "some companies may define diversity expansively to include differences of viewpoint, professional experience, education, skill, and other individual qualities...while others may focus on diversity concepts such as race, gender, and national origin."[30]

If the committee or the board has "a policy with regard to the consideration of diversity in identifying director nominees," the issuer must "describe how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy."[31] That is, a corporation must make these further disclosures if, and only if, it has a diversity policy with respect to nominations; it is not required to have such a

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[27]*See* Securities Exchange Commission, *Proxy Disclosure Enhancements*, 74 Fed. Reg. 68,334, 68,335 (Dec. 23, 2009). These changes have been codified at 17 C.F.R. § 229.407(c)(2)(vi)(2011).

[28] 17 C.F.R. § 229.407(c)(2)(vi) (2011). The regulation formerly required an issuer to disclose "any specific minimum qualifications that a nominating committee believes must be met by a nominee for a position on the board."

[29]Securities Exchange Commission, *Proxy Disclosure Enhancements*, 74 Fed. Reg.at 68,344 ("[W]e have not defined diversity in the amendments.").

[30]*Id.*

[31]*Id.*

policy. The term "policy" is also undefined, leaving it unclear exactly what triggers these additional disclosure requirements.[32]

The SEC approach deliberately attempts to avoid making any direct statement about the meaning or importance of racial or gender diversity.[33] Disclosures under the SEC rule have been vague and inconsistent, in part due to a lack of interpretive guidance from the SEC.[34] Indeed, because the existence of a diversity "policy" entails additional disclosure requirements about its implementation and effectiveness (which increase both workload and potential liability exposure for inaccurate disclosures), Regulation S-K may actually encourage companies *not* to adopt formal diversity policies.[35]

The UK Company Law's disclosure requirements are more pointed with respect to diversity: for example, listed companies must disclose the number of males and females among their directors, senior managers, and employees.[36] This kind of requirement may have a therapeutic effect if a corporation's management finds it potentially embarrassing to disclose an absence of women directors. SEC regulations, however, do not require the disclosure of gender (or racial) composition. Thus a U.S. corporation with

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[32]*See* Thomas Lee Hazen and LissaLamkin Broome, *Board Diversity and Proxy Disclosure,* 37 U. DAYTON L. REV. 39, 74 (2011).

[33] It has been criticized for this reason. *See* Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C. L. REV. 855, 874 (2011) (calling the SEC's refusal to define "diversity" "devastating to the rule's potential effectiveness").

[34]*See* Hazen and Broome, *supra,* at 74.

[35]*See Id.* at 66; Douglas M. Branson, *Initiatives to Place Women on Boards of Directors: A Global Snapshot*, 37 J. CORP. L. 793, 813 (2012).

[36]*See* UK Companies Act 2006, Part 15, Chapter 4A, § 414C(8)(c), as amended by The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013; Available at http://www.legislation.gov.uk/uksi/2013/1970/contents/made. With respect to diversity policy, UK listing standards have a disclosure requirement similar to that in Regulation S-K. The Corporate Governance Code requires listed companies to provIde "a description of the board's policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives." Financial Reporting Council, UK Corporate Governance Code B.2.4, (Sept. 2012), Available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf.

few or no women directors need not disclose that fact; it could satisfy the law with generic assurances that it does indeed "consider diversity." Because public companies must disclose the identities of their directors, the gender composition of a board cannot be kept secret. But an interested party would have to do some research to determine the gender composition of a board. Making gender composition a specific disclosure requirement would call far greater attention to the issue, and also make it easier to track aggregate data about gender representation on boards.

While the anodyne nature of the SEC disclosure requirements may be unsatisfying, recent developments in U.S. law suggest that more expressly "therapeutic" disclosure rules may be constitutionally prohibited. First Amendment protection for corporate and commercial activity has increased steadily since the 1970s. The best-known recent example of this trend is the Supreme Court's protection of corporate political spending in *Citizens United v. FEC.*[37] This trend in First Amendment law may threaten mandatory disclosures under the federal securities laws, because the First Amendment protects against governmentally compelled speech. In a recent example, the U.S. Court of Appeals for the D.C. Circuit recently held that the government could not compel tobacco companies to put graphic warning labels on cigarette packages where there was no proof that the labels would serve the governmental interest in public health.[38]

A decade ago, a leading First Amendment commentator could say with confidence that the federal securities disclosure regime was immune to this trend for historical and political reasons, "remaining a domain largely

[37] 558 U.S. 310 (2010). In another recent example, the Court held that pharmacies have a First Amendment right to sell pharmaceutical companies information about doctors' prescription practices, despite a state law intended to protect medical privacy and limit the influence of pharmaceutical marketing on doctors' prescription decisions. *See* Sorrell v. IMS Health Care, 131 S.Ct. 2653, 2659(2011).

[38] R.J. Reynolds Tobacco Co. v. U.S. Food & Drug Admin., 696 F.3d 1205 (D.C. Cir. 2012). *But see* Discount Tobacco City & Lottery Inc. v. U.S. Food & Drug Admin., 674 F.3d 509 (6th Cir. 2012) (rejecting a First Amendment challenge to the same regulation).

outside the coverage of the First Amendment."[39] But the tide may be turning. In April 2014, the D.C. Circuit struck down an SEC disclosure rule on First Amendment grounds.[40] The rule required corporations to disclose if certain mineral components of their products were "not found to be DRC conflict-free" (that is, if their production or sale were implicated in the ongoing conflict in the Democratic Republic of Congo). The court held that this requirement constituted impermissible compelled speech because it required manufacturers to make political statements. According to the court, "it is far from clear that the description at issue—whether a product is 'conflict free'—is factual and non-ideological." By contrast, the same court recently upheld a different disclosure regulation against a similar First Amendment challenge. A Department of Agriculture regulation requires meat to be labeled with its country of origin. In *American Meat Inst. v. USDA* (*AMI*),[41] the D.C. Circuit found this permissible because it compelled only a "purely factual" disclosure.[42] It is unclear what kinds of diversity-related disclosures would be factual and which might be considered "ideological."

This doctrine continues to develop, and remains unclear. The D.C. Circuit held an *en banc* rehearing of the *AMI* case and affirmed the original decision in July 2014.[43] The *en banc* decision revisited the circuit's previous holding that regulations compelling speech must be "'reasonably related to the State's interest in preventing deception of consumers.'"[44] The original *AMI* decision had rejected this rule, while *NAM* had reiterated it. The *AMI en banc* opinion rejected the rule, and overruled earlier cases, including *NAM*,

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[39] Frederick Schauer, *The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience*, 117 HARV. L. REV. 1765, 1780 (2004).

[40] *See* National Assn. of Mfrs. v. SEC, 748 F.3d 359 (D.C. Cir. 2014).

[41] 746 F.3d 1065 (D.C. Cir. 2014).

[42] *Id.* at 1071.

[43] American Meat Inst. v. U.S. Dept. of Agriculture, No. 13-5281, 2014 WL 3732697(D.C. Cir., July 29, 2014)(*en banc*).

[44] R.J. Reynolds Tobacco Co. v. FDA, 696 F.3d 1205, 1213 (D.C.Cir.2012)(quoting Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 651 (1985)). In *Zauderer,* the Supreme Court had upheld speech-compelling regulations that were "reasonably related" to protection against deception, but had not expressly limited regulation to that context.

insofar as they state this rule.[45] *NAM*'s invalidation of the conflict-minerals disclosure requirement did not expressly rely on the fact that it was unrelated to deception, however. The *NAM* court seemed most concerned that the disclosure requirement compelled an issuer "to confess blood on its hands"—that is, to make ideologically loaded statements about ethical responsibility for the Congo conflict.[46] The *AMI en banc* decision did not address that issue, nor did it expressly overrule the result in *NAM*. Thus objections to SEC disclosure regulations like those in *NAM* seem likely to remain viable.

IV. VOLUNTARY REFORM AND TITLE VII

Even if regulators were to impose therapeutic disclosure requirements (and they survived judicial scrutiny), race and gender parity on boards would ultimately depend on voluntary reform by corporations. In the UK, publicly traded companies have begun adopting voluntary policies recommended by a 2011 government-commissioned study.[47] For example, as of April 2013, 38 of FTSE 100 corporations had set targets for the percentages of women board members they aim to have by 2015.[48] Forty-seven executive search firms, which together "account for the vast majority of the Board work in the UK," have adopted a voluntary code of conduct, which includes a recommendation that the initial "long lists" of candidates they present to boards include at least 30% women.[49]

In the U.S., constitutional Equal Protection does not apply to nongovernmental actors, and thus would not govern voluntary affirmative-action policies in private corporations. Racial and gender discrimination in private employment is generally governed by Title VII, which protects employees and applicants for employment. Title VII thus may be the basis

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[45] American Meat Inst. v. U.S. Dept. of Agriculture *(en banc),* 2014 WL 3732697 at 3.
[46] 748 F.3d at 371.
[47] DEPARTMENT FOR BUSINESS, INNOVATION & SKILLS (UK), WOMEN ON BOARDS (April 2013), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/182602/bis-13-p135-women-on-boards-2013.pdf.
[48] *Id.*
[49] *Id.*

for discrimination claims by women or minorities who are underrepresented on boards. But it may also be the basis for claims that affirmative action in director nominations constitutes discrimination. Indeed, because affirmative action constitutes intentional conduct by management, the latter type of claim would probably be more likely to succeed.

Title VII may not apply in the directorship context, however. The Equal Employment Opportunity Commission's Compliance Manual states that "in most circumstances" directors and officers are not "employees" eligible for Title VII protection.[50] According to the Manual, the determination is not based on job title, but on a case-specific inquiry into "whether the individual is subject to the organization's control."[51] The Compliance Manual does not have the force of law, however. Indeed, it cites as authority a judicial opinion that had nothing to do with "whether the individual is subject to the organization's control." Rather, the case held that whether shareholder-directors of a professional corporation were employees depended on "the extent to which they manage *and own* the business."[52] Director status in a corporation does not in itself confer any ownership interest. Furthermore, even if sitting directors are not covered by Title VII, employees seeking nomination to the board may arguably be covered. According to the EEOC Compliance Manual, "[e]ven if someone in a particular position is not covered, consideration by an employer of its own employees for such positions may constitute a term, condition, or privilege of employment."[53]

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[50]EEOC COMPLIANCE MANUAL § 2-III.A.1.d., *Available at* http://www.eeoc.gov/policy/docs/threshold.html.

[51]*Id.*

[52] Devine v. Stone, Leyton&Gershman, P.C., 100 F.3d 78, 81-82 (8th Cir. 1996)(emphasis added). The case did not hold that the shareholder-directors at issue were not employees; it found only that the plaintiff had failed to make a sufficient evIdentiary showing to that effect for purposes of summary judgment. *Id.* at 82.

[53]*Id.* at n.77, citing *Hishon v. King & Spalding*, 467 U.S. 69 (1984). *Hishon* held that Title VII applied to a law-firm associate applying for partnership, even though law-firm partners are not considered employees under Title VII. In that case, consideration for partnership was part of the contractual relationship with the firm. Although that factor is unlikely to apply to

V. VOLUNTARY REFORM AND INTERNAL CORPORATE GOVERNANCE: THE ROLE OF SHAREHOLDERS

Voluntary reform by corporations would not of course be initiated by "corporations" per se; it would require individuals to exercise their corporate governance authority. Most likely, such reforms would have to be initiated by incumbent corporate boards. Shareholders' ability to influence corporate policy is limited. Their primary governance roles consist of electing directors and passing nonbinding proposals. Shareholders do have the ability to make binding amendments to corporate bylaws.[54] But state law gives directors power to set corporate policy,[55] and shareholder-enacted bylaws may not constrain directors' discretion over how to use this power in the best interests of the corporation. For example, one case rejected a shareholder-proposed byelaw that would require the corporation to reimburse successful shareholder-led director election campaigns. The court justified its decision by pointing out the unlikely possibility of a campaign that successfully elected directors whose election was not in the best interests of the corporation.[56] In such case, the court argued, the proposed rule would compel directors to reimburse a campaign that was contrary to the interests of the corporation. Thus the rule was improper because it *could*, in theory, require directors to violate their fiduciary duty. A shareholder-initiated byelaw requiring affirmative action in director nominations might be challenged under similar logic: rules requiring incumbent boards to follow quotas or to consider particular characteristics in making nominations might be challenged as

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a corporate employee who wishes to be nominated to the board,*Hishon* did not rule out other justifications for the application of Title VII to employees seeking non-employee positions.

[54]*See, e.g.,* Del. Gen. Corp. L. § 109(a).

[55]*See, e.g.,* Del. Gen. Corp. L. § 141(a) ("The business and affairs of every corporation...shall be managed by or under the direction of a board of directors....").

[56]*See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008). The court proposed the following rather far-fetched hypothetical: "if a shareholder group affiliated with a competitor of the company were to cause the election of a minority slate of candidates committed to using their director positions to obtain, and then communicate, valuable proprietary strategic or product information to the competitor," the mandate to reimburse the shareholder campaign would require directors to violate their fiduciary duty to the corporation.

potentially requiring directors to compromise their duty to select the candidates that best serve the interests of the corporation.

VI. VOLUNTARY REFORM AND JUDICIAL DEFERENCE TO DIRECTORS

Much of the discussion about diversity on boards focuses on claims about the supposed value of diversity to corporate profits, despite the inconclusive nature of the relevant data. There is some evidence that increasing the number of women on boards can increase profits, but the question is far from settled.[57] For example, at least one study suggests that, due to investor bias, female leadership might have a negative effect on a corporation's stock value.[58] Unfortunately, the very fact that so few women serve on boards makes it difficult to measure their effect on the bottom line directly.

In any case, the rhetoric of shareholder value is likely to continue to dominate the discussion of voluntary affirmative action policies, as it dominates corporate law and policy discourse generally. Because the business judgment rule defers to directors' decisions, corporate boards are under no enforceable *legal* duty to maximize share value. Nonetheless, economic pressure from the investment markets effectively requires corporations to justify their policies in bottom-line terms. Thus management often justifies corporate social responsibility projects on both social *and* economic grounds, under the mantra of "doing good while doing well." Affirmative action jurisprudence reflects this preference for justifying social-justice policies with bottom-line reasons. Prior to *Grutter v. Bollinger,* the only clearly constitutional justification for affirmative action was a social justice concern: the correction of specific acts of past discrimination. The notion that diversity concerns justify affirmative action had never commanded a Court majority until *Grutter*. *Grutter*did not frame diversity in social-justice terms, however. Rather, it suggested that diversity may have a bottom-line justification. Citing an amicus brief submitted by a number of multinational corporations, the Court

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[57]*See* Lynne Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1393 n. 181 (2002).
[58]*See* Joan MacLeod Heminway, *Sex, Trust and Corporate Boards*, 18 HASTINGS WOMEN'S L. J. 173, 185-86 (2007).

stated, "the skills needed in today's increasingly global marketplace can only be developed through exposure to widely diverse people, cultures, ideas, and viewpoints."[59]

While the focus on bottom-line justifications suggests a mercenary philosophy, the generous judicial deference given to those justifications suggests the opposite. That is, insofar as bottom-line justifications need not be proven, they may actually serve as rhetorical conventions for articulating social-justice concerns that cannot be explicitly stated due to the American squeamishness about acknowledging race and gender. While constitutional jurisprudence is not controlling in judicial review of voluntary affirmative action, it tends to set the tone for affirmative-action rhetoric generally. In particular, if Title VII applies in this context, courts may look to constitutional analysis for guidance. As noted above, the *Grutter*Court *deferred* to the law school's education-related justification for affirmative action, even while nominally applying strict scrutiny. Indeed, the benefits of diversity *Grutter*cited are—like the putative benefits of board diversity—nearly impossible to prove. *Grutter*may suggest that proof is unnecessary—at least where the Court trusts the decision maker's expertise.

As noted above, *Grutter*'s deference resembles the business judgment rule's deference to directors. A corporation would surely refer to the putative material benefits of diversity to defend an affirmative-action policy for director nominations. If shareholders were to challenge the policy, the business judgment rule would require a court to defer to management's justifications. That is, a court would not require the board to prove a business rationale for board diversity. (This reasoning might also influence the analysis if Title VII were to apply to boards' director nominations.)

The fact that courts might defer to affirmative-action policies is of course no guarantee that any given corporation will pursue such policies. Corporations are equally free to *refuse* to engage in affirmative action. In short, American law may *permit* voluntary affirmative action in director nominations, but corporations must take the initiative. Such initiative could be encouraged by enhanced therapeutic disclosure requirements (assuming

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[59]*Grutter,* 539 U.S. at 333.

they survive First Amendment scrutiny), and by informal pressure from shareholders, customers, politicians, and social activists—and of course by directors themselves.

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