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- Ashima Obhan & Akansha Dua, *Upside Sharing Structures in India- Evolution of the law and its downsides.*
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I. INTERNATIONAL CONCERNS AND INDIA'S NATIONAL ACTION PLAN (NAP) ON BUSINESS AND HUMAN RIGHTS: ISSUES AND CONCERNS*

Abstract

The implementation of Human Rights always (traditionally) was considered as the domain of the State, and therefore, the State is duty-bound to enact laws and build an environment to protect and preserve the human rights of all, especially the persons in dire need, marginalised and weaker sections of the society. We had seen exponential growth of the 'business sector' in the past decades. In fact, many of the Corporates annual profit margins are equivalent to or better than the Gross Domestic Product (GDP) of many nations. The business sector was always considered as the major stakeholders of the Society and, therefore, towards this goal, it is long desire to have a comprehensive National Action Plan (NAP) on Business Sector so that protecting human rights would not solely be the responsibility of the State and corporates should act responsibly towards the society. United Nations Guiding Principles on Business and Human Rights 2011 (UNGP) has provided a comprehensive framework to do so. There are three major pillars of this framework, the first pillar covers the State duty to

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protect Human Rights, whereas, the second pillar is about building corporate responsibility to respect Human Rights. The third pillar is about building a robust structure to provide access to remedy. The purpose of this research paper is to examine whether the above pillars are proving a guiding force for maintaining socially sustainable globalisation in the present global economic context. And, after elaborately analysing the NAP and UNGP guidelines on Human Rights, it was found that primarily, the purpose of the 'Business' is to extract maximum profit. And, any investment in protecting and preserving human rights of all, would certainly affect the profit margins of the Corporates, but businesses are run by human beings for human beings and therefore, National Action Plan (NAP) in this regard under the guidance of the UNGP, can act towards achieving human rights through the business sector. In this regard, in the first part, the author has traced the inter-connections between the business and the human rights, and thereafter in the second part, broad human rights issues are analysed which are affected by the corporates, and in the third part, rights and obligations of the corporates are discussed and examined in the light of National Action Plan on Business and Human Rights to analyse whether these are in consonance with appropriate and effective remedies when breached.

I. INTRODUCTION

Protecting Human Rights is an international concern and every nation-state is committed to preserve, protect and respect it. It is

evident that the growth of the human rights regime received impetus as a public policy after the Second World War. And, in this regard, both at national and international levels, commitments are made by the governments to enact and implement Human Rights through International Conventions and domestic legislations. Universal Declaration of Human Rights 1948 (UDHR) can be considered as an important 'International' stepping stone towards this direction. But, in the past four decades, the role of the 'State' is shrunken and the role of 'Businesses' grown up and they are now occupying much larger spaces.[1] Multinational Corporations are grooming and occupying mostly all the spaces in the present global economic environment and they necessarily work as a profit-generating mechanism only. The only motive of a business is to earn profits and therefore, how far it is justiciable to force them to pay towards human rights, for which otherwise state has the responsibility. The business sector, in fact, provides dignified living by providing 'work' and 'wages' to the people. And, if the state has the responsibility to protect and preserve the human rights of the individual then why there is a need to search for the connections between the business and Human Rights. The need arises because of the influence made by corporates in the lives of the people. It is

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[1] As per J Paul in "Holding Multinational Corporations responsible under International Law", Hast Int Comp Law Rev 24: 285 et seq, fifty two out of hundred biggest 'Economic Entities' of the world are corporations and only forty-eight are states.

essential to know that we are living in the consumer society, where almost all the products and services are provided by the private businesses and they are in constant touch with the society for every demand and supply and therefore, it is their duty to be socially responsible towards society and therefore, it is expected from them to build a healthy environment, where their activities would be in consonance with the requirements of the society, and, because they provide space to work, it is their foremost duty to provide workplaces which do not violate human rights norms of the workers working there, and simultaneously, there goods and services produce should also not violates the human rights of the people.

1. THE RELATION OF BUSINESS AND HUMAN RIGHTS IN INDIA

India is committed to inclusive development and works towards 'Collective Effort, Inclusive Development' and therefore, the realization of Human Rights is on the priority list of India. Indian Constitution carries a detailed list of Fundamental Rights, Directive Principles of State Policy, and provides for a robust independent framework of independent judiciary along with various human rights commissions in the states to monitor the human rights compliance. India had also, on the one hand, adopted measures to secure human rights of the vulnerable and marginalised population

by taking affirmative actions, and on the other hand, has taken a proactive stand in shaping 'Sustainable Development Goals' (SDGs) 2030, who had recognised 'Business Sector' as one of the most important partners in building human rights regime. In the past many years, the Indian judiciary effectively committed to providing recourse against bad business practices, where the human rights of the consumers suffered the most. For example in the Johnsons case (2018), the procedure of hip implants done by 'Johnsons and Johnsons Company' was found faulty and the 'Central Drugs Standard Control Organisation' (CDSCO) directed the company to pay Rupees 90.26 lakh and Rupees 1.01 crore to the patients from Uttar Pradesh (UP), India.[2] In this way, the health rights of the individuals were protected by the courts. Similarly, in Nestlé India's Maggi Noodles case also, it was found in the laboratory test, the Maggi noodles consist of the presence of monosodium glutamate which is dangerous for the human body. And, therefore, the court imposed Rupees Twenty Lakh fine. Here, again Courts had protected the rights of the individuals. In this way, it is seen that there is a strong need to build a corporate regime which follows

[2] The Economic Times, April 30, 2019.

human rights legislations. And, there is a need to check corporate behaviour through regulations and law.[3]

II. WHY MULTINATIONAL CORPORATIONS (MNCS) SHOULD FOLLOW HUMAN RIGHTS?: PHILOSOPHICAL INSIGHTS

The question is why MNCs should take responsibility on their shoulders for implementing Human Rights, needs detailed analysis, for which there are three models prevalent in the present times. As, per the first model, the corporates have no human rights obligations other than imposed on them by the state legislations. And, by following those laws the corporates are shredded off all their responsibilities. This model is now no more accepted and rather rejected by almost all the states, in fact, the corporations themselves are ready to fulfil human rights obligations. As per the second model, there can be a creation of voluntary-self codes to discipline oneself by the corporations. In this model, almost all the companies, irrespective of its size and strength, opted to self-regulate themselves by creating and following voluntary codes. And as per the third model, corporations have direct human rights obligations similar to that of nation-states and therefore, they should

[3] See Christopher Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics,* First Edition (Hart Publishing, Oxford and Portland, Oregon, 2015), p. 173.

be directly held responsible for promoting, protecting, and respecting human rights. Under globalisation, the role played by Multinational Corporations is shifting and therefore it is essential to re-examine the role of the business sector in the contemporary economic context and there is strong need to examine their role in the present global societies, keeping in mind the importance of contemporary 'Shareholder owned' businesses especially corporations, in shaping the international business environment.[4] It is essential to know that in the present times, the corporates, especially, multinational corporates are acting like governments.[5] Peter Drucker argues people start depending upon the corporation for their living.[6] And, for Charles Derber, corporations are 'a nation within a nation'[7] and he observes the beginning of a 'world-wide' civilization. The distribution of work and wealth is in the hands of the corporations. In fact, the decisions taken by the corporation has a huge impact on the lives of the people. They are influencing each and every part of the lives of the individual. They are determining the character of the society. For Noreena Hertz, the corporates are

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[4] See Wesley Cragg (ed.), *Business and Human Rights,* First Edition (Edward Elgar, Cheltenham, UK, 2012) p. 3.
[5] See Florian Wettstein, *Multinational Corporations and Global Justice: Human Rights Obligations of a Quasi-Governmental Institution,* First Edition (Stanford University Press, 2009), p. 213.
[6] Peter Drucker, *The New Society: The Anatomy of the Industrial Order,* (New York, Harper and Row, 1949), p. 44.
[7] Charles Derber, *Corporation Nation: How Corporations are taking over our Lives and what we can do about it,* (New York, St. Martin's Griffin, 1998), p. 54.

silently taking over human beings.[8] Corporates have fostered the culture of Materialism and consumerism. Corporates are working on 'networked capitalism'[9] also and by this, they have extended their presence globally. And now, because they have a global presence, and because they are influencing the lives of the people it is essential to build a robust framework to interconnect business with human rights.

III. UNITED NATIONS INITIATIVE TOWARDS BUILDING SOCIALLY RESPONSIVE CORPORATES

United Nations Commission on Human Rights (UNCHR) in 2005 had passed a resolution by forty-nine votes to three, with a request to the United Nations Secretary-General to appoint a Special Representative for 'Human Rights and Transnational Corporations and Other Business Enterprises'. The resolution was passed after detailed discussions with all the stakeholders, especially in the business sector. The norms on the Human Rights Responsibilities of Transnational Corporations and Other Business Enterprises were adopted in August 2003 after the expert advice provided by the UN Sub-Commission for the Promotion and Protection of Human

[8] See Noreena Hertz, *The silent takeover: Global Capitalism and the death of Democracy,* First Edition (London, William Heinemann, 2001).

[9] Contemporary businesses are restructuring their organisation in a way so that their activities be spread in various countries of the world for tax incentives and maximization of profits. And in this way they are plundering the resources of the other nations also at a meagre cost.

Rights. The norms were based on the idea that it is the State who has the primary duty to protect the human rights of the individuals, and because the business sector works as an important organ of the society, it should also protect and promote 'Human Rights'. It was challenged throughout, that how can Corporations be directed by international law to secure human rights, as they are not subjects of international law. Even otherwise, these norms were seen as competing with the other UN flagship program, Global Compact, which was proposed by Kofi Annan in 1999 and which was promoting Corporate Social Responsibility by way of setting voluntary codes. In fact, more than 2000 companies were delisted from the webpage of Global Compact because of the failure in complying with the prescribed reporting requirement.[10] UNGP has developed certain guidelines to be followed by the Corporates, for protecting, promoting, and respecting human rights.[11] Generally speaking, the 'Business Sector' can easily protect human rights by following laws of the country, where they are executing various tasks and activities, which includes 'performing positive obligations towards the implementation of Human Rights'. One of the positive

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[10] Surya Deva and David Bilchitz, *Human Rights Obligations of Business: Beyond the Corporate Responsibility to Respect?,* First Edition (Cambridge University Press, 2013), p. xvi and xvii.

[11] To fulfil the objectives of the UNGP's 'Guiding Principles on Business and Human Rights' special representative of the Secretary-General had developed a broad policy framework, "Implementing the United Nations 'Protect, Respect and Remedy' covering issues related to businesses inclusive of transnational corporations and human rights. The Human Rights Council (HRC) endorsed these principles vide resolution no. 17/4 of 16 June 2011.

obligations to be followed by the 'Corporates' is to follow the environmental standards of the nation as is provided in their laws. Sustainable development can only see a day when all the business practices are inclusive of following the environmental norms 'honestly'. Similarly, the human rights of the laborers can only be protected, when the 'Corporates' would follow the best practices. But these are two different things, 'Corporates should follow the laws' and 'the laws followed by the Corporates', and therefore, it is essential to see how 'Access to Remedy' is available to the stakeholders in case of violation of human rights by the 'Corporates'. Due to huge difference in theory (presence of the laws) and practice (following of the Laws) by the Corporates, it is essential to follow certain standard principles which would provide the framework for the effective implementation of human rights norms, inclusive of 'access to remedy' in case of violations of the Law. The best part of these guiding principles is that they apply to each and every business, irrespective of their size, sector, business structure, location, and ownership. There are various ways by which Corporates can protect human rights, such as, by way of Corporate Social Responsibility (CSR), following labour laws, Self-regulations, etc.

IV. BUSINESS AND HUMAN RIGHTS: INTER-CONNECTEDNESS

There is always the presence of a strong relationship between business and human rights. This can further be gauged by the fact that for fulfilling basic necessities of life, people tend to work in Companies and enterprises and therefore, it is essential to protect, promote and preserve the rights of the persons at workplaces. Though, in the recent past, we had seen irresponsible activities from the Corporates such as, violating environmental norms by the Real-Estate Developers, which was responsible for causing huge environmental blunders, violation of the tax norms by the big multi-national companies, investment of the big corporate houses in the tax haven nations[12], etc. Milton Friedman is of the view that the function of the corporate executive is to generate profits for the Corporates as per the desire of the employer and for this, the Corporates should adhere to the 'basic rules of the society' found in both 'law' and 'ethical custom'.[13] Even Friedman is of the opinion that the corporation's conduct should be subject to ethical standards. The passing of the UN Resolution of guiding principles on Business and Human Rights in 2011 provides detailed guidelines to be followed by the Corporates as they are the important organs of the state.

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[12] Read Ritu Sarin, Jay Mazoomdaar and P. Vaidyanathan Iyer, *The Panama Papers: The Untold India Story of the Trailblazing Global Offshore Investigation,* First edition, (Penguin, 2019).

[13] Milton Friedman, "The Social Responsibility of Business is to Increase its Profits', New York Times Magazine, 13 September 1970, p.1.

1. SIGNIFICANT DEVELOPMENTS AFFECTING THE RELATIONSHIP BETWEEN BUSINESS AND HUMAN RIGHTS

There are significant developments that have taken place in the past three decades, both at the organisational level and technological level. At the organisational level, corporations are establishing complex web of networks such as use of various business models to bypass the tax nets of the nation-states, by using tax havens and using different business arrangements, such as contract manufacturing, commissionaire agreements, etc. Similarly, at the technological level, the internet has intensified the pace of the Corporates, and there are various business models based on the internet, such as E-commerce, the growth of the virtual world, had favorably affected the growth of the Corporates. But, at this pace for profits, the Corporates had started ignoring the human rights of the persons, which need to be checked. In contemporary times the questions are not whether Corporates had the obligation to check the human rights issues? But, now the pertinent question is, how do they do it, and with whom they should collaborate for achieving the goal of preserving and protecting human rights.

With the working and running of the business, on the one hand, jobs and wages are available to the individuals, and on the other hand, by imposing a tax on the income of the Corporates, the nation-states would receive revenue for financing the welfare

activities of the government. In this way, one cannot ignore the role played by the Corporates in implementing human rights. The whole list of essential rights, such as the right to work, right to food and shelter, right to health, right to education, right to freedom of speech and expression, association and movement, etc. are supported by the Corporates. In this way, the corporations are the most essential component of present-day life, especially in urban settlements. But, there are certain corporations who work against the spirit of humanity and therefore, are responsible for causing human rights violations, instead of protecting them. There are Corporates, which treat their workers very badly and force to them to work in unhealthy conditions. Similarly, there are businesses, which are responsible for causing environmental pollution, as they are discharging industrial waste either on the land or on the rivers such as, Ganga or Yamuna. In fact, the Corporates discriminate against the marginalised persons, Scheduled castes, Scheduled tribes, certain ethnic or religious groups, Persons with disabilities, against women, etc.

V. PARADIGM SHIFT IN THE ROLE OF CORPORATES

Bhopal gas tragedy can be termed as a turning point in Indian context towards creating Responsible Businesses[14], as it led

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[14] See Surya Deva, *Regulating Corporate Human Rights Violations: Humanizing Business,* First Edition (Routledge, 2012), p.1. Surya Deva has used the term 'Humanizing' in the

to the death of more than three thousand people. Methyl isocyanate was leaked along with other highly toxic gases from the plant of Union Carbide India Ltd. (UCIL), and therefore this incident is also known as the symbol of 'Inhumane Business'[15]. Though there are certain political scholars such as Atul Kohli, according to whom, the Indian State in the past four decades becomes more pro-business[16]. But, the present trend shows a shift in the policies of the Multinationals. There is an evolution going on. The corporations had started following the multi-stakeholders approach.[17] They are no more hovering around the debate, whether it is their duty to fulfil human rights obligations or not? The Corporates had acknowledged the fact that they have to engage with the issues pertaining to human rights in the right perspective and have to work with external stakeholders. Though, despite the paradigm shift, it is yet not clear, how the businesses would usher their responsibility of implementing 'Human Rights'. One of the ways by which the Corporates can

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context of changing the nature of business by injecting in it 'human rights'. And, for this precise reason, he advocated for the promotion of 'responsive businesses' towards society.

[15] The term 'Inhumane Business' was used by Surya Deva while describing the Bhopal gas tragedy and to explain how the multinational corporations, blatantly violates the human rights obligations and also thereby evade the accountability towards the society by manoeuvring the laws and regulations of the State.

[16] Atul Kohli, *Poverty Amid Plenty in the New India,* First Edition (2012, Cambridge University Press), p. 19. Also see, Christophe Jaffrelot, Atul Kohli and Kanta Murali, *Business and Politics in India,* First Edition (2019, Oxford University Press). It is argued that the Indian State's commitment towards socialism is replaced in the contemporary context with the promotion of businesses, especially, private enterprises.

[17]Dorothee Baumann-Pauly and Justine Nolan (ed.), *Business and Human Rights: From Principles to Practice,* First Edition (Rutledge, 2016), P.31.

implement human rights is by diligently following the domestic laws of the land and submitted to the local judicial recourse. But the problem is not whether the Corporates would follow the laws or not. The actual problem is the laws in most of the developing countries are either very weak and not up to the mark or are affected by institutional integrity. That is why, for the purposes of implementation of Human Rights, it's not safe to rely on host nations. It is precise because of this reason, the multi-stakeholder approach is proposed. For example, for the successful implementation of human rights legislation, the cooperation of Corporates with Non-governmental Organisations (NGOs) State Governments and International Institutions (such as International Labour Organisation, ILO), Trade Unions, is necessary as it would help in protecting the workers/ labourers.

VI. NATIONAL ACTION PLAN (NAP)[18] ON BUSINESS AND HUMAN RIGHTS: INDIAN INITIATIVE TOWARDS BUILDING 'RESPONSIBLE BUSINESSES'

The State formulation of National Action Plans has resulted in the offshoot of or response to UN Guidelines on Business and Human Rights (2011). European Union, in 2011, asked member states to soon form NAPs to have socially responses business

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[18] The Zero Draft of National Action Plan on Business and Human Rights was prepared on 10th December 2018 by the Ministry of Corporate Affairs, Government of India.

sector. Soon the UN Human Rights Council (UNHRC) in 2014 in India followed suit.[19] NAP would achieve success as it works holistically in building a human rights environment. The Indian NAP on protecting 'Human Rights' through business revolves around Corporate Social Responsibility as basic edifice, and the same can be achieved through taking various measures such as, *firstly*, by building business responsibility of reporting framework of the SEBI, *secondly*, providing processes of protecting whistleblowing and creating an institutional structure for protecting whistle-blowers, *thirdly*, creating provisions for nonfinancial reporting framework, *fourthly*, preventing harassment of women at the workplace by building protective environment, and *fifthly*, building broader policy framework for regularly monitoring fair wages to the workers. There cannot be a possibility of an exhaustive list covering all the duties and obligations of the Corporates towards society.

1. PILLAR I – THE STATE DUTY TO PROTECT HUMAN RIGHTS

India is committed to protecting Human Rights, which can easily be gauged from the fact that India is a signatory to almost all the International Conventions related with the Human Rights, inclusive of International Covenants on both Civil and Political Rights (1966) and Economic Social and Cultural Rights (1966).

[19] Human Rights Council, 'Human Rights and Transnational Corporations and Other Business Enterprises', A/HRC/RES/ 26/22 (15 July 2014).

Similarly, India is also a party to Conventions on Elimination of All Forms of Discrimination against Women (1979), Rights of Child (1989), and Persons with Disabilities (2006). And, to fulfil the commitments, India has built a robust legal framework, starts from the constitutional framework providing Fundamental Rights, which are justiciable in nature. Judiciary had already interpreted Article 21 of the Constitution of India in a much wider way to include various other human rights also under it, such as the Right to Clean Environment, Right to Work, etc. Companies Act as discussed above was enacted with special provisions to promote corporate social responsibilities. And, it was a mandate for the corporates to work for the social activities beneficial for the society, such as work towards creating the hunger-free world, promoting education, gender quality, ensuring a sustainable environment, protecting national heritage, rural and slum development projects, etc. Various regulators are also created by the Government such as, National Financial Reporting Authority (NFRA) which is aimed to monitor and regulate accountancy standards. Similarly, the above measures are supplemented with National Voluntary Guidelines (NVGs) on Social, Environmental and Economic Responsibilities of Business 2011 and National Guidelines on Responsible Business Conduct (NGRBC) 2018. Interestingly, 'Human Rights Due Diligence' is included in Principle 5 of the NGRBC 2018. Indian Government is because committed to protect human rights, therefore, had enacted

various laws towards implementing Human Rights, such as, to protect Environment, Environment (Protection) Act 1986, Water (Prevention and Control of Pollution) Act, 1974, Air (Prevention and Control of Pollution) Act, 1981, The Noise Pollution (Regulation and Control) Rules, 2000, etc. are enacted. Similarly, different Regulatory bodies are also created to protect the environment such as the Central Pollution Control Board (CPCB). Similarly, Labour laws are enacted to protect workers and for securing the rights of women. A number of legislations are enacted in past decades, such as the 'Protection of Women from Domestic Violence Act 2005',[20] 'The Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act 2013'[21]. There are various other vulnerable persons or groups, such as, Children, Persons with Disability, Scheduled Castes and Scheduled Tribes, for whom the government has enacted laws. By way of Consumer Protection Act 1986 rights of the consumers are protected and by Competition Act 2002 fair competition is promoted. To promote transparency and accountability, the Government had launched in August 2018, Government e-Marketplace (GeM), which can be considered as National Public Procurement Portal (NPPP).

[20] The act was enacted to protect the women from domestic violence.

[21] The act was the outcome of *Vishaka and others vs. State of Rajasthan and Others* AIR 1997 SC 3011.

2. Pillar II – Corporate Responsibility to Respect Human Rights

National Voluntary Guidelines (NVGs) on Social, Environmental and Economic Responsibilities of Business 2011 and National Guidelines on Responsible Business Conduct (NGRBC) 2018 were set out to create Socially Responsible Business. The purpose of NVGs was to set the highest standards of corporate governance. It is evident from the fact, now the expectation from the businesses increased in past decades, and, through NGRBC 2018, it is expected from the businesses to shift from 'the minimum compliance' to set 'the highest standards' on conduct and performance of businesses in India. There are nine principles adopted by NGRBC 2018, Businesses,

Firstly, should work with integrity,

Secondly, as far as possible, provide sustainable delivery of goods and services.

Thirdly, should build an environment conducive for all the employees including employees in the value chains.

Fourthly, should be respectful and responsive towards all the stakeholders.

Fifthly, should respect and promote Human Rights

Sixthly, should make efforts to restore the environment

Seventhly, should while in engagement with public and regulatory bodies behave in a transparent and responsible manner.

Eighthly, should work towards the promotion of inclusive growth and equitable development.

Ninthly, should value their customers.

In this way, a self-regulatory code is created to be followed by the 'Businesses' to promote human rights.

3. PILLAR III – ACCESS TO REMEDY

Access to remedy is the most important pillar of the National Action Plan. In India, there are various Redressal mechanisms created to tackle different types of human rights issues. Supreme Court of India and High Courts through their writ jurisdiction enforce fundamental rights. Supreme Court has the power to do complete justice. There are various tribunals, such as, National Green Tribunal, which exclusively looks after the cases related to the environment. Similarly, there is various specialised commission which works for the specific groups such as, National Commission for protection of Child Rights (NCPCR) for protecting child. There are Labour Courts to adjudicate labour disputes. Legal Aid is also provided to persons in dire need. In this way, the Indian National

Action Plan on Business and Human Rights is promoted. But, there are various issues left unattended in this action plan, such as the role of regulatory bodies in promoting human rights. How regulators should regulate the businesses? What are the other effective means to promote human rights? Interestingly, these voluntary guidelines make no case for human rights for businesses, due to a lack of sanctions.

VII. CONCLUSIONS

Business in any sector adversely affects human rights.[22] And, there are two predominant trends going on at the international level, *first*, almost all the governments across the globe started forming policy document, National Action Plans (NAPs) on business and human rights, which are created to implement United Nations Guiding Principles on Business and Human Rights (UNGPs), *second*, now there is a demand for 'mandatory measures' while addressing human rights violations related to businesses.[23] This trend clearly shows that sooner, businesses have to enforce human rights obligations. National Action Plan on Business and Human Rights in this regard is a welcome step. Especially, in developing states like

[22] See Robert Stumberg, Anita Ramasastry and Meg Roggensack, "Turning a Blind Eye? Respecting Human Rights in Government Purchasing: Turning a Blind Eye?", The International Corporate Accountability Roundtable (ICAR), September 2014, p. 1.

[23] Sara Blackwell; Nicole Vander Meulen, "Two Roads Converged: The Mutual Complementarity of a Binding Business and Human Rights Treaty and National Action Plans on Business and Human Rights", 6 Notre Dame J. Int'l Comp. L. 51 (2016).

India, which has one of the biggest markets of the world and where the Corporates are creating their space like never before. Corporates are influencing the daily lives of the people in multifarious ways, and therefore, it is essential to have laws regulating their behaviour. In this regard, it is essential to know that the businesses, especially MNCs are by their own, ethically disciplining their conduct either by following self-voluntary codes or by following the laws made to regulate their behaviour, which can be a possibility only when they preserve and protect the human rights of the human beings. NAP provides detailed code for bridging the Corporates with that of human rights. For building socially responsible business, it is essential to work firstly, on Corporate Social Responsibilities (CSR). India is one of the nations, which had included CSR within the statutory framework of the Companies Act 2013.[24] National Action Plan on Business and Human Rights is a big step in the right direction and only time will tell its success.

[24] As per Section 135 of the Companies Act 2013, there is a mandate that companies should spend minimum 2 per cent of their profits annually on CSRs. And for this, Companies (Corporate Social Responsibility) Rules, 2014 were formed along with Schedule VII, which provides for mandatory provisions to be followed by the Companies to fulfil CSR.

II. <u>UPSIDE SHARING STRUCTURES IN INDIA – EVOLUTION OF THE LAW AND ITS DOWNSIDES</u>*

Abstract

The following paper aims to provide an insight into the background of the upside sharing structures in India and how the applicable law around the same has evolved. The Paper is divided into the following sections:

- *Introduction – What are Upside-Sharing Agreements?;*
- *How the upside-sharing structure came under the microscope in India?;*
- *SEBI's Points of Concerns;*
- *The Amendment;*
- *Extant Position;*
- *Applicability of the Amendment;*
  - *<u>Accelya Kale Solutions Limited</u>*
  - *<u>Mphasis Limited</u>*
  - *<u>PNB Housing Finance Limited</u>*
- *Specific Downsides of the Amendment; and*
- *Conclusion.*

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*The Paper discusses a significant amendment in the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015, that took place in 2017 ("**Amendment**") and the associated downsides for the listed entities and its stakeholders. The Paper also sheds some light on the on-ground implementation of the Amendment by different entities in India and the issues faced by them. Each case is followed by the response from the Securities and Exchange Board of India ("**SEBI**") which was given keeping in mind the facts of the relevant case.*

The Paper concludes with a brief analysis of the Amendment and its impact on a larger scale.

I. INTRODUCTION – WHAT ARE UPSIDE-SHARING AGREEMENTS?

Upside-sharing agreements, commonly also known as incentive fee arrangements and earn-out structures, imply arrangements entered into amongst promoters or key employees of a company and an investor reflecting the understanding that a certain share of profits on the investment made by the investor at the time of his exit will be shared with these individuals. Such agreements act as incentive instruments for the employees and/or management of the companies. In almost all cases, companies are not privy to such

arrangements, and therefore, no obligations are undertaken by such companies.

The upside-sharing arrangements may form part of an employee stock option plan adopted by the company, or a shareholders' agreement or employment agreement where the company itself is also a party. Usually though, as the concerned company is not a party to the agreement, the compensation is not charged to or recoverable from the company itself. Moreover, such a transaction is not reported within the realm of related party transactions amongst the company and its management or controlling shareholders.

II. HOW THE UPSIDE-SHARING STRUCTURE CAME UNDER THE MICROSCOPE IN INDIA?

It all started with the issue of a show-cause notice to PVR Limited (**PVR**) in November 2016 by the Securities and Exchange Board of India (**SEBI**) highlighting violations of corporate governance and disclosure-related norms and the code of conduct for board members on account of non-disclosure of relevant information. SEBI also sought a justification as to why such an agreement was not unveiled to the company's shareholders at the point of execution.

Mr. Ajay Bijli, Managing Director and Chairman of PVR, had entered into an incentive fee agreement with a private equity investor in PVR, wherein it was agreed that profits at the time of the investor's exit in the future will be shared with him. The arrangement was not disclosed to the shareholders or the stock exchanges based on the premise that any future payments that may be made would not be made from PVR's books and hence no disclosure was required.[1]

Thereafter, on December 29, 2016, PVR informed SEBI that Mr. Bijli had entered into agreements with Multiples Private Equity Fund and L Capital. PVR also informed SEBI that pursuant to the reward agreements, reward mechanisms were set up to incentivize Mr. Bijli for exceptional performance, where such incentive was linked to the creation of shareholder value as reflected by the share price of the company.[2] In the said case, a negotiated settlement took place between SEBI, Mr. Bijli and PVR through a consent order.

Thereafter, multiple instances of private equity funds executing compensation agreements with promoters, directors, and key

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[1] Secret pact helps PVR's Bijli earn 'profits', DNA India, https://www.dnaindia.com/business/report-secret-pact-helps-pvr-s-bijli-earn-profits-2142866.

[2] PVR CEO Ajay Bijli settles securities market related violation with SEBI, Economic Times, January 5, 2018, https://economictimes.indiatimes.com/markets/stocks/news/pvr-ceo-ajay-bijli-settles-securities-market-related-violation-with-sebi/articleshow/62383668.cms?from=mdr.

managerial personnel of listed investee companies, based on the performance of such companies came to the forefront.

III. SEBI'S POINTS OF CONCERNS

SEBI noted that incentive fee arrangements or upside sharing agreements, executed without the shareholders' prior approval, led to unfair practices and therefore demanded regulation. In SEBI's view, any such agreement not only gives promoters and/or management encouragement to act on a short-term basis but also incentivize promoters and/or management to act in their personal interest rather in the larger interest of the company and the public shareholders. SEBI highlighted these concerns in the consultation paper titled "Corporate Governance Issues in Compensation Agreements" released by SEBI dated October 4, 2016[3] (**Consultation Paper**).

Two views were taken into consideration by SEBI to address the foregoing concerns – one view was that there should be no place at all for such side agreements in case of listed companies. While the other (and the more popular) view was that focus should be placed on the principle of disclosure and transparency in the governance of listed entities. The Consultation Paper invited public comments on

[3] Consultative Paper - Corporate Governance Issues in Compensation Agreements, SEBI, https://www.sebi.gov.in/sebi_data/attachdocs/1475575683683.pdf.

the possible amendments to the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (**Listing Regulations**).

Subsequently, SEBI received a mixed bag of comments and suggestions by 12 entities (9 advocates/law firms, 1 company secretary, 1 listed entity, and 1 individual entity). Out of the 12 responses, 7 entities agreed to SEBI's proposal and 5 expressed reservations. Approval of the board of directors and/or disclosures was considered enough in a few responses. However, other commentators suggested that voting on resolutions should be made a special resolution instead of an ordinary resolution for transactions beyond a certain prescribed threshold. A few responses that were received were against the idea of need to regulate such arrangements backed up by the premise that such arrangements could incentivize employees and/or directors and/or key managerial personnel to enhance shareholder value and that it is a common practice in various jurisdictions.[4]

IV. THE AMENDMENT

In view of the above context, after seeking public comments, on November 23rd, 2016, SEBI approved an amendment to Regulation 26 of the Listing Regulations, by the insertion of Regulation 26(6)

[4] Corporate Governance Issues in Compensation Agreements, SEBI, https://www.sebi.gov.in/sebi_data/meetingfiles/1481180931118-a.pdf.

("**Amendment**")[5]. The Amendment was notified on January 4, 2017. With the introduction of the Amendment, SEBI has come to terms with regulating all such arrangements by bringing them under the approval-based regime of its shareholders. The Amendment requires each company to obtain prior approval from the board of directors and public shareholders before executing compensation arrangements and disclose previously entered agreements. It also placed a bar on interested parties to vote on these approvals.

V. EXTANT POSITION

Summarized below is the current position with respect to the execution of upside sharing agreements by listed companies in India subsequent to the Amendment:

- New Upside Sharing Agreements: Any new agreement between an employee, including any key managerial personnel or director or promoter of a listed company, and a shareholder or third party with regard to compensation or profit sharing in connection with dealings in the securities of such listed entity would require prior approval from the board of directors of the concerned listed company and public shareholders of the listed company through an ordinary resolution. Public shareholders

[5] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Third Amendment) Regulations, 2016, SEBI, January 4, 2017,https://www.sebi.gov.in/sebi_data/attachdocs/1483605829638.pdf.

mean all shareholders of the listed entity excluding promoters and entities and individuals in the promoter group.

- Existing Upside Sharing Agreements: The Amendment mandated that in order to remain valid and enforceable, upside sharing agreements existing as on the date of the Amendment should be approved at the next meeting of the board of directors. Subsequent to the board's approval, all such approved existing agreements were to be placed before the public shareholders for approval by way of an ordinary resolution in the next general meeting of the listed company.

- Disclosure of existing Upside Sharing Agreements: The Amendment further requires that subsisting agreements, whether subsisting or expired, entered during the preceding three years from the date of the Amendment (i.e. executed in the past 3 years prior to January 4, 2017) are required to be disclosed to the stock exchanges for public dissemination.

The Amendment clarified that all interested persons involved in the transaction covered under the underlying agreement shall be ineligible to vote in the general meeting. Interested persons will mean any person holding voting rights in the listed company who is, any manner, whether directly or indirectly, interested in an agreement or proposed agreement, entered into or to be entered

into by such a person or by any employee or key managerial personnel or director or promoter of such listed entity with any shareholder or any other third party with respect to compensation or profit-sharing in connection with securities of such listed entity.

It can be seen from the above that SEBI does not prohibit upside sharing agreements. Its sole objective behind the Amendment was to ensure transparency and to regulate such arrangements so that they do not lead to unfair practices. One of the most organic consequences of the Amendment is that it takes away the promoters' and the investor's flexibility to strike deals that could be material to enhance profitability of the company. The Amendment takes away considerable flexibility that was available to the investor community to construct effective compensation structures. It will be interesting to see how this regulation pans out in terms of investor and employees' flexibility in the future investments made in listed entities.

VI. APPLICABILITY OF THE AMENDMENT

A few interesting cases were brought to light post introduction of the Amendment where clarifications were sought from SEBI regarding the applicability of the Amendment to such cases. The same are discussed below:

1. ACCELYA KALE SOLUTIONS LIMITED

Accelya Kale Solutions Limited ("**AKSL**")[6] had requested informal guidance from SEBI regarding the applicability of Regulation 26(6) to the facts of their case. AKSL is part of the Accelya group of companies, which operates across a number of countries. 74.66% shares in AKSL are indirectly held by Accelya Holding (Luxembourg) S.A. ("**Accelya Luxembourg**"), which is in turn is held by a private equity fund, Chequers Capital XV FPCI ("**Chequers**"). As a part of their global programme, several senior managers of the Accelya group, including those of AKSL, subscribed to shares and convertible preferred equity certificates ("**Securities**") of two offshore group companies. In 2014, the global senior managers entered into sale agreements as per which they were required to sell the Securities in the offshore group companies to Accelya Luxembourg. The payment for such a sale was required to be made in three tranches. While the first two tranches of payments were made to the selling senior managers in 2014 and 2016, the final tranche was to be paid on the occurrence of an 'exit event', which was when Chequers exits from its investment in the Accelya group. The deferred consideration, i.e. payment for the third tranche, was to be paid in accordance with a value that was linked to the sale consideration as part of the exit event. Such deferred consideration

[6] SEBI, May 12, 2017, https://www.sebi.gov.in/sebi_data/commondocs/aug-2017/AccelyaKaleResponse_p.pdf.

was to be paid to Mrs. Neela Bhattacharjee, the Managing Director of AKSL. The primary question that arose in this context was whether the payment of the deferred consideration would fall afoul of Regulation 26 (6) of the Listing Regulations.

SEBI in its response reiterated that Regulation 26(6) pertains to restriction on employees including key managerial personnel or director or promoter of a listed entity entering into agreements for himself or on behalf of any other person, with any shareholder or any third party with regard to compensation or profit sharing in connection with dealings in the securities of such listed entity. In light of the facts of the case and the legal provision, SEBI opined in the said case that the 'deferred consideration' in the application pertains to the third and first tranche of the purchase price of securities which are not of the listed entity in India and therefore, the provisions of Regulation 26 (6) were not attracted in this case. Secondly, the 'additional deferred consideration' in the application pertains to the third and final tranche of the purchase price of those securities which were that of the listed entity in India and thus, the provisions of Regulation 26(6) were not applicable in this case. Therefore, since the compensation was linked to the securities of the group as a whole, which included unlisted entities, Regulation 26 (6) was held to be of no applicability thereto. The said opinion given by SEBI suggested that so long as the securities in question do not

relate to the listed company, profit-sharing arrangements may be permissible.

2. MPHASIS LIMITED[7]

Straying remarkably from the Accelya case, SEBI in the case of Mphasis Limited offered a rather comprehensive view of Rule 26 (6) of the Listing Regulations and clarified that it will be applicable to employees of any unlisted subsidiary of a listed entity. In the said case, Hewlett Packard Enterprise ("**HPE**"), through its wholly-owned subsidiaries ("**EDS**") entities, was the owner of a controlling stake in an Indian listed entity, Mphasis. In 2016, the EDS entities sold off their entire shareholding in Mphasis to the Blackstone Group. HPE had, prior to its exit, issued certain incentive letters to a few eligible employees of Mphasis and its wholly owned unlisted subsidiaries, according to which, HPE had agreed to make payments to eligible employees in certain situations, including HPE's exit, retention payment for remaining in employment for one or two years following HPE's exit, and severance payment in case of termination of employment without cause prior to completion of two years from HPE's exit. HPE sought SEBI's opinion on the applicability of the Amendment in respect of the payments that

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[7] SEBI, July 19, 2017, https://www.sebi.gov.in/enforcement/informal-guidance/oct-2017/informal-guidance-in-the-matter-of-mphasis-limited_36310.html.

were to be made by HPE to eligible employees of Mphasis's unlisted subsidiaries.

In its informal guidance, SEBI amplified the extent of the Amendment, which clearly applies only to listed Indian companies, and opined that any payments to eligible employees of unlisted subsidiaries of Mphasis would fall under the scope of the Amendment.

3. PNB HOUSING FINANCE LIMITED[8]

In 2009, Destimoney Enterprises Limited, Mauritius ("**DEL-M**"), through its Indian subsidiary, Destimoney Enterprises Limited ("**DEL-I**") acquired a non-controlling stake in PNB Housing Finance Limited ("**PNBHFL**"). DEL-I's principal assets were shares of PNBHFL. In 2005, Del-M's holding in Del-I was bought by a company based in Mauritius, Quality Investments Holdings ("**QIH**"). In appreciation of the tremendous returns received by DEL-M from the said sale, DEL-M decided to make ex-gratia payments to senior management of PNBHFL. Having initially put in on hold, Del-M revived this proposal when PNBHFL got listed in November 2016.

[8] SEBI, September 6, 2017, https://www.sebi.gov.in/sebi_data/commondocs/dec-2017/PNBinformalguide_p.pdf.

It was contented by PNBHFL that since the shares of Del-I were transferred from Del-M to QIH in 2015 (when PNBHFL was unlisted, and prior to the date of the Amendment), there was no direct dealing in shares of PNBHFL by Del-M or by Del-I. However, SEBI was of the opinion that the proposal to make payments was revived when PNBHFL had got the listing, and Regulation 26(6) of the Listing Regulations was effective. Accordingly, PNBHFL would require approval from its board and shareholders before accepting ex-gratia payments from Del-M.

VII. SPECIFIC DOWNSIDES OF THE AMENDMENT

While the Amendment ostensibly applies only to listed companies to check possible instances of violations of corporate governance norms, it could have implications for IPO-bound companies, according to legal experts[9]. Summarized below are the specific negative implications of the Amendment:

- One of the provisions of the Amendment that received significant criticism from different stakeholders was inclusion of all employees, including key managerial personnel or director or promoter under the scope of the Amendment. It is important to

[9] Profit-sharing agreement norms may be a hurdle for PE-backed firms' IPO plans, livemint, January 30, 2017, https://www.livemint.com/Money/W9VhqDUhorNokBJXXeBM7N/Profitsharing-agreement-norms-may-be-a-hurdle-for-PEbacked.html.

highlight here that all employee stock option plans issued under the SEBI (Share Based Employee Benefits) Regulations, 2014 are already subject to shareholders' approval by a special resolution. Any other employee benefit or incentive plan that is contracted by employees may also attract shareholder approval requirement under Regulation 26 (6) of the Listing Regulations even in cases where the beneficiaries are not key managerial personnel or promoters etc.

- The next anomaly under the Amendment is its broad scope that covers compensation or profit-sharing in relation to dealings in securities or otherwise. It is said that SEBI contemplated two specific rewards under Regulation 26 (6). The investors could agree on the particular condition where the rewards payment gets attracted upon sale of the investor's shareholding in the listed company and profit-making, over and above a pre-determined threshold. Commonly, these arrangements are associated with the internal rate of return that the investors may make at the time of exit from the listed company. In the alternate, the investors may also reward the employee of the listed company by stipulating a fixed amount of compensation which gets triggered upon fulfillment of certain conditions

mentioned under the agreement. For example, the parties to compensation agreement may agree that if the employees stay in the investee organization for a certain amount of time, or upon achievement of a certain turnover level or amount of net worth or profit, the investor will reward the employee with a fixed amount. It is evidently clear that SEBI intended to cover all types of arrangements, be it security based or otherwise within the ambit of the Amendment thereby leaving the investors with least flexibility whatsoever.

- Further, as mentioned above, the Amendment requires that approval of the "public" shareholders is required for any agreement meeting the requirements of Regulation 26 (6) and entered into subsequent to the Amendment coming into effect. It is fairly understood from a corporate governance perspective, that interested persons are excluded from casting a vote on incentive fee arrangements or upside-sharing arrangements. However, the Listing Regulations, in their current form, presume that 'promoters' are interested parties. Such a presumption may not necessarily hold be true at all times, especially in structures curated to incentivize and retain non-promoter employees.

- Another issue that came to the forefront with the release of informal guidance by SEBI in the case of Mphasis was with

respect to listed companies having unlisted subsidiary companies in India. The informal guidance, though not binding in nature, reflects upon the comprehensive compliances and the entailing costs that will be applicable to the unlisted subsidiaries pursuant to the guidance. However, given its non-binding nature, it may still be argued that the requirement under the Listing Regulations and more specifically, the Amendment, could be limited to listed companies, or to material subsidiaries of listed companies only.

- SEBI mandated that employees of a listed company should obtain prior approval of the board of directors as well as public shareholders by way of ordinary resolution for the execution of any agreement between the investor or third party and the employees which relate to compensation or profit-sharing in connection with dealings in securities of the listed company. Regulation 26 (6) of the Listing Regulations also requires that all agreements (including expired agreements) entered during the preceding three years ought to be disclosed to the stock exchanges. SEBI further mandates that all the subsisting agreements between the employees and the investor shall be approved by the board of directors of the investee in their forthcoming board meeting. Upon receipt of approval from the board of directors, the same shall be placed before the public shareholders for approval by any ordinary resolution. This has

created ambiguity for the subsisting agreements. The consequences of the board or the shareholders not approving any subsisting agreements have not been clarified by SEBI. If the rationale is that the employees should not receive any compensation in such cases, it seems a little unfair as the compensation to the employee is neither sourced from the investee listed company or the public shareholders but only the private equity investors, at their discretion.

- The requirement for a listed or to-be-listed company to make public disclosure and obtain requisite approvals under the Listing regulations and the underlying compliance cost may persuade against some companies, in terms of convening a general meeting for the passing of an ordinary resolution for approving such arrangements. These strict disclosure requirements may motivate companies to remain unlisted, or explore avoidance mechanisms such as moving the shareholder arrangements or obligations a level up or overseas or moving the capital market activity overseas so that the nature or level of disclosure required is reduced while achieving an equivalent objective.

- It is useful to reiterate that SEBI's requirement to regulate upside-sharing arrangements has and will continue to ensure

transparency. Companies continue to list or seek listing on the basis of offer documents containing disclosures on upside-sharing, including Security and Intelligence Services (India) Limited, which filed its draft offer document with SEBI in September 2016, but completed its listing in August 2017, as well as MAS Financial Services Limited, CMS Info Systems Limited and TCNS Clothing Co. Limited, which have all been filed after the Amendment was notified by SEBI.

VIII. CONCLUSION

India has witnessed a couple of instances where private equity investors rewarded the employees of unlisted companies at the time of exit with or without a contractual obligation. Needless to mention, the key purpose of an investor entering into a compensation agreement is to enhance the value of the investment by incentivizing the employees or management. This in turn enhances the investment value for the public shareholders as well. One of the significant purposes of executing such an agreement is to motivate employees of the investee company for its growth.

The introduction of Regulation 26 (6) through the Amendment has created a conundrum. The investee companies are usually not a party to any such compensation agreements and these agreements are generally executed between employees of the companies and

their investors. The amount of compensation or reward paid by the investor is neither from the account of the listed company nor from the company's shareholders' account. Further, the intent behind such agreements is not to deflate the value of the shareholding of the public shareholders.

In our view, regulation of compensation agreements or upside sharing agreements or any such arrangement of a like nature may be warranted solely from the point view of corporate governance. The only concern which the public shareholders or SEBI may have is the governance issues that could financially affect the shareholders of the listed company. The shareholders of a listed company are made aware of the fact that the employees may be inclined to work in the interests of the investors in order to obtain the benefits of such compensation. Such disclosures may act as a check and balance to ensure that interests of all stake holders are balanced. However, the question arises as to the required extent and type of regulation needed to strike an adequate balance between better governance and investor incentive. It will be interesting to see SEBI's take on this aspect in the near future.

III. <u>CORPORATE GOVERNANCE IN DYSFUNCTIONAL FAMILY-RUN COMPANIES</u> *

Abstract

In India, close to 90% of companies are controlled by families, be it big companies like Reliance, Tata, Godrej, Times of India or Mom and Pop stores. The family patriarch is deeply rooted in India and its economy. However, these family-run companies haven't had the long run as they all have started in the post-independence era. It is unlikely for a family company to cross three generations, due to problems like succession, mismanagement, conflicts, family feud, division and separation of companies, etc. Without having a mandatory Family Constitution or a Corporate Governance Code with specific provisions to govern family-run companies, especially large private companies, it is difficult to govern dysfunctional family-run companies in India. A set of rules need to be in place to ensure the success and long life of the corporation. This would also ensure the protection of goodwill and protection of interest of the stakeholders. In this paper, I would first analyze the current situation in India in terms of the existing legal framework and what are the restrictions imposed by Companies Act, 2013 and SEBI Regulations which would affect family-run companies and ensure corporate governance. I would also look into some case studies of dysfunctional companies that were/are run by families in India,

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especially large private companies. Secondly, I would briefly look into the laws, guidelines and practices adopted in other jurisdictions with respect to family-run companies and lastly, I would examine what are Family Governance Institutions and Family Governance Documents, which could ensure corporate governance in family-run companies in India. This paper establishes the need for the MCA to mandate a Corporate Governance Code for family-run companies, and suggests a basic framework for the same.

I. INTRODUCTION

There is emerging research on corporate governance with its multi-theoretical approaches, such as Managerial Hegemony,[1] Resource Dependence,[2] Theories of Convergence, External Pressures, Post-Enron Theories,[3] Team Production Theory[4] in addition to Agency Theory,[5] Stakeholder theory,[6] Stewardship theory[7], etc. However,

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[1]Jeffrey R. Cohen, Ganesh Krishnamoorthy & Arnold M. Wright, *Form versus Substance: The Implications for Auditing Practice and Research of Alternative Perspectives on Corporate Governance*, 27 AUDITING: A JOURNAL OF PRACTICE & THEORY 181–198 (2008), https://aaajournals.org/doi/10.2308/aud.2008.27.2.181 (last visited Nov 10, 2019).
[2]Amy J. Hillman, Albert A. Cannella & Ramona L. Paetzold, *The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change*, 37 JOURNAL OF MANAGEMENT STUDIES 235–256 (2000), https://econpapers.repec.org/article/blajomstd/v_3a37_3ay_3a2000_3ai_3a2_3ap_3a235-256.html (last visited Nov 10, 2019).
[3]THOMAS CLARKE, THEORIES OF CORPORATE GOVERNANCE: THE PHILOSOPHICAL FOUNDATIONS OF CORPORATE GOVERNANCE 319 (2004).
[4]John Parkinson, *Models of the Company and the Employment Relationship*, 41 BRITISH JOURNAL OF INDUSTRIAL RELATIONS 481–509 (2003).
[5]Patrick Mccolgan, *Agency theory and corporate governance: a review of the literature from a UK perspective* (2001).
[6]Anant K. Sundaram & Andrew C. Inkpen, *Stakeholder Theory and "The Corporate Objective Revisited": A Reply*, 15 ORGANIZATION SCIENCE 370–371 (2004).

corporate governance in family firms still remains unexplored.[8] Especially in a country like India, where the majority of the businesses are family-run, laying down specific rules and regulations to ensure corporate governance of family-run companies is the need of the hour.

A family business may be in the form of a sole proprietorship, a partnership firm, or a company with limited liability. It may be defined as a company that is owned, controlled, and operated by members of one family where non-family members may also be employed.[9] Another definition is, a firm or a company in which the family has a strong influence on the day to day running of the business[10]. The family firm is a firm where there is the presence of a group of people related by blood or marriage with large ownership stakes.[11]A family business can also be defined as an "owner-managed enterprise with family members exercising considerable

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[7]Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTRALIAN JOURNAL OF MANAGEMENT 49–64 (1991).
[8]Trung Quang Dinh & Andrea Calabrò, *Asian Family Firms through Corporate Governance and Institutions: A Systematic Review of the Literature and Agenda for Future Research*, 21 INTERNATIONAL JOURNAL OF MANAGEMENT REVIEWS 50–75 (2019).
[9]Ashok Panjwani, Vijay Aggarwal & Nand Dhameja, *Family Business: Yesterday, Today, Tomorrow*, 44 INDIAN JOURNAL OF INDUSTRIAL RELATIONS 272–291 (2008), https://www.jstor.org/stable/27768196 (last visited Nov 10, 2019).
[10]A. Narayanan, *Book Reviews : Sudipt Dutta, Family Business in India, New Delhi: Response Books, 1997, pp. 267*, 6 THE JOURNAL OF ENTREPRENEURSHIP 256–258 (1997).
[11]Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 THE JOURNAL OF FINANCE 2741–2771 (2002).

financial and/or managerial control."[12] Examples of family-owned enterprises in India include Tatas, Birlas, Ambanis, Singhanias, Chidambrams, Bangurs, Chbarias, Goenkas, and Kirloskars.[13]

In India, family firms or family-owned firms constitute 99.9% of all private Indian companies,[14] be it big companies like Reliance, Tata, Godrej, Times of India, or Mom and Pop stores. Family patriarchy is deeply rooted in India, owing to the prevalence of joint family system.[15] However, these family-run companies haven't had the long run as they all have started in the post-independence era. It is unlikely for a family company to cross three generations, due to problems like succession, mismanagement, conflicts, family feud, division, and separation of companies when inherited, family versus non-family employment and promotion,etc. which negatively influences the firm value.[16]

Despite India not having a Corporate Governance Code, the Companies Act, 2013 and SEBI Regulations are said to ensure corporate governance in Indian companies. However, by and large,

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[12]PANIKKOS POUTZIOURIS, KOSMAS SMYRNIOS & SABINE KLEIN, HANDBOOK OF RESEARCH ON FAMILY BUSINESS (2008).
[13]Panjwani, Aggarwal, and Dhameja, *supra* note 9.
[14]Phani B V et al., *Insider Ownership, Corporate Governance and Corporate Performance*, SSRN ELECTRONIC JOURNAL (2005).
[15]Ashok Panjwani, Vijay Aggarwal & Nand Dhameja, *Family Business: Yesterday, Today, Tomorrow*, 44 INDIAN JOURNAL OF INDUSTRIAL RELATIONS 272–291 (2008).
[16]Vrajlal Sapovadia, *Corporate Governance Issues in Indian Family-Based Businesses* (2012), https://mpra.ub.uni-muenchen.de/55226/(last visited Nov 10, 2019).

the express provisions for corporate governance exist only for listed companies. There are no special provisions for family-controlled un-listed companies in India, no matter how so big it is.[17]Without having a mandatory Family Constitution or a Corporate Governance Code with specific provisions to govern family-run companies, especially for large private companies, it is difficult to govern dysfunctional family-run companies in India. A set of rules needs to be put in place to ensure the success and long life of the corporation. This would also ensure the protection of goodwill, increase the value of the firm, and protection of interest of the stakeholders among other benefits arising from corporate governance.

II. CURRENT SCENARIO IN INDIA

Promoter driven firms (like Tatas, Infosys, etc.) dominate the Indian market. Most of the family-owned and promoter-driven firms in India dominate minority shareholders and occupy a lead role in decision making and often influence the decisions of the board.[18] The Uday Kotak Committee Report on corporate

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[17]*Id.*

[18]SUDERSHAN KUNTLURU, *Corporate Social Responsibility and Firm Performance: Indian Evidence* (2019), https://econpapers.repec.org/paper/iikwpaper/317.htm (last visited Nov 10, 2019).

governance,[19]which came into effect on 1 April 2019, aimed to break the nexus between promoters and their companies. The chairperson, a non-executive director, can no longer be related to the MD or CEO as per the definition of "relative" under the Companies Act, 2013, leading to a conundrum in succession for family-run companies. Another underlying theme was to achieve an independent and wholesome board. However, these provisions are applicable only to the top 500-2000 listed companies leaving out large private companies and smaller public companies. Further, these corporate governance provisions (irrespective of being applicable only for public listed companies) do not provide for separate regulations to be followed by family-run companies. Corporate Governance in a family-run company differs considerably from a non-family-run company. Family businesses are usually reluctant to apply corporate governance as it means reducing the family power and control over the business.[20] Family-run companies face governance issues with respect to succession planning, employing family or non-family members, promotion, conflict of interests between the old and new generation, which causes interference in decision making, expansion of business, risk management, etc.

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[19]SEBI | REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE, https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html (last visited Nov 10, 2019).
[20]Sapovadia, *supra* note 16.

Especially in India where corporate governance regulations are not mandated to be followed by large private companies and the absence of having regulations applicable for family-run companies, regulations mandating Family Constitution and Family Governance Institutions need to be put in place. The need for this is apparent and this is demonstrated in the following case studies where corporate governance in family-run companies, especially in large private companies are left unaddressed.

In one of the recent cases, where the need for corporate governance in the dysfunctional family business was emphasized, was the case of the feud between the Singh Brothers.[21] The Singh brothers are scions of what used to be the Ranbaxy empire which was started by their grandfather. Ranbaxy, being the world's largest exporter of generic drugs, was sold to Japanese pharma firm Daiichi Sankyo in 2008. Sankyo initiated a suit against the brothers for concealing material information related to misdemeanors at Ranbaxy. Subsequently, they even had substantial stakes in two listed companies, Fortis and Religare, from the money they got from their Ranbaxy sale. Now, the two are accused of cheating, fraud, and misappropriation of funds to the tune of Rs 740 crore and are being

[21]Madhavan Narayan, *Singh brothers' feud is a wake-up call for corporate governance in dysfunctional family-run companies*, FIRSTPOST, February 18, 2019, https://www.firstpost.com/business/singh-brothers-feud-is-a-wake-up-call-for-corporate-governance-in-dysfunctional-family-run-companies-6105471.html (last visited Nov 10, 2019).

investigated by various government bodies. The Singh brothers blew Rs 22,500 crore in less than a decade[22] and lost control over Fortis Healthcare and Religare Enterprises. They tanked 3 companies to the ground in less than a decade, allowing to governance issues. There are numerous cases filed between the brothers and against the former chairman of Religare, Godhwani, who was considered as the 'third brother' and when appointed by the brothers, threw open a host of corporate governance issues in transactions among group companies, including alleged widespread forgery, false claims, and fake documentation. There are allegations that Shivinder Singh's wife was not present at a Board Meeting since she was abroad, but the minutes recorded her presence. Further, there are allegations that there was an understanding between the brothers that ladies in the family were not supposed to ask any questions regarding business dealings.[23] Although the dispute between the brothers has turned ugly, with criminal complaints filed for death threats and physical assault,[24] the more pressing issue is that often, these feuds

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[22]Rajeev Dubey & Joey C Mathew, *The Baba, Singh Brothers and the Squandered Rs 225,00,00,00,000*, BUSINESS TODAY, September 9, 2018, https://www.businesstoday.in/magazine/the-hub/the-baba-singh-brothers-and-the-squandered-rs-225000000000/story/281437.html (last visited Nov 10, 2019).

[23]Rajeev Dubey, *Singh brothers case: Shivinder's lawsuit exposes widespread forgery, fake documentation, corporate governance issues*, BUSINESS TODAY, September 6, 2018, https://www.businesstoday.in/current/economy-politics/singh-brothers-case-shivinder-lawsuit-exposes-widespread-forgery-fake-documentation-corporate-governance-issues/story/282108.html (last visited Nov 10, 2019).

[24]Megha Bahree, *The Singh Brothers Are At It Again: Malvinder Accuses Shivinder Of Death Threats, Fraud*, FORBES, 2018,

involve the bleeding of companies to the detriment of banks, small investors, and mutual funds.[25]

The family business has been synonymous with insider succession.[26] On the other hand, succession planning is almost absent in family-owned businesses in India,[27] making it the prime issue faced by family-run businesses. Even the biggest private sector company in India, Reliance faced huge problems after the patriarch died without leaving a will. Dhirubhai Ambani's death in 2002, sparked a feud for control which ultimately lead to the split of the Reliance Group.[28] The dispute between the Ambani brothers shook the Indian economy and became an issue of national interest, which forced the then finance minister Pranab Mukherjee to intervene and request the brothers to settle the dispute privately. Their mother, Kokilaben managed to broker a demerger in 2005, which gave Mukesh control of oil and gas, petrochemicals, refining, and manufacturing while Anil took reign over electricity, telecoms and financial services. Although the dispute was resolved after the intervention by the mother, rather than laying the foundations for peace, the agreement

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https://www.forbes.com/sites/meghabahree/2019/02/18/the-singh-brothers-are-at-it-again-malvinder-accuses-shivinder-of-death-threats-fraud/ (last visited Nov 10, 2019).

[25]Narayan, *supra* note 21.

[26]Panjwani, Aggarwal, and Dhameja, *supra* note 9.

[27]Sapovadia, *supra* note 16.

[28]Mamta Badkar, *The Full Story Of The Massive Feud Between The Billionaire Ambani Brothers*, BUSINESS INSIDER, May 26, 2011, https://www.businessinsider.com/ambani-brothers-feud-reliance-2011-05 (last visited Nov 10, 2019).

set the stage for more highly publicized bickering, often involving various government bodies and with billions of dollars at stake.[29] Finally, the agreement bearing the non-compete clause was scrapped in 2010, and Mukesh pumped money into telecom, with the introduction of Jio.[30] Irreparable damage had already been caused to the brothers, their company and the economy as a whole since the feud lasted years. Reliance also slipped from its position in the Forbes List.[31]

While succession within the family is a problem, a further complex situation is in the case of non-family successors. When the new generation is reluctant to step into the family business or doesn't exist to take over the business, the older generation of aging businessmen are unwilling to retire and hand over the reins[32] to a non-family successor. This in turn affects the performance and value of the company. This can be seen from the recent case of Jet Airways wherein 2018, Naresh Goyal was reluctant to cede control

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[29]Heather Timmons, *India's Top Court to Try to Settle Ambani Feud*, THE NEW YORK TIMES, October 19, 2009, https://www.nytimes.com/2009/10/20/business/global/20ambani.html (last visited Nov 10, 2019).

[30]Bhuma Shrivastava, *The $41 billion wealth gap that divides Anil and Mukesh Ambani*, THE ECONOMIC TIMES, October 20, 2018, https://economictimes.indiatimes.com/news/company/corporate-trends/the-41-billion-wealth-gap-that-divides-mukesh-and-anil-ambani/articleshow/66280874.cms?from=mdr (last visited Nov 10, 2019).

[31]Ritu Bhattacharyya, *Road Blocks in Enhancing Competitiveness in Family-Owned Business in India* (2007), http://localhost:80//handle/2259/73 (last visited Nov 10, 2019).

[32]Panjwani, Aggarwal, and Dhameja, *supra* note 9.

of the loss-making company, in order to make way for their new investor, Tata Sons. Tata Sons was then the only suitor with a comprehensive offer for Jet, who decided to walk off and to never return, which led to the fall of India's oldest private airline. The fall of Jet is inseparable from the fall of its founder.[33]

In a twist of tale, Tata also had faced its own set of problems, despite having a family successor. When Ratan Tata, the fourth generation Chairman of the 143 years old Tata Group, retired in 2012, Cyrus Mistry, who is related by marriage to the Tata family and the largest private shareholder of the group's holding company Tata Sons, stepped up as Chairman.[34] However, his rule was short-lived. In 2016, Ratan Tata appealed to its shareholders to sack Mistry as his continuation would be a "serious disruptive influence" and will make the companies dysfunctional.[35] Ratan Tata stepped in as interim chairman, while a panel was constituted, which chose Natarajan Chandrasekaran, a non-family successor, as its new

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[33]Anirban Choudhury & Mihir Mishra, *The rise and fall of India's oldest private airline*, THE ECONOMIC TIMES, April 22, 2019, https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/jet-airways-naresh-goyals-folly-how-to-crash-a-business/articleshow/68930916.cms (last visited Nov 10, 2019).

[34]Ratan Tata retires as Tata Group chairman, BUSINESS TODAY, January 28, 2013, https://www.businesstoday.in/current/corporate/ratan-tata-retires-as-tata-group-chairman/story/191096.html (last visited Nov 10, 2019).

[35]Megha Mandavia, *Cyrus Mistry's presence in Tata Group boards is disruptive: Ratan Tata*, THE ECONOMIC TIMES, December 28, 2016, https://economictimes.indiatimes.com/news/company/corporate-trends/cyrus-mistrys-presence-in-tata-group-is-disruptive-ratan-tata/articleshow/55856940.cms?from=mdr (last visited Nov 10, 2019).

Chairman in 2017. This stand-off between Ratan Tata and Cyrus Mistry rocked the roots of corporate governance. It proved how the Board swayed in favor of the Emeritus and how its predecessor was reluctant to cede control. Mistry alleged that Tata considered himself as a Chairman who never retired.[36] The probability of the Emeritus questioning the decisions of the company's key officials and thereby a tussle arising between them is quite high. This is the case where both the predecessor and successor belong to the same family,[37] let alone ceding control for a non-family member. An Emeritus being an honorary position having no legal consequences is solely governed by a contract by the company and there is no provision in this regard under the Companies Act, 2013.[38] Since there is the utility of having an Emeritus, i.e, to mentor the successor, it cannot be ruled out. This would be a boon to family-run businesses when the family successor is not capable enough. Therefore, the circumstances in which a company's Emeritus could legitimately or

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[36]Ratan Tata thinks himself as the chairman who never retired: Cyrus Mistry, THE ECONOMIC TIMES, January 24, 2017, https://economictimes.indiatimes.com/news/company/corporate-trends/ratan-tata-thinks-himself-as-the-chairman-who-never-retired-cyrus-mistry/articleshow/56744185.cms (last visited Nov 10, 2019).

[37] See : Sunil BaghelSunil Baghel et al., *Vijaypat Singhania sacked as Raymond Chairman-Emeritus; warned of legal action*, MUMBAI MIRROR, https://mumbaimirror.indiatimes.com/mumbai/cover-story/vijaypat-singhania-sacked-as-raymond-chairman-emeritus/articleshow/66251763.cms (last visited Nov 10, 2019).

[38]Srinivas Gunta & N. Ravichandran, *Infosys: Transition at the Top*, 3 IMJ 38–52, 43 (2011), http://www.iimidr.ac.in/wp-content/uploads/Infosys.pdf (last visited Nov 10, 2019).

justly interfere with the decisions of its key officers should be laid down.[39]

From the case studies discussed above, it is clear as to what are the issues faced in the corporate governance of family-run businesses. Owing from placing personal interest above business interest, lack of succession planning, hesitance to cede control by the outgoing KMP, lack of independent decision making by the successor due to interference by the predecessor, a weak Board swaying towards the promoter or older member of the family, family feud and disputes regarding ownership are some of the issues faced in family-run businesses.

III. COMPARATIVE ANALYSIS OF LEGAL FRAMEWORK AROUND THE GLOBE

Having observed the current scenario in India, let us look at how family-run businesses are regulated across the globe in other jurisdictions. While some jurisdictions have a special enactment for the same, some have carved out a section and made special provisions for family businesses under their Corporate Governance Code. There are a majority of jurisdictions, like India, which are yet to accommodate governance of family-run businesses within their

[39] Priya Garg, *The (Ambiguous) Position of Chairman Emeritus in Corporate Governance*, INDIACORPLAW (2018), https://indiacorplaw.in/2018/12/ambiguous-position-chairman-emeritus-corporate-governance.html (last visited Nov 10, 2019).

statutory framework. In this paper, we shall look into three kinds of Codes or statutes: 1) Regulations for Large Private Companies, 2) A Code which provides guidance to govern family-run businesses, 3) A Statute which is binding on family-run companies to follow, otherwise provides for statutory offense and penalties.

1. COMPANIES (MISCELLANEOUS REPORTING REGULATIONS) 2018 AND THE WATES CORPORATE GOVERNANCE PRINCIPLES FOR LARGE PRIVATE COMPANIES:

In the UK, similar to that in India, the regulations provide for a corporate governance framework, where the strongest corporate governance and reporting standards are applied to publicly listed companies.[40] In large private companies, the relationships between shareholders, directors and senior management can vary dramatically, since they are not a homogenous group and are established under a variety of different ownership and legal structures, including family businesses.[41]

With the introduction of the UK Government's new reporting requirement under the Companies (Miscellaneous Reporting Regulations) 2018, all UK incorporated companies over a certain size are required to make a statement on their corporate governance

[40] FINANCIAL REPORTING COUNCIL, *Consultation: Wates Corporate Governance Principles for Large Private Companies* (2018), https://www.frc.org.uk/getattachment/48653f86-92c3-4cd6-8465-da4b7cac0034/;.aspx (last visited Nov 10, 2019).
[41] *Id.*

arrangements for financial years beginning on or after 1 January 2019.[42] Since, large private companies in the UK, for the first time will have to make public disclosures on their governance arrangements[43] and in order to help companies subject to the thresholds make a corporate governance statement in compliance with the Regulations,[44] the Government invited the Financial Reporting Council (FRC) to work with a variety of partners to develop a set of corporate governance principles for large private companies. Although these Principles offer just as guidance, the UK has taken a step in the right direction, by bringing in large Private Companies under the scanner for corporate governance, which includes family-run businesses.

Under the Principles, the Companies such as a large family-owned companies may seek to appoint an independent director to its board to introduce the independent challenge, which can improve board decision-making.[45]

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[42]Ernst & Young LLP, *Governance in large private companies and the Wates Principles* 7, https://www.ey.com/Publication/vwLUAssets/EY-Wates-Principles-and-Private-Company-Governance-Update/$File/EY-Wates-Principles-and-Private-Company-Governance-Update.pdf (last visited Nov 10, 2019).
[43]*Id.*
[44]*Id.* at 3.
[45]FINANCIAL REPORTING COUNCIL, *supra* note 40.

2. GCC FAMILY COMPANY GOVERNANCE CODE:

In order to support the family business which amounts to 70% of the business in the GCC economy, the Family Business Council – Gulf (FBCG) in partnership with FBN International and in collaboration with 10 leading regional and international governance experts, released in May 2016 the inaugural GCC Governance Family Business Code.[46] The GCC Governance Code has been drafted to offer guidance for the family business in avoiding risks and hurdles.[47] This Code addresses a wide range of governance areas such as family governance, ownership governance, corporate governance, wealth governance, public engagement, and succession planning.[48] The Code also contains some communication standards and systems, procedures for the integration of the next generation, and dedicated guidance into the auditing standards.[49] The Code also sheds light on Family Charter and governing bodies such as Family Assembly and Family Council. Although this Code served as a voluntary guide, it is better to start somewhere, in an attempt to ensure corporate governance in family-run organizations.

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[46]Alexander Koeberle-Schmid, *Family business Governance Code - KPMG Global*, KPMG (2018), https://home.kpmg/xx/en/home/insights/2016/09/family-business-governance-code.html (last visited Nov 10, 2019).

[47]Family Business Council - Gulf, *The GCC Governance Code* 10, https://fbc-gulf.org/mediafiles/articles/doc-1360-20171116053708.pdf (last visited Nov 10, 2019).

[48]Babu Das Augustine, *FBC launches first GCC family business governance code*, GULF NEWS, May 23, 2016, https://gulfnews.com/business/fbc-launches-first-gcc-family-business-governance-code-1.1833276 (last visited Nov 10, 2019).

[49]Koeberle-Schmid, *supra* note 46.

3. FAMILY COMPANY ACT (MALTA):

The European Commission has been a recurrent voice in asking its Member States to enact legislation on family businesses.[50] The Maltese Family Business Act was one of the first enacted statutes to regulate family businesses in Europe. It is encouraging fellow member states to introduce similar legislation. The Act's key features include a formal definition of what constitutes a family business, who should be considered as a family member, how its governance is regulated, and how foreign-owned family businesses can avail themselves of the Act. Further, it also provides for incentives and schemes to assist family businesses and their members, when transferring and running the business and its wealth to the next generation.[51] The Act also provides for offenses and penalties.[52] Despite being a small member state of the EU, it has surpassed other jurisdictions to bring out an enacted legislation that is binding and incentivizes family-run companies to follow.

In the absence of established regulations or guidelines to govern family-run businesses, Wallenberg Company - Sweden's legendary family run company, which is more than 160 years old, has stood as

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[50] The Family Business Act, https://economy.gov.mt/en/familybusinessact/Family%20Business/Pages/Introduction.aspx (last visited Nov 10, 2019).

[51] Nadine Lia, *Explaining the benefits of the Family Business Act*, TIMES OF MALTA, April 16, 2017, https://timesofmalta.com/articles/view/Explaining-the-benefits-of-the-Family-Business-Act.645342 (last visited Nov 10, 2019).

[52] Family Business Act, Chapter 565, Article 33 to 37.

an exemplary example of corporate governance. The hallmark of the Wallenberg corporate structure is its family control over the entire group of companies, including giants such as Ericsson, Scania, and ABB, through the dual-class commons owned by Investor, the main company.[53] Through its holding company Investor AB, the family is said to control companies representing over 40% of the value of the Stockholm stock exchange.[54] The single most important ingredient of their business venture is the fact that they are aware that, they we can never stay on top of all the issues and all the details, given the size of the companies and the complexity of the businesses.[55] Instead, they are dependent on a great group of people to head and run several businesses. It is the Wallenberg family foundation and not the family members that own stakes in these companies.[56]This model of ownership is what the Wallenbergs give credit to, for such longevity of their company and avoiding the squabbles that have

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[53]Hwa-Jin Kim, *Concentrated Ownership and Corporate Control: Wallenberg Sphere and Samsung Group*, 14 J. KOREAN L. 39 (2014), https://heinonline.org/HOL/Page?handle=hein.journals/jkorl14&id=47&div=&collection= (last visited Nov 10, 2019).

[54]Howard Muson, *The Wallenbergs*, FAMILIES IN BUSINESS (2002), //www.campdenfb.com/article/wallenbergs (last visited Nov 10, 2019).

[55]Richard Milne, *Meet the Wallenbergs*, FINANCIAL TIMES, June 5, 2015, https://www.ft.com/content/4f407796-0a35-11e5-a6a8-00144feabdc0 (last visited Nov 10, 2019).

[56]Håkan Lindgren, *Succession strategies in a large family business group: The case of the Swedish Wallenberg Family*, *in*SIXTH EUROPEAN BUSINESS HISTORY ASSOCIATION ANNUAL CONGRESS, HELSINKI (2002).

hampered other dynasties.[57] Although the family members sit on several corporate boards, they don't make it to the 'richest man' list of Sweden and each of them have to earn their living. They are said to follow a modest lifestyle and are not seen living a luxury life, while they are more focused on the company.[58] It can be said that their way of lifestyle is in stark contrast to the Ambanis and Birlas of India.

The Wallenberg family business continues to be a case study for business management and corporate governance. Having considered the regulations, guidelines, and companies from around the globe, which suggests a framework for corporate governance of family businesses, let us now look at what is the family constitution and its governing bodies, which can be adopted by companies.

IV. FAMILY INSTITUTION AND FAMILY CONSTITUTION

In order to address the challenges unique to family-owned businesses, the companies ought to set up Family Governance Institutions and Family Governance Documents. However, these corporate governance solutions vary depending on the stage of

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[57]Richard Milne, *The Wallenbergs: where money meets Swedish science*, FINANCIAL TIMES, February 14, 2017, https://www.ft.com/content/f9e5af4e-f1d9-11e6-8758-6876151821a6 (last visited Nov 10, 2019).
[58]Milne, *supra* note 55.

family ownership.[59] According to Harvard Professor John Davis, the evolution of family companies can be divided into three phases.[60] The initial phase is called the "founder stage" when there is an individual founder. The second stage is called "siblings' partnership" when the ownership transfers to the next generation and the third stage being "cousins' confederation" when the company transitions to future generations, by when the company reaches maturity.

Family Governance Institutions:

The IFC Family Business Governance Handbook, published by the International Finance Corporation,[61] recommends the establishment of family governance institutions. The main idea behind establishing such an institution is to allow family members to gather, strengthen communication links between the family and the business. Depending on the stage of the family's company, the Handbook suggests three types of governance structures to be established, the excerpt of which is given below–

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[59]OECD, *Governance Challenges for Family-Owned Businesses*, *in*PRACTICAL GUIDE TO CORPORATE GOVERNANCE, https://www.oecd.org/daf/ca/corporategovernanceprinciples/43654301.pdf (last visited Nov 10, 2019).

[60]Peter S. Davis & Paula D. Harveston, *The Influence of Family on the Family Business Succession Process: a Multi-Generational Perspective*, 22 ENTREPRENEURSHIP THEORY AND PRACTICE 31–53 (1998), https://doi.org/10.1177/104225879802200302 (last visited Nov 10, 2019).

[61]IFC Family Business Governance Handbook, https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+CG/Resources/Guidelines_Reviews+and+Case+Studies/IFC+Family+Business+Governance+Handbook (last visited Nov 10, 2019).

	Family Meeting	**Family Assembly**	**Family Council**
Stage	Founder	Sibling partnership/ cousins' confederation	Sibling partnership/ cousins' confederation
Status	Usually Informal	Formal	Formal
Purpose	Allows the founder(s) to communicate family values, generate new business ideas, and prepare the next generation of the family business' leaders	Helps avoid potential conflicts that might arise among familymembers because of unequal access to information and other resources	The representative body of the Family Assembly,to deliberate on familybusiness issues. The primary link between the family, the board, and senior management

Membership	Usually open to all family members. Additionalmembership criteriamight be set by the founder	Usually open to all family members. Additional membership criteria might be set by the family	Family members elected by the family assembly.
Size	Small size, usually 6–12 family members	Depends on the size of the family and membership criteria	Ideally 5-9 members
Number of meetings	Depends on the stage ofthe business' development. When business is growing rapidly, can be as frequent as once a week	1-2 times a year	2-6 times a year

Main activities	➢ Communication of family values and vision. ➢ Discussion and generation of new business ideas. ➢ Preparation of the next business leader(s)	➢ Approval of any change in family values and vision. ➢ Education of family members about their rights and responsibilities. ➢ Approval of family employment and compensation policies. ➢ Election of family council members (if	➢ Conflict resolution ➢ Suggesting and discussing the names of candidates for board membership. ➢ Development of the major family-related policies and procedures ➢ Coordination of the work with

		the council exists). ➢ Election of other family committees' members. ➢ Other important family matters.	management and the board and balancing the business and the family

A family council or family assembly complements the board of directors and does not replace them. The family council sets policy for the family and recommends it to the board, such as the employment of family members in the business. The board of directors sets policy for the business and may also make recommendations to the family council in matters that concern the business.[62]

Family Governance Documents:

[62]The Three Components of Family Governance, HBS WORKING KNOWLEDGE (2001), http://hbswk.hbs.edu/item/the-three-components-of-family-governance (last visited Nov 10, 2019).

There is a need to formalize documents and policies, as and when they are adopted. Especially in a family run business, at the founder stage, most transactions are informal and unrecorded. Documents such as the mission and vision of the company, family members' employment policy,[63] succession plan, etc. These policies regarding family governance, when put together form the Family Constitution.

A Family Constitution is a formal document that sets out the rights, values, responsibilities, and rules applying to stakeholders in the family business and provides plans and structures to deal with situations that arise in the course of the family business's operation.[64] It often defines the roles, compositions and functions of family governance institutions and the company's governance bodies, such as the shareholders' meeting, the board of directors, and senior management.[65]However, unlike company constitutions, a family constitution tends not to be legally binding on the family members.[66]

Thus, these are some suggestive frameworks which can be adopted by family run companies, to build trust and communication between

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[63] OECD, *supra* note 59.

[64]McInnes Wilson Lawyers-Taryn Hartley, *Family constitutions – what, when and why | Lexology*, https://www.lexology.com/library/detail.aspx?g=e5d5c264-e453-4d03-b1a6-b93f958f9f17 (last visited Nov 10, 2019).

[65]IFC Family Business Governance Handbook, *supra* note 61.

[66]McInnes Wilson Lawyers-Taryn Hartley, *supra* note 64.

the family and business, and to ensure transparency and resolve conflicts, if any, between family members.

V. CONCLUSION

In India, due to the absence of a special statute which mandates a corporate governance framework of large private companies, especially family-run companies; it is best for these companies to voluntarily apply these guidelines and suggestions to ensure corporate governance. Alternatively, the Ministry of Corporate Affairs (MCA), must consider implementing such mandates within the Companies Act, by carving out a separate provision, which applies solely to family-run companies. By drawing inspiration from Corporate Governance Codes of other jurisdictions, as mentioned above, MCA should implement these mandates, in the interest of the company and its stakeholders. Regulations which counter the unique challenges faced by family-run companies such as family disputes, change in control, succession, employment of non-family member, etc., are the need of the hour. The primary reason for demanding mandatory adoption of the best corporate governance practices, in family-run companies, is due to the sheer percentage of family-run companies, in India. Otherwise, in the near future, India would become a scam-haven due to dysfunctional family-run

companies, which would lead to decrease in foreign investment in India, thereby having a drastic effect on the economy.

IV. "A SWITCH IN TIME, SAVES NINE" - MINIMIZING CORPORATE CRIME BY MAXIMIZING CORPORATE WHISTLE-BLOWER PROTECTION IN INDIA*

Abstract

One of the key elements of corporate governance is the determination of means and mechanisms to ensure effectiveness, efficiency, and transparency in the organisation, undertake efficacious and strategic business decisions, and to further the shareholder interests of the corporation. Corporate whistleblowing is one of the significant and salient aspects of corporate governance.

Corporate whistleblowing may be described as the act of calling out by an employee any form of misconduct or a violation of the law or the unethical practices undertaken by a corporation. The whistleblower in such an instance may reveal the information to the general public or a position of authority (such as the top management, audit committee, etc).

The practice of corporate whistle-blowing, although legislatively at a nascent stage in India, has a substantial jurisprudence in the developed countries such as the USA and the UK. However, it has been a part of the human resource and corporate policy of a significant number of corporations in India.

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<u>The research paper has been pigeonholed into the following sections:</u>

Section 1: *The first section seeks to deconstruct the concept of corporate whistleblowing and provides a legislative context from multiple global jurisdictions such as the USA and UK.*

Section 2: *We thereafter, in the next section, seek the causative rationale for encouraging such a practice and analyse the key elements of such corporate whistleblowing policies. This section also highlights the positive as well as negative consequences of being a corporate whistle-blower.*

Section 3: *The paper then delves into the analysis of the existing (although niche) legislative framework for corporate whistle-blowing in India.*

Section 4: *Finally, certain recommendatory suggestions along with the research observations and conclusion have been delineated to ensure and provide a robust and effective mechanism of dealing with corporate whistle-blowers in India.*

SECTION 1: INTRODUCTION

1. CONCEPT OF CORPORATE WHISTLEBLOWING:

In the case of corporate governance in India, we have many examples of good governance as well as mis-governance. With the rise in the number of corporate crimes, rules and policies are also

getting more stringent to prevent such frauds. Corporate whistleblowing is a new and recent emergence in this space. It is a concept that can be defined as the warning provided to the corporation by its employees about the misconduct or an illegal act within the organisation. According to Ahern and McDonald (2002) and Bolsin et al. (2005), Whistleblowing can be elucidated as an endeavor made by an existing or former member of an association to declaim a forewarning to a higher authority of that association or the public regarding perilous misconduct or any misconduct engendered or concealed by the organization. It is the disclosure by a current or former organisation member of illegal, inefficient, or immoral or illegitimate practices in an organisation, to persons or organisations that may be able to take some action to cease the same or have resources or power to take action.[1] Whistleblowing is an indispensable tool for ensuring good corporate governance in today's corporate world.

Whistleblower's policy is relatively a nascent concept for the Indian legal system. The policy has been in existence in UK and US for a long time, wherein the US has U.S. Securities Exchange Commission (**SEC**) and the Department of Justice (**DOJ**) as the watchdogs over the defaulters. The whistleblower policy provides

[1] Moral & Ethical Issues surrounding Whistleblowing, GMUL 5063 Law, ethics & Social responsibility, (October 16, 2019, 2:00 pm), https://www.scribd.com/doc/99177778/Whistle-blowing.

the appropriate platform to the company to let its employees, clients, contractors, and vendors, etc. to report to the company about any unethical or illegal activity going on within the organisation before reporting it to the external law enforcement agencies for the larger good. The International Labour Organisation (**ILO**) defines whistleblowing as "*the reporting by employees or former employees of illegal, dangerous or unethical practices by employers*."

Whistleblowers can be considered as the audacious guardians of the values that are of greater importance than unethical conduct of the organisations. However, some people within the organisation perceive them as fraudulent perpetrators who should be demotivated and removed from the corporate culture.

2. THE LEGISLATIVE FRAMEWORK IN DIFFERENT JURISDICTIONS

Hugh B. Kaufman, an EPA whistleblower once said, "*If you have the god, legislation, the press and the facts on your side, you have a fifty-fifty possibility of triumphing over the conspirators*."[2] A Human Rights Report of 2013 indicated that the countries with the most advanced whistleblower protection legislations included South Africa and the UK with almost 40 countries have adopted national laws on

[2] FIRAS QUSQAS AND BRIAN H. KLEINER, *the difficulties of whistleblowers finding employment,* Volume 24 Number 3/4 2001

whistleblowing in various forms.[3] To date, there are no corporate whistleblowing laws that are fully aligned with the thirty Transparency International principles for effective whistleblower protection legislation."[4]

However, in order to analyse the implementation of whistleblowing policies in Indian corporate culture and to evaluate the protection afforded to the whistleblowers in the country by the Whistleblowers Protection Act, 2011, it is of grave importance to draw a comparative analysis of the said law with those of other jurisdictions such as the UK and the USA. Since UK and the USA have very strong whistleblowing laws incorporated into their legislative mechanism, understanding their policies can provide a good insight to the prevalent lacunae in the Indian law.

i. U.S.A.

Whistleblowing being a very sensitive subject has divided opinions over the world, particularly in the US. Whistleblowing is a very beneficial tool in achieving the goal of good corporate governance but there is a darker side to this. The informants, often known as the "*whistleblowers*" are highly exposed to retaliation within the

[3] NIMISHA BHARGAVA AND MANI K. MADALA, An Overview of Whistleblowing Status in Various Continents Across the World, Volume 3, No. 10 ISSN: 2319-4421

[4]https://www.europeanceo.com/business-and-management/whistle-while-you-work-the-benefits-of-corporate-whistleblowing/

business/ organisation. It can at times even prove to be fatal to the life of the whistleblowers to expose the corruption and fraud being perpetrated in the company.

Whistleblowing policies in US have evolved for more than 150 years. The laws however differ at state and federal levels. There has been a number of cases that have set the precedent for protecting whistleblowers. There are over fifty pieces of legislation at the federal level however, the three principal Acts are the False Claims Act, 1863; the Whistleblower Protection Act, 1989 and the Criminal Accountability Act (Sarbanes-Oxley Act) 2002.

- The U.S False Claims Act, 1863

The U.S False Claims Act, 1863 is the legislation behind empowering private individuals to litigate fraudulent claims by the government as well as corporate fraud.[5] This was the first law enacted for the protection of whistleblowers and was later revised in 1986.[6] This law provided protection to whistleblowers from malafide retaliation from the company and paved the way to even acquire benefits or damages acquired by the government. This Act has resulted in more than $17 billion dollars of recoveries for the

[5] NIKHIL VARSHNEY & AMARTYA SAHA, The Whistleblower Bill, 2010: A critical Analysis, 1 NSLJ (2012) 79.

[6] DR. V.K CHAURASIYA, NANDITA SINGH, PRIYANKA DWIVEDI & TRISHNA CHATURVEDI, Whistleblower's Protection Act 2011, India: A critical Analysis, (October 16, 2019, 11:00 pm), www.ijarcs.info/index.php/ijarcs/article/download/1766/1754

U.S Government since 1986.[7] In furtherance to this, the Act provides for whistleblowers 15-30% of government's total recovery, the percentage depending upon the extent to which the whistleblower took the action that enabled the recovery to be effected.[8] This Act was amended in 1986 to provide protection to whistleblowers and to prevent unnecessary harassment and retaliation against them.[9]

- Whistleblower Protection Act, 1989

The Whistleblower Protection Act, 1989, came into the existence in the year 1989 which was amended in 1989 and then again in 1994, under which federal employees are protected from workplace retaliation after disclosing fraud. This act is a federal law that protects federal whistleblowers, or persons who work for government who report agency misconduct. The sole purpose of the Act was to strengthen the protection afforded to federal employees. The House of Representative approved the

[7] Kanika Chaudhary, Whistleblowing: Comparative Analysis of India and U.S, (October 16, 2019, 11:00 pm), https://www.academia.edu/9901507/WHISTLEBLOWING_COMPARATIVE_ANALYSIS_OF_INDIA_AND_U.S.

[8] Peter Bowden, A comparative Analysis of Whistleblower Protection, (October 17, 2019, 1:00 pm), https://www.researchgate.net/publication/228175753_A_Comparative_Analysis_of Whostleblower_Protection.

[9] *Id.*

Whistleblower Enhanced Protection Act in 2007.[10] One of the substantial and significant features of this Act is the creation of more realistic burdens of proof. Another commendable provision is the ability of whistleblowers to opt for a transfer.[11] The legal position in USA has not been stagnant ever since the enactment of the WPA Act in 1989. In 1994, twenty amendments were made to the WPA Act in order to strengthen the protection given to whistleblowers.[12] Various statutes were amended to make provisions for the protection of whistleblowers which tried to minimize the fear of retaliation in the whistleblowers.

- Sarbanes-Oxley Act, 2002

With the mark of 21st century, companies such as Enron, WorldCom and Global Crossing became big names as accounting fraud and other business abuse became public.[13] Such malafide corporate practices of these companies cost billions of dollars to shareholders and tarnished the reputation of the securities market and corporate governance. Employees of such companies, however,

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[10] *Id.*

[11] Abhinav Chandrachuda, Protection for whistleblowers: Anlaysing the need for legislation in India, (October 17, 2019, 2:00 pm), http://www.supremecourtcases.com/index2.php?option=com_content&itemid=135&do_pdf=1&id=622.

[12] *Id.*

[13] Robert G. Vaughn, America's First Comprehensive Statue Protecting Corporate Whistleblowers, Administrative Law Review, Vol. 57, No.1 (Winter 2005), pp.105, https://www,jstor.org/stable/40712202.

were aware of these frauds and still did not come forward to bring the same to the light of the day. Therefore, in response to the public hue and cry, Congress enacted the Sarbanes-Oxley Act.[14]

The Sarbanes-Oxley Act of 2002 provides protection to the 'Employees of Publicly Traded Companies (Section 806).[15] This is the act in which Congress introduced a series of corporate governance initiatives into the federal securities laws.[16] The SOX provided explicit legislative directives for SEC regulation of what was previously perceived as the state's exclusive jurisdiction.[17] One of the most important provisions of this statute which is often ignored during the course of legal discussions protects employees of publicly traded companies and entities connected with these companies from retaliation for disclosing corporate fraud.[18] A violator of such a law may be fined and imprisoned for upto 10 years as per the provisions of the law.

ii. U.K.

- Public Interest Disclosure Act, 1998

[14] *Id.*
[15] *Supra* note 8.
[16] *Supra* note 13.
[17] *Supra* note 13.
[18] *Supra* note 13.

In the United Kingdom, the condition has been very much clear. Financial scandals, Health and safety disasters, all have emphasized the need to provide greater protection for whistleblowers in the UK. The Public Interest Disclosure Act 1998 (PIDA) came into effect in July 1999 as Part IVA of the Employment Rights Act 1996 (ERA).[19] The PIDA 1998 was the model for South Africa's Protected Disclosure Act 2000 and has been regarded as an exemplary piece of legislation in debates in other countries such as the Netherlands, New Zealand, and some Australian states.[20]

The PIDA 1998 is the Act which was enforced to protect the employees from the unfair and detrimental treatment of employers. The Public Interest Disclosure Act, 1988 (hereinafter known as the UK Act), as a result of the serious deliberations of the Nolan Committee Report. This Act specifically applies to a "worker" in both public and private sectors and also extends protection to contractors. In 2014, the UK Supreme Court established that even members of an LLP Partnership are "workers" under the Act.[21]

A distinctive feature of the UK Act is that it lays more emphasis on the information that is being provided, rather than the person who

[19] *Supra* note 11.

[20] David Baladen Lewis, Nineteen years of whistleblowing legislation in the UK: Is it time for a more comprehensive approach?, International Journal of Law and Management, Vol. 59 Issue: 6, pp.1126-1142.

[21] Clyde & Co LLP and anr. v. Bates van Winkelhof, (2014) UKSC 32.

provides such information. Public interest in protecting whistleblowers was never vividly articulated prior to the PIDA 1998. It was this Act which tried to consolidate the same albeit in a restrictive manner. However, since this Act does not stand upto the international standards, the same shall be replaced as soon as possible. The key objectives of the new statute should be such as to encourage people to raise concerns about wrongdoing; to ensure proper investigation and protect the whistleblowers.

SECTION 2: CAUSATIVE RATIONALE FOR ENCOURAGING WHISTLEBLOWING AND ITS IMPACTS

Corporate governance has emerged as an important aspect both nationally as well as at the global platform. With trade and market at its highest peak, the expectations of shareholders are extremely high and the scrutiny by the regulators and investors incredibly stringent. In response to the same, the Indian companies are also enacting measures to combat issues of increasing corporate fraud and corporation.

For several years, whistleblowing was considered to be an act against the better interest of the organisation. There was always a threat for the whistleblower in regards to retaliation and being treated indifferently within the organisation. A need was thus felt to define

the concept of loyalty towards the organization and whether whistleblowing is in fact violating that loyalty or not.[22]

1. WHY WHISTLEBLOWING?

Mahatama Gandhi once quoted, "*There is a Court, higher than the Court of Justice, it is the Court of Conscience, and it supersedes all*." Benevolent concerns are often one of the major reasons a whistleblower comes forward to blow the whistle. The desire to undo the wrongdoing which might harm the public interest or can cause damage to the reputation of the organisation at large is the altruistic reason to blow the whistle.[23] Apart from this, in certain cases, the organisation often rewards the whistleblower. Federal statutes in the USA also provide for such compensations or rewards to the whistleblowers to the extent of 30% of the total money being recovered as a result of such whistleblowing. (Paul and Townsend, 1996; and Carson et al., 2007).

It is of importance to understand that it is not always the benevolent or altruistic forces guiding a person to come forward and expose such frauds. In certain cases, there might be psychological factors driving him such as the feeling of vengeance against the organisation and reinstatement of employment, etc. (Paul and Townsend, 1996).

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[22] Siddhartha Dasgupta and Ankit Kesharwani, Whistleblowing: A survey of literature, Vol. IX, No. 4, 2010, The IUP Journal of Corporate Governance. https://www.academia.edu/976633/Whistleblowing_A_Survey_of_Literature?email_work_card=view-paper

[23] *Id.*

2. RATIONALE BEHIND PROMOTING WHISTLEBLOWING POLICIES

ArjumandBano&Dr. Sanjay Baijal[24] in their paper, "*Whistle blowing in India- Introspection*", highlighted the concept and importance of whistleblowing in an organisation. The authors' extensive research has helped the researchers in highlighting the status of whistleblower in India and further throws light on the miserable treatment of whistle blowers.

In another paper by Mr PrabhukarMundkur,[25] the need for protection of whistle blowers in India has been highlighted by bringing to light a few recent scandals which occurred in the country. The author discussed about the disturbing treatment of companies such as Indigo Airlines towards whistle blowers and also discussed the Infosys scandal wherein a whistleblower had exposed the company's wrongdoings.

It is very important for an organisation to bring in robust whistleblowing mechanism to the employees in order to avoid external exposure. Dinesh Thakur, the whistleblower in the case of Ranbaxy stated in an interview that he reported and revealed the

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[24]ArjumandBano&Dr. Sanjay Baijal, Whistleblowing in India- Introspection, (October 18, 2019 1:00 pm), http://www.ijetmas.com/admin/resources/prohect/paper/f201503031425430684.pdf.
[25]PrabhukarMundkur, Whistle blowers and corporate governance, (October 18, 2019 1:00pm), https://www.linkedin.com/pulse/whistle-blowers-corporate-governance-prabukar-mundkur.

information to the US authorities because he was not aware whether a comprehensive statute like the False Claims Act (FCA) in the US existed in India where private citizens were provided protection to help the Indian government prosecute companies carrying out illegal activities. This incident is indicative of the fact as to how having a well-formulated law on whistleblowing provisions in the corporate world is the need of the hour.

Transparency International, a global anti-corruption watchdog has also recommended that India should introduce effective legislation to protect the whistleblowers in the private sector.[26] In furtherance to this, the Whistleblower Protection Act, 2011 does not cover commercial whistleblowers under its ambit and does not have the jurisdiction to cover the private corporate sector.[27]

In today's global scenario, having a robust whistleblowing policy cannot be treated as a mere luxury but rather should a concrete necessity. There are ample reasons as to why India should adopt a mandatory whistleblowing regime in all the public as well as private companies. A few of such incentives include:[28]

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[26]https://www.indiatoday.in/india/story/india-needs-law-to-protect-whistleblowers-in-private-sector-transparency-international-report-1338421-2018-09-12

[27] NIMISHA BHARGAVA AND MANI K. MADALA, An Overview of Whistleblowing: Indian Perspective, Vol. 4, Issue 2, IJIRSET, ISSN: 2319-8753.

[28]Shivam Goel, Protection of Whistleblowers in India: A corporate perspective, (October 16, 2019 2:00 pm),

- It is an easy means to ensure good governance within the organisation by encouraging the people associated with the organisation to keep a regular check on such policies.

- It paves a path for easier alerts to avoid a potentially larger disaster.

- It infuses a sense of fear in the minds of people and prevents them from committing frauds to an extent.

- It is an efficient means to promote the sense of openness in the organisation.

- Helps in building and retaining the trust of interested parties in the organisation.

- In furtherance to this, it brings transparency to the organisation.

3. CONSEQUENCES OF BEING A WHISTLEBLOWER

It is important to understand as to what can be the consequences of being a whistleblower in any corporation. Whistleblowing affects not only the professional life but also the personal life of the whistleblower.[29] For any act of whistleblowing, there can be positive

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https://www.academia.edu/6174619/Protection_of_Whistle_Blowers_in_India-_Shivam_Goel_NUJS

[29] Kayla L. Delk, Whistleblowing—Is It Really Worth the Consequences?, WORKPLACE HEALTH & SAFETY • Vol. 61, No. 2, 2013.

outcomes as to what have been mentioned above. However, it being a situation where the veil is lifted from the bad deeds of the responsible people who at times are people at the top management can have certain repercussions. A few of such instances are delineated below:[30]

- There can be a sense of hostility towards the whistleblower and he may be either fired or forced into quitting the job.

- Whistle-blowing behaviour can bring legal or market-related consequences for the organization.[31]

- Although the law prohibits any kind of retaliation, a poor or hostile working environment can cause a sense of alienation and depression in the mind of the whistleblower.

- Possible destruction of lifelong job security or career success.[32]

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[30] Fraser Sherman, Negative consequences of whistleblowing, (October 16, 3:00 pm), https://bizfluent.com/info-8153422-negative-consequences-whistleblowing.html

[31] Neil Kokemuller, What Are the Hazards of Whistleblowing and Their Effects in the Workplace?, (October 17, 2019 1:00 pm), https://smallbusiness.chron.com/hazards-whistleblowing-effects-workplace-15733.html

[32] Marian V. Heacock and Gail W. McGee, Whistleblowing: An Ethical Issue in Organizational and Human Behavior, Business & Professional Ethics Journal, Vol. 6, No. 4, pp. 35-46, https://www.jstor.org/stable/27799960

- Another major concern is not being able to gather enough proof to fight against a huge corporation followed by a lack of legal protection from such negative consequences accruing as a result of the whistleblowing.[33]

It is essential to understand that management can avoid external whistleblowing by providing a hospitable environment.[34] Whistleblowing within the organisation can save the reputation of the organisation at the external level without causing much damage. It is important that whistleblowers should be treated as audacious guardians of the organisation and they should be perceived as the assets of the organisation rather than disloyal or deceitful employees.

SECTION 3: ANALYSIS OF EXISTING LEGAL FRAMEWORK IN INDIA

It is an undisputed fact that whistleblower protection laws in India are at its embryonic stage. Though the Whistleblower Protection Act 2014 has catered to the need to an extent however, the Act still does not have jurisdiction to try cases of corporate world. It is only with an efficient management system and robust policies, transparent governance can be achieved. Such policies need to be

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[33]Chanjyot Kaur, Whistle blowing: An anti- corruption tool, Vol 1 No. 5, IJARMSS, ISSN: 2278-6236.

[34] Marcia P. Miceli & Janet P. Near, Whistleblowing: Reaping the benefits, Academy of Management Executive, 1994 Vol 8 No.3, https://www.jstor.org/stable/4165204?read-now=1&seq=1#page_scan_tab_contents

formulated in a way that acts of corruption, fraud, and illegal practices in the company can be easily detected and minimized. Such policies have been in place in the form of legislative act even before the enactment of the Whistleblower Act, which was well recognised u/s 199(9) of the Companies Act, 1956 which provides that all public companies have to establish a vigilant mechanism for employees and senior executives.[35]

However, with the lack of a solid law in place to keep a check on corporate whistleblowing, there is a significant need to raise and set the benchmark of corporate governance, and whistleblowing provisions shall be made mandatory for private companies too.[36]

1. SCOPE AND CLARITY OF THE INDIAN LEGISLATIONS

- The Companies Act, 2013

Apart from the Act, section 177(9) of the Companies Act, 2013provides that all public listed companies have to establish a vigilant mechanism for employees and senior executives. In furtherance to this, they are bound to establish a whistle blower policy with clear and adequate safeguards against victimisation of

[35] LOVINA MALHOTRA, Know the law on Whistleblower Protection in India, (October 16, 2019, 3:00 pm), http://legodesk.com/blog/whistleblower-protection/.

[36] KARN MAHAWA, "Corporate governance and whistle blowing in India: Promises or Reality?", International Journal of Law and Management, Vol. 59 Issue: 3, pp.430-441.

whistleblowers.[37] The amendments in the company law have been designed in a way to avoid corporate frauds and eliminating unnecessary loopholes. The independent directors are also given the task of reporting any concern over any wrong or suspected fraud or unethical behaviour for the violation of any code or policy of the company.[38] There is now onerous responsibility on auditors to act as whistleblowers by reporting directly to the Central Government if they have reason to believe a fraud is being, or has been committed against the company by its officers or employees.[39]

- The Securities and Exchange Board of India (SEBI)

In 2003, the SEBI vide its circular introduced Clause 49 of the Listing Agreement which talked about the formation of a whistleblower policy. It was not mandatory to put a policy in palace however, it was necessary to disclose its adaptation within the company.

In 2015, the SEBI (Listing Obligations and Disclosure Requirements) Regulations made it mandatory for the listed

[37] Whistle Blowing: Balancing on a Tight Rope, Knowledge Paper series-5, (October 17, 2019 1:00 pm), https://www.icsi.edu/media/webmodules/45th_nc/WhistleBlowing_BalancingonaTightRope.pdf

[38] Whistleblowing policy in India by Anubhav Pandey, https://blog.ipleaders.in/whistleblowing-policy-india/

[39] Harinderjit Singh, *New company law closes in on economic crimes*, The Hindu Business Line, http://www.thehindubusinessline.com/features/taxation-and-accounts/new-company-law-closes-in-on-economic-crimes/article5251749.ece

companies to have a whistleblower mechanism for their employees and directors under Regulation 22.[40] However, notwithstanding the foregoing legal strides, there is a widely held perception that current laws lack sufficient teeth to encourage whistleblowers to report wrongdoings freely. There is some merit in this perception because the whistleblower still lacks complete control when it comes to keeping his or her identity anonymous.[41]

- The Whistleblower Protection Act, 2014

The Whistleblower Protection Act in India is the Indian legislation dedicated to whistleblowers protection. The Act covers person making disclosure only in the public sector. The Act still is far from perfect and provides that disclosure should be made by a person or public servant or a non-governmental organization to a competent authority. In relation to the public sector, the Act states that the complaint should be made to the Central Vigilance Commission or the State Vigilance Commission. These disclosures however only seek to address "corruption or wilful misuse of power of discretion against any public servant.[42] It has no provision for appeals to

[40] Whistle Blowing: Balancing on a Tight Rope, Knowledge Paper series-5, (October 17, 2019 1:00 pm), https://www.icsi.edu/media/webmodules/45th_nc/WhistleBlowing_BalancingonaTightRope.pdf

[41]https://www.accdocket.com/articles/an-indian-perspective-on-whistleblowing.cfm

[42]Whistleblowers Protection Act, 2011, (October 16. 2019 3:00 pm) http://www.advocatekhoj.com/library/bareacts/whistle/4.php?Title=Whistle%20Blowers%

challenge an impugned order from the concerned competent authority.

Another important point is that the Act states that the identity of the whistleblower shall not be revealed unless so decided by the Competent Authority itself or it became necessary to reveal the same.[43] However, the Amendment Bill 2015 has proposed to make it compulsory for the complainant to reveal his name in the complaint which makes it a serious concern for the whistleblowers to come forward. The bill was passed by the parliament sans public poll and is currently pending the Rajya Sabha. The proposed amendments have been largely modeled on Section 8(1) of the RTI Act which provides for certain exemptions from disclosure of information. It is however crucial to note that there are serious repercussions on national security, secrecy can legitimately be claimed as it would then be in the larger public interest that such matters are not disclosed.[44]

SECTION 4: RECOMMENDATORY SUGGESTIONS ON BUILDING A ROBUST CORPORATE WHISTLE-BLOWING CULTURE IN THE COMPANY

20Protection%20Act,%202011&STitle=Requirement%20of%20public%20interest%20disclosure.

[43] *Id.*

[44] Prakriti Bhatt, Whistle Blowing: A Hobson's Choice? Cherry-Picking Between State Authorities and Third-Party Internet Platforms, (2019) 10 Law Rev GLC 1.

Therefore, the corporate whistle-blowing culture is not only something that has been encouraged by the global regulatory bodies but also a trend which is catching up with a majority of corporations doing business in India. A robust corporate whistle-blowing policy not only acts as a catalyst for building a work environment on transparency and trust but also prevents major reputational damages to organisations, due to the corporation's active participation towards preventing instances of alleged misconduct.

Internal corporate whistle-blowing is also imperative in highlighting potential red flags in addition to the ongoing misconduct at the organisational level.

In order to build a robust internal policy in support of corporate whistle-blowers, the following steps may be undertaken:

1. Enforce and implement a "*speak up*" program with a 24-hour confidential hotline service dedicated towards the corporate whistle-blowing matters;

2. Provide adequate training to the employees regarding internal whistle-blowing policy of the corporation and the importance of preventing instances of bribery and corruption, as per the existing legislation, including, but not limited to the Foreign Corrupt Practices Act 1977, UK Bribery Act 2010, Prevention of

Corruption Act 1988, etc. This shall also help in de-stigmatizing the concept of corporate-whistleblowing among employees;

3. Build a strong corporate compliance structure to ensure timely submission/ payment of dues, annual returns, etc and minimize the cash payments to the bare minimum;
4. Document adequate supporting documentation, invoices and proof of performance of the payments made to vendors and other third-party consultants hired by the organisation;
5. Ensure that the internal anti-corruption policies, standards, guidelines apply to the directors and other Key Managerial Personnel in addition to the employees of the organisation;
6. Ensure that integrity pacts and anti-bribery anti-corruption (**ABAC**) clauses form part of all third party contracts and agreements;
7. Once a whistle-blowing allegation is raised, the organisation/ company must initiate an internal investigation, document its findings, and implement necessary countermeasures (including disciplinary action) for the alleged misconduct.

Therefore, the age old phrase, *a switch in time, saves nine,* is of utmost importance in case of corporate whistleblowing. Companies must prepare themselves through preventive and policing procedures to ensure compliance in addition to taking adequate investigative steps

from the curative perspective of alleged complaints of bribery and corruption through internal corporate whistle-blowing mechanisms.

V. CORPORATE GOVERNANCE IN FAMILY-CONTROLLED BUSINESS WITH SPECIAL REFERENCE TO THE SUN PHARMACEUTICAL DEBACLE*

Abstract

The concept of Corporate Governance has been around since the time of the advent of Corporate Law that governs the proper functioning of corporate bodies. It is not really possible to explain the exact meaning of corporate governance, however, briefly, corporate governance refers to a set of rules that the company needs to abide by and which also keeps a check on the company's performance and the direction in which the company is headed. These are essentially a set of policies and regulations that the core members and persons incharge of the company must abide by and accordingly conduct themselves. This paper shall discuss about various challenges faced by family-controlled businesses in India and what makes it tough for the companies in India to ensure and implement proper good governance mechanisms within the company. The paper shall also make an effort to make a detailed study of the lapses regarding Corporate Governance by Sun Pharmaceuticals and how Corporate governance lapses can affect huge companies and their repute in the stock market. Lastly, the paper would also propose a few reasonable solutions that can be considered by the

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persons in-charge of a company in order to ensure that their company is in the right direction by complying with the proper corporate governance practices.

Keywords: Corporate Governance, Company performance, Family-Controlled, Repute, Stock Market

I. INTRODUCTION

In the current corporate scenario, it usually happens that the shares are mostly concentrated in the hands of the promoters, and family-controlled businesses mostly dominate the corporate structure. There is huge pyramiding and burrowing among Indian business gatherings despite inexhaustible revealing necessities and evidence of earning the management. This isn't astounding: concentrated proprietorship and family control are significant in nations where enforceable legitimate insurance of minority property rights is moderately feeble. Family controlled organizations give a hierarchical structure that lessens exchange costs and topsy-turvy data issues under these conditions.

Due to the high involvement of the promoters in business activities, either at a strategic level or in regular course, performance is enhanced. Because of unequivocal or inferred convergence of power among family members, they can take snappy choices in light of

market requests. Another advantage is self-evident, that promoters are persistently checking and ensuring resources of the company because of their own stake in the business and property of the organization. Then again, present-day corporates run as a law-based standard. On the off chance that greater parts of the Board individuals are supportive of a family, they can make choices (if not abusing any express lawful arrangement) as they like and to family's greatest advantage. The great corporate administration guideline requires choices in the enthusiasm of the organization as opposed to in enthusiasm of part or individuals or family. All the more especially, in conditions of irreconcilable circumstance, human inclination is slanted to choose in claim support rather than the organization. Corporate Governance demands generally. In the second circumstance, when, there is an irreconcilable situation among society and friends, human inclination is to take the choice that favors organization, corporate administration standards anticipate something else.

1. CORPORATE GOVERNANCE IN INDIA:

Corporate Governance involves a set of relationships between a company's management, Members of the Board, shareholders, and other stakeholders. Corporate governance provides a principled process and structure through which the objectives of the company,

the means of attaining the objectives and systems of monitoring, measuring & rewarding performance are set. Corporate governance is a set of accepted principles by the management of:

1. The indubitable rights of the shareholders as the owner of the company and of their own rule as trustees on behalf of the shareholders, and duty of the key managers when any actions are detrimental to the society.

2. It is about commitment to values, ethical business conduct, transparency, making a distinction between personal and corporate resources in the management of the company and to harmonize conflict of interest.

II. CHALLENGES IN FAMILY-CONTROLLED PUBLIC COMPANIES

A big number of publicly listed Indian companies are endorsed and handled by the families. About one-third of the companies registered under Sensex can be said to be controlled and managed by families only. It is important to know that these constitute large enterprises in the country which just by the very size of them must have gotten out of the family's limits and authorities. A lot of companies in today's world, which are family-controlled, have managed to lay down their management and ownership quite

distinctly. They purposefully refrain when it comes to the management deriving the benefits arising out of ownership.[1] It helps them keep conflict of interest at bay. But, the situation in India is far from perfect. It so happens that the promoters, even when they have fewer holdings, have a lot of say in the running of the enterprise. The company and the stock-exchange are bound by the listing agreement, which is a Regulatory Framework by SEBI. Through this, India has adopted a more middle-road to ensure that companies maintain their behavior when it comes to Corporate Governance. Countries like the US have adopted much stricter measures.

1. THE CURRENT ISSUES:

In the present scenario, there are two major issues. They can be summed up as follows:

- Whether the Boards of Directors in FMCs have contributed positively to promoting Corporate Governance?
- Issues relating to the independence of directors- about the directives regarding proportion, the question of real independence, and whether there is a problem in getting

[1] Christine A. Mallin, Corporate Governance, 83 (3rd ed.2010).

independent directors of the right caliber, and insufficient numbers.

On whether Boards of Directors (BOD) of Indian FMCs have been playing a constructive role in furthering corporate governance:

Although a large number of companies are managed and controlled by families, failure of the corporate machinery has never happened due to below-par Corporate Governance, which is heartening. It is interesting that the Family-owned companies played a large role in promoting entrepreneurship in a country fraught with controls, but, whether or not, they can hold ground today, with stricter dimensions, remains to be seen.

In addition to a general need for better practices, there have been instances in Corporate scenario which have been unsettling. Reliance Industries Ltd. saw one such happening, which led people to believe that not everything is right in the corporate structure.

It is surprising that such a big decision of Demerger was taken by individual i.e. Mrs. Kokilaben, by merely issuing a statement to the media.

It seems rather strange that Mrs. Kokilaben who held a meager 34% share in the company, could finalize that the demerger would be in the interest of the other shareholders who constituted the other 66% of the holding. There was not a single instance when the Board Of Directors of Reliance Industries Ltd., using their power and authority, questioned this arbitrary stance. This just goes on to reflect some of the governance practices. Post the split, even if Anil Ambani turned whistle-blower shed some light on the governance practices of the company, still, the above stance of decision making remained unclear. Not one out of the six Independent Directors (out of twelve), questioned this 34% holding. This in turn led to a compromise with the future health of the company.

On the issues relating to Independent Directors:

It is well established that as a Family-owned business grows, there arises a greater need for capital. This is met with, by introducing more Outside Owners. At such juncture, separation of management from ownership becomes fundamental. Hence, it is not enough to only appoint these Independent Directors. It is essential that they should be brave enough to challenge the CEO when needed. They should realize their fiduciary duty. Only then can a corporation thrive to become better. When everything seems still, and there are no eyes on the company, how it behaves reflects its culture. Many

giants like Enron, WorldCom, and Parmalat have bombed because of such cultural shortcomings.

Currently, Clause 49 of the listing agreement stipulates that companies shall have a 50% independent component if the Chair is full time or executive and one-third in case the Chair is non-executive. But if we take into account FMCs, this can be quite misleading. Take the case of a company like Tata Motors, belonging to the Tata group. For instance, Ratan Tata became the Non-Executive CM of Tata Motors, thereby relinquishing the earlier held position of Executive CM. Now, Clause 49 stipulates regarding independent directors based on Executive or Non-Executive CM of a company. But Ratan Tata relinquishing the post made it unclear whether power equations would change post that. Hence, it would have made more sense had Clause 49 decided the Independent Directors based on the CM's independence.

The presence of a good independent director absolutely depends on the culture of the enterprise. In the presence of people like Nusli Wadia holding positions for stretches of nearly thirty years, a credible Director will be hard to find. Hence, it is imperative for companies to look and capable people in the Director's position rather than the ones who are famous. They may be from the lower hierarchies also, for e.g., below the Board level. These selected

people should be given time to effectively lay down their plans and execute them for the proper functioning of the company. This process of Director Development is a must for any given company.

III. CORPORATE GOVERNANCE OF LISTED FAMILY BUSINESSES IN INDIA

It has been found upon extensive research and study[2] that the corporate governance in family-run or controlled businesses differs from that found in non-family run businesses. The reason for that is because owners have multiple roles in a family business. In the Indian context, where family-owned or controlled companies are the prominent type of business organizations, this is the case not only in small and medium scale companies in India, but it was also found that 64% of listed companies too are family-controlled.

As explained, Adani Group director, Mr. Rajesh Adani, who is the Executive Director of the group and has been associated with the company since its inception, revealed the main reasons that a family business tends to be publicly listed are incentives, compliance, attracting top people, and the need of funds. To elaborate this further, it has been disclosedthat most of the Indian companies have

[2]Masulis et al, The Journal of Finance (2009), The Journal of Finance, 1881 (2007).

stable ownership structure and therefore ownership is more likely to be exogenous to performance.

Furthermore, direct managerial ownership in India based companies is relatively small, because ownership is usually dominated by another corporate entity. These entities usually have family ownership as the ultimate owners, and therefore, direct managerial ownership does not play an influential role in the Indian context. And the existence of family ownership as a controlling shareholder, either through direct ownership or through another corporate entity, is a common feature of Indian listed companies. Hence, the key concern of family ownership is that it leads to the majority of directorships in these companies being held by the family members and the transferring of the management of the companies from one generation to another of the controlling shareholder families.

Supplementary to this, inadequacies in the Indian legal structure and framework for the protection of investors' rights have also contributed towards the presence of a controlling shareholder. Further, the study found that traditional corporate governance mechanisms cannot mitigate principal-agency conflict in family firms in emerging markets. More importantly, their study indicated a requirement for the promulgating or streamlining of corporate laws

in emerging markets to reduce the possibility of expropriation of minority shareholders by politically-powered family firm owners.

1. DECISION MAKING IN FAMILY-CONTROLLED LISTED COMPANIES:

Basically, founders of family businesses tend to make decisions at their own risk and calculate their own rate of return. However, with the next generation's involvement, decision making becomes more formalized and decisions are made via risk committees and other formal bodies. By explaining this situation further, major Indian family business leaders of huge companies such as the Aditya Birla Group, Reliance Industries, Adani Group, etc have agreed that though founders put more weight on their inner feelings and intuition, structured governance is truly important for the next generations. As the reason for this, the family business leaders have expressed their view as: - "A lot of things in the early day were based on gut and emotion. Public companies and families are two different things, and we're trying to find a happy medium. The gut feeling is exciting, but rational decisions must be made keeping the larger good in mind".

More importantly, another key point he made was that with the end of the war many businesses needed longer-term investment policies

and for that a more structured way of governance as indeed need. This does not suggest that the only important mechanism is formal rules and regulations to govern the business.

However, as family business members have the freedom to do so, their own way of making decisions could be used when it is needed. This is indicated by the statement stated in the research findings: - "If all the rules and regulations worked, I wouldn't be here. It is gut feeling that brings people to their decisions. When I was about 29, I recall telling my dad not to buy something as I didn't feel we could afford it. Now, of course, we have different advisors and committees. But at the end of the day the gut feeling needs to govern you sometimes. If you're bogged down by committees, the business cannot grow."

Therefore, it is clear that decision-making processes in family-controlled listed businesses unlike in other listed corporate bodies is a two-phase process which involves both rational decisions- making process as well as family members' intuition.

2. POSITIVE ASPECTS OF FAMILY-CONTROLLED LISTED COMPANIES:

- Commitment to the business project and the wishes of the shareholders.

- The long-term vision for the overall development of the company.
- Alignment of interests between owners and directors.
- Greater importance of extrinsic compensation systems based on motivation.
- More efficient supervision mechanisms, as there is less asymmetrical information.
- Lower risk of conflicts of interest between shareholders and directors.
- Lower risk of opportunistic conduct by directors.
- Can foster creativity; rich interplay of roles and goals
- Closely held; family owned; high degree of control; earnings are motivators
- Clearly defined culture leads smooth governance
- Fewer principal-agent problems
- Continuity in leadership thereby encouraging long-term orientation
- Co-ownership within the family leading to better investment strategies

3. NEGATIVE ASPECTS OF FAMILY CONTROLLED LISTED COMPANIES:

- Prevalence of large-scale Nepotism
- Absence of meritocracy.
- Control prevails over achievement of financial targets
- Less efficient internal control mechanisms (i.e. board of directors and compensation) due to the family ties between the parties.
- Less efficient external control mechanisms (i.e. takeovers) due to the strong control over the company by the family
- Greater risk of conflicts between family shareholders and minority shareholders.
- Greater risk of adverse hiring. Difficulty in attracting external talent and disciplining executives that are family members.
- Must be managed to avoid confusion; can be a drain of resources and energy
- May sacrifice growth for control; do not have to answer to stockholders.
- Autocracy and paternalism lack democracy
- Family issues get in the way; unwillingness to let go; inability to choose a successor and thus May have to depend on even weak leader

- Lack of motivation for professional managers.

IV. CHALLENGES IN FAMILY CONTROLLED COMPANIES IN RELATION TO CORPORATE GOVERNANCE

1. **CEO Duality:** It is when the CEO is a family member; this becomes quite difficult and awkward which can create further unsuitable problems for management and as a whole business. This family CEO believes that being the owner of the majority share owner he has the full right for different experiments as well to do according to their force. Secondly, if the CEO and Chairperson is one and the same, we get in to the same mayhem, since he is the authority within the organization as well on the Board. To avoid such compromises, it is recommended by all Codes of Corporate Governance in the intact world that the two roles be handled by separate individuals.
2. **Internal Control Formation:** Since many families Controlled businesses are managed by the founders or their children, with their close supervisor the control environment is largely customized to their needs, and according to their indulgent. The problem comes when controls do not grow along with the company, as the businesses grow with the passage of time

and the situation becomes more complex. This space is a crucial spot of concern for external investors for their decision making and long-term survival.

3. **Succession Planning:** Two words "Succession Planning" seem so simple and easy to follow and yet it is so difficult because it means coming to terms with the fact that you are not indispensable. However great a leader maybe, he/she has to realize that the organization is larger than the individual, that it has an ongoing life of its own, irrespective of who head sit. A leader has not been successful if the organization cannot manage without him and fairs poorly after his exit. On family businesses, there is a saying – "the first generation creates, the second inherits and the third destroys".
4. **Constitution & Functioning of the Board:** When it comes to board membership, most families Controlled businesses reserve this right to members of the family and in a few cases to some well trusted non-family managers. This practice is generally used to keep family control over the dir1ection of its business. Indeed, most decisions are usually taken by family member directors. Family directors who are also managers in the business would naturally encourage reinvesting profits in the company so as to increase its growth potential. On the contrary, family directors who do not work in the business

would rather make the decision of distributing the profits as dividends to family share holders. These gain say views can lead to major conflicts in the board and negatively impact its way of functioning.

5. **Family Constitution:** Weaknesses Family constitution is a living document that evolves as the family and its business continue to grow. As a consequence, it is necessary to regularly updatetheconstitutioninordertoreflectanychangesinthefamilyand/orthebusiness.Family governance structures and institutions require a certain degree of formalization if they are to function well. As families adopt policies on the family's approach to the business and on governing the business, they will formalize these efforts with documents that will differ depending on their ownership stage.

V. THE SUN PHARMACEUTICALS FIASCO

Sun Pharmaceuticals is arguably India's largest drug maker, established by Mr. Dilip Shanghvi, who currently also acts as the Managing Director of the company. Among the core people currently managing the company, close to 60% are Mr. Dilip Shanghvi's close family members or his kith and kin. A few years

ago, Sun Pharmaceuticals had acquired the business of its closest rival in the market, Ranbaxy Laboratories, and thus became the parent organization of Ranbaxy Laboratories. Ever since this successful takeover of the business of Ranbaxy Laboratories, Sun Pharmaceuticals has unfortunately found itself under SEBI's radar owing to lapses regarding corporate governance. Much of the corporate governance lapses have been attributed to Mr. Sudhir Valia who was a whole-time director of Sun Pharmaceuticals, and who is also the brother-in-law of Mr. Dilip Shanghvi.

Owing to a scathing note by an Australian brokerage firm Macquarie and several whistleblower complaints over the months, SEBI has been critically monitoring Sun Pharmaceuticals' transactional activities in the share market and has also undertaken several high level and strict investigations to find out if there is any substance in the accusations and whether the company is indeed guilty of severe corporate governance lapses. Owing to all these accusations that have rocked the company's repute in the stock market, Sun Pharma has been at the receiving end of losses of close to $ 1 billion in valuation in the last half of the year 2018. Sun Pharma's stock has dipped to an all-time low to a measly 29% since October 2018 as the company has since faced regular investigations by SEBI.

The heart of the matter based on the complaints received is that a subsidiary named Aditya Medisales had lent some money to certain companies run by Mr. Shanghvi's brother-in-law, Mr. Valia, and the Sun group had chosen to use the services of certain banned traders to run their fundraising mandate in the year 2004. Since such accusations came into existence, the Sun authorities have decided to discontinue their domestic tie-up relation with Aditya Medisales and also went ahead to recall loans from third parties, while establishing a special internal committee that shall be responsible for overseeing the corporate governance matters of the company. According to Mr. Shanghvi, owing to such complaints against Mr. Valia, the latter has chosen to step away from the mainstream business of the company for the time being, and instead of continuing as a whole-time director, has chosen to take up the role of a non-executive director.

Another issue of lapse of Corporate Governance within the Sun Pharmaceuticals framework came into the picture in the year 2015 when Sun Pharmaceuticals had acquired the business of its closest rival in the competitive market, Ranbaxy Laboratories. The crux of the matter in this case was that the key persons of Sun pharmaceuticals in-charge of running the company had decided to do away with a certain number of employees and get rid of certain manufacturing units in a series of events, once it had acquired the business of Ranbaxy Ltd. The company claimed that owing to the

deal with Ranbaxy, there shall be a combined profit of $250 million when the deal to acquire the business of Ranbaxy is finally effected. The company, however, failed to disclose the means of achieving the said combined profit of $250 million.

It was only predicted by market analysts and experts that the claim by the company of a combined profit $250 million was to be achieved through job cuts and laying off of workmen and also selling off of assets such as manufacturing units of the company. It was found out very soon that as it was anticipated by analysts, soon after the taking over of the business of Ranbaxy, Sun Pharma had indeed engaged in an act of job cuts and had laid off close to 150 employees including some senior executives in both India as well as its US businesses.

Towards the end of the year 2015, Sun Pharmaceuticals was engaged in acts of disposing of several of its manufacturing units, claiming that such actions were being taken to strengthen their manufacturing capacity and ability, in a select few places. For example, the company sold one of its manufacturing units in the US to Nostrum Laboratories, and the money raised through this deal was not disclosed by the company.

In such cases, the company had not only failed to ensure there exists the crucial requirement of good corporate governance in all its dealings by failing to uphold transparency in its transactions, it had actively tried to make the investors believe that there is no such intention or plan to lay off senior executives and other employees of the company, and also there is no such objective of divesting the company's assets, by actively denying the reports being put forward by the industry experts and market analysts alike. Hence, it can reasonably be concluded that the company was not only non-transparent, which itself is a wrongful practice in relation to good corporate governance, the company had also deliberately tried to defraud the investors and shareholders alike, by its active and frequent denials regarding events that eventually turned out to be true.

There have also been issues of poor corporate governance due to reports of Insider Trading, which shall be dealt with under the Insider Trading section of this research work.

VI. INSIDER TRADING

The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 1992,[3] does not directly define the term Insider Trading. But it defines the term "Insider", "Connected Person" and "Price Sensitive Information". Insider Trading is the trading of securities of a company by an Insider using the company's non-public, price-sensitive information while causing losses to the company or profit to oneself. According to the Regulations, "Insider" means any person who is or was connected to the company or is deemed to have been connected with the company and who reasonably is expected to have access, connection to unpublished price sensitive information in relation to that company.

The Regulation defines that a "connected person" means any person who-

(i) Is a director, as defined in clause (13) of section 2 of the Companies Act, 1956[4] of a company, or is deemed to be the

[3] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations (1992).

[4] Companies Act, Section 2(1956).

director of the company by virtue of sub-clause (10) of section 307[5] of the Act.

(ii) Occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company, whether temporary or permanent, and who may reasonably be expected to have access to unpublished, price-sensitive information in relation to that company.

In 1984, in the case of *Dirks vs SEC,*[6] no one was termed liable of Insider Trading as they disclosed the information for exposing fraud and for no personal gains. This gave rise to the concept of "constructive insiders". Constructively Insiders are Lawyers, Investment Bankers, and others who receive confidential information from a corporation while providing service to the corporation.

In 1997, O'Hagans Case[7], the court recognised that a company's information is its property: " A Company's confidential information qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of fiduciary duty constitutes fraud akin to embezzlement-

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[5] Companies Act, Section 307(1956).
[6] Dirk v. S.E.C.463 U.S. 646(1983).
[7] United States v. O'Hagan, 521 U.S. 642 (1997).

the fraudulent appropriation to one's own use of money or goods entrusted to one's care by another."

1. INSIDER TRADING IN SUN PHARMACEUTICALS:

Very recently, that is to say, in April 2019, the former chief of Sun Pharmaceutical Laboratories, which is a wholly-owned subsidiary of Sun Pharma, Mr. Abhay Gandhi and his wife had agreed to settle a dispute in relation to insider trading, with market regulator SEBI by paying a sum of Rs. 70 lakh as settlement charges. The matter relates to trading of shares case whereby shares of noted pharmaceutical company Ranbaxy Laboratories were traded in 2014 by Mr. Gandhi, who is the current CEO of Sun Pharma's North America business, and his wife.

Sun Pharma, in the year 2013 had approached another noted pharmaceutical company named Daiichi Sankyo, who were also the promoters of Ranbaxy, in order to acquire it. According to SEBI, advisors of Sun Pharma had sent mails to Daiichi during the months of September to November 2013. Further, it was also observed by SEBI that several emails were exchanged between Daiichi and the advisors of Sun Pharma during the period from January 2014 to February 2014, which eventually led to Daiichi forwarding the proposal put forth by Sun Pharma, to Daiichi's advisor. In response,

Daiichi had asked Sun Pharma for particular dates and times to finalize the said deal. Here, one of the most crucial constituents of the said deal was the agreement of Daiichi to consider any sort of transaction.

According to SEBI, since Daiichi Sankyo were the promoters and majority shareholder to be in considerable control and efficient management of Ranbaxy Laboratories, any transaction whatsoever without the agreement or acquiescence of Daiichi was just not possible. Daiichi had asked for suitable dates and time for the closure of the deal in February 2014, after necessary meetings with the advisors of both Daiichi and Sun Pharma and after the appointment of Goldman as the financial advisor. This, according to SEBI, shows that Daiichi had indeed agreed to the proposal put forth by Sun Pharma.

This very information that the proposal that was put forth by Sun Pharma to acquire the business of Ranbaxy Laboratories was agreed to by Daiichi was a Price Sensitive Information (PSI). This very price sensitive information came into being on February 14, 2014 and was released into the public domain on April 7, 2014, before the start of the trading hours. Hence, the period of the said unpublished Price Sensitive Information (UPSI) existed from February 2014 to April 6, 2014. During that time Mr. Abhay Gandhi was the chief of

Sun Pharma and thus he and his wife qualified as being insiders under the rules laid down by SEBI.

When the proposed deal had not been made public as of yet, Mr. Gandhi and his wife had traded in 454 shares and 6770 shares, respectively, when the UPSI period was still in existence. This trading in of shares of Ranbaxy Laboratories while the UPSI period was still in existence and further selling the said shares immediately when the UPSI period ceased to exist and the information was released into the public domain, amounted to a violation of the insider trading rules laid down by SEBI.

In this particular matter concerning the Sun Pharmaceuticals, what can one conclude? It is against the interest of the shareholders of a company if people occupying key managerial positions in the company engage in the practice of trading of shares without letting the shareholders know of the same by trading in the shared before the price sensitive information is released into the public domain. The question now arises why is it that trading of shares before the price-sensitive information is released into the public domain considered a wrongful practice in relation to corporate governance?

The share market deals with the assignment of capital funds in an economy. This feature ensures that there is efficiency in the market

where the concerned market's price shows the surrounding risk and also the future returns, with utmost accuracy. If the trading of shares will be allowed before the price-sensitive information are released into the public domain, it shall be a biased act against the investors and shareholders of the company since the "insiders", as per the definition under the SEBI rules, shall be having additional price-sensitive information before them and the same can be used by the insiders to make immense profits. It does not just end there. Such acts also go on to prove that such trading of shares also result in the investors suffering huge losses or atleast not gain the deserved profits that are enjoyed by a select few who have engaged in such an act.

If a share market is free of these negative practices of unauthorized trading in of shares, it ensures of maintaining a healthy environment that is conducive to the proper growth of the market as a whole, and such markets, in turn, succeed in winning the confidence of the investors. It has been time and again proven that a share market that is plagued by illegal transactions and trading of shares, leads to the loss of confidence of the prospective investors which eventually leads to the market dealings coming to an abrupt halt, thereby effecting a scenario that can be compared to the Great Economic Depression of the United States. Besides that, as mentioned earlier, any information about the company is the exclusive property of the

company and thus only the company must profit from it, which includes all the investors and shareholders alike.

2. REASONS TO CONTROL INSIDER TRADING:

- To protect general investors. The manipulation of the market by using Insider trading generally causes great losses to a company, thus leading to a loss for investors or great profit only for the Insiders and no investor. It steals away the possibility of earning profit from an investor.
- To protect the interest and reputation of the company. Once a company faces a problem of Insider Trading, investors tend to lose confidence in the company and stop investing in the company and also selling all the stocks of the company.
- To maintain confidence in the stock exchange operations. With SEBI also regulating all the tradings, if any Insider gets a chance to get past the laws, it decreases the investors' confidence in the stock exchange operations itself.
- To maintain public confidence in the financial system as a whole. Indian Financial Market is still very low in the domestic investment rate. To have a healthy economy, a proper financial system is a must and for that, confidence in the market is of utmost importance.

3. RATIONALE BEHIND PROHIBITING INSIDER TRADING:

The securities market deals with the allocation of capital in an economy. This function enables market efficiency, where the market's price reflects the risk and future returns accurately. Insider trading appears biased to investors as insiders have additional price-sensitive information before them and can use it to make profits while the late reception of information makes investors suffer loss or not gain the deserved profits. If a market is integrated and free of illegal trading, it may lead to the healthy growth of the market, and such markets can inspire the confidence of the Investors.

Insider trading leads to loss of confidence of Investors on the market which can lead to a halt in market dealings thus causing a situation similar to the Great Economic Depression of the United States. Besides, a company's information is its property and no one but the company must profit from it.

VII. SUGGESTIONS FOR GOOD CORPORATE GOVERNANCE IN FAMILY-CONTROLLED BUSINESSES

Encourage autonomy of ideas and execution:

Promoters have to promote and encourage independence of thought among not only independent directors but also among all. When the company turns public, there arises a fiduciary duty upon the promoters to work towards the common good of the company and entire shareholders. The regulators should also go easy on fixing criteria for ensuring structural independence as far as directors go. Unrestricted impediments should be overlooked or completely done away with.

Acting under the free will:

Organizations that are self-regulatory in nature should be established for the Directors of all PLCs and interactive sessions and orientation programs must be held for their development. Various bodies like IACD, which has been set up in lines of NACD, can stipulate the standards of performance for directors in such Public Family-controlled companies.

Auditors and independent directors will not have any other financial relationships:

Auditors of companies should refrain from any financial relationship not only with the company in which they are auditors

but any other company of the same group as well. Analysis points to many such instances. Similarly, independent directors also shall not undertake any assignments pecuniary in nature with their companies and also refrain from taking up the directorship in group companies.

Devise a management philosophy and bring it into the public domain:

The promoters in Family-controlled companies should devise a management policy regarding the whereabouts of management and publish it in their annual records. This is especially imperative for companies where the shares held by the family are substantial (say more than 25%). This would help them in competing in the global scenario.

Independence should mean real independence:

Shareholding by Independent Directors should be done away with and they should not be issued any options whatsoever, on the guise that they will work in favor of the shareowners. It is quite ironic to give shareholding power to Directors. Currently, the regulators prescribe that the Independent Directors cannot hold in excess of 2% shares in the company. This shows they feel that more than that would result in the Directors aligning with shareowners. Hence,

there is no logical explanation for keeping 2%. Hence, it should be done away with.

Presence of written charter:

The presence of a written charter to stipulate various practices relating to effective Corporate Governance is highly essential. The powers, duties & responsibilities of different classes of directors should be lucidly penned down. The charter should cover all areas of board and governance-related aspects like role of the board, the information needed & its format for delivery, monitoring process, fixing of CEO evaluation criteria, CEO compensation, evaluation of other senior executives and their compensation, annual review of firm's performance, frequency of board meeting and committees, review of directors and board as a whole, etc.

Performance review process:

It is imperative that a review mechanism for the Board's performance be instituted. A performance review shall be initiated for the board. The self-evaluatory process of the Board and the Individual Directors as well should be made compulsory. This should be accompanied by Peer Feedback.

Leaders should lead by example:

Corporate leaders should lead by example. Leaders like K.M. Birla, who led the committee set up by SEBI on Corp Governance, are not expected to miss Board Meetings and AGMs. And the onus is on the companies as well to lay down responses for such delays or absence.

Role of SEBI in raising awareness:

It is the duty of Regulators such as SEBI to raise awareness about good corporate governance practices. One such thing could be encouraging the Institutional Investors as well as Investors, in general, to be vocal about their concerns in shareholder meetings. The general tendency is that they are more or less subservient in front of owners. And that is detrimental to the interests of the company.

VI. THE INFOSYS CRISIS: WHO ENDED UP PAYING THE 'PRICE'?*

Abstract

The corporate world is ridden with controversies concerning the propriety and ethics of the remuneration packages of top-management and executives, few of which at least alleged to be preposterously lofty and inconsistent with performance. In the Indian context, issues regarding the managerial labour market and executive compensation garnered attention only in the last ten to fifteen years. There has been much debate about the salary of Infosys' erstwhile executive, Mr. Vishal Sikka, for it tops the charts of remuneration rendered to professionals in corporate India. A 'tug-of-war' between founders and the management regarding this pay had engulfed the "once high on corporate governance" company in a series of allegations and fight back, ultimately resulting in his resignation.[1] The paper discusses the events that unfolded at Infosys in light of its repercussion on corporate governance. It examines the applicable regulations and scholarly literature regarding executive pay to evaluate whether the Board at Infosys was legally non-compliant in awarding Mr. Vishal Sikka's remuneration. The paper concludes with the finding that

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[1] Sunny Sen, *Infosys Chairman Defends Vishal Sikka's Salary, Says No Boardroom Battle*, Feb 13, 2017, available at https://www.hindustantimes.com/business-news/infy-chairman-defends-ceo-salary-dismiss-conflict-of-interest-with-founders/story-0E0bUFQ0whJu5x89tTZj2N.html (last visited on Sep 20, 2019) ["Sen-Hindustan Times"].

though the Infosys Board made complete disclosures and obeyed the regulatory procedural laws, these disclosures were not sufficient to address the deep displeasure of the founder group and led to a major public row, leading to a huge goodwill associated risks globally for a company listed on Indian and international stock exchanges, and renowned for its good corporate governance practices. The paper recognises that there is little that regulatory reforms can do to avoid similar scenarios when groundwork of executive compensation itself is based on corporate governance which itself stems from ethics, fiduciary duties and self-regulation. However, it proposes various measures that could help ensure that a balance is maintained between compensation that helps retain talent and hefty unjustified pay that compromises the interest of other stakeholders.

I. INTRODUCTION

The corporate world is ridden with controversies concerning the propriety and ethics of the remuneration packages of top-management and executives, few of which at least alleged to be preposterously lofty and inconsistent with performance. In the Indian context, issues regarding the managerial labor market and executive compensation garnered attention only in the last ten to fifteen years. Economic liberalization along with other widespread changes in the need for managerial talent has led to considerable

changes in the pay policies adopted by Indian companies.[2] Though the number of such controversies seems to be limited in India compared to its western counterparts, there have been a few instances of disproportionally high pay raising governance issues. A recent report revealed that top management in companies is paid at least 260.5 times the median pay of other employees on an average.[3] In fact, Sajjan Jindal, the Chairman and Managing Director of JSW Steel, earned a preposterously high package of INR 70.3 crore, which was 1,052 times the pay of an average employee in the firm. This issue is not recent as even in the year 2005-2006, there was a 248% increment in the pay of Mr. Naveen Jindal, the Managing Director of Jindal Steel and Power to, amounting to INR 13.54 even though the profitability of the company remained stagnant. Similarly, Hero Honda' Managing Director, Pawan Kant Munjal, earned a 15% salary raise despite the company witnessing an 11% reduction in net profits.[4]

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[2] A Parthasarathy, D. Bhattarcharjee& K. Menon, *Executive Compensation, Firm Performance and Corporate Governance: An Empirical Analysis*, Jaunary 2006, available at https://dx.doi.org/10.2139/ssrn.881730 (last visited on Sep 20, 2019).

[3] M Saraswathy& Prince Mathews Thomas, *Do Indian CEOs get 'obscene' salaries? Here is what we found*, Sep 13, 2019, available at https://www.moneycontrol.com/news/business/companies/do-indian-ceos-get-obscene-salaries-here-is-what-we-found-out-4434191.html (last visited on September 21, 2019).

[4] Varun Israni, Executive Compensation In India, Feb 25, 2013, available at http://corporatelawreporter.com/2013/02/25/executive-compensation-india/ (last visited on Sep 18, 2019).

There has been much debate about the salary of Infosys' erstwhile executive, Mr. Vishal Sikka, for it tops the charts of remuneration rendered to professionals in corporate India. A 'tug-of-war' between founders and the management regarding this pay had engulfed the "once high on corporate governance" company in a series of allegations and fight back.[5]

II. WHAT WENT DOWN AT INFOSYS?

Infosys was incorporated in 1981 by seven engineers including N. R. Narayana Murthy, Nandan Nilekani, S. Gopalakrishnan, and others with a beginning investment of only US$ 250.[6] Infosys has grown tremendously since 1981 to become a US$ 11.8 billion company and India's second-biggest software services exporter[7].

Vishal Sikka, a former SAP SE executive, was recruited as the CEO in July 2014 to boost the company's performance following a slow growth period in the previous two years or so.[8] This was a paradigm shift for the company as a non-promoter CEO was appointed by

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[5] Sen-Hindustan Times, *supra* note 1.

[6] Infosys, About Us, available at https://www.infosys.com/about/Pages/history.aspx (last visited on Sep 19, 2019).

[7] Outlook, *Infosys Founders, Board Clash Over Governance, Compensation*, Feb 10, 2017, available at https://www.outlookindia.com/newswire/story/infosys-founders-board-clash-over-governance-compensation/965734 (last visited on Sep 18, 2019) ["Outlook 2017"].

[8]HarichandanArakali, *Infosys board reiterates confidence in CEO Sikka, denies 'governance lapses*, Feb 10, 2017, available at http://www.forbesindia.com/article/the-infosys-divide/infosys-board-reiterates-confidence-in-ceo-sikka-denies-governance-lapses/45893/1 (last visited on Sep 18, 2019) ["Arakali-Forbes"]

them for the first time. An extraordinary general meeting was called wherein his appointment as Infosys' managing director and the chief executive officer was ratified and a huge remuneration package of a maximum of $7.08 million or about Rs 42.48 crore was approved.[9] Sikka thus assumed the CEO and MD position at Infosys and strived to revive and further expand the organization with a huge salary. Vishal Sikka's arrival positively impacted the company as it achieved many goals during 2015-2016. Infosys thus enhanced Sikka's remuneration, giving him an opportunity to get up to $11 million in the corresponding financial year, including performance-based variable pay and stock options.[10]

However, this period of calm was disrupted by a rift between founders and board- exposed to the public through an open letter by co-founder Narayana Murthy questioning executive compensation and corporate governance in the company.[11]Murthy had retired from his position as the Chairman in 2014 but still had an aggregate stake of 12.75% in the company.[12]

Reports exposed that Mr. Murthy, along with Nandan Nilekani and S Gopalakrishnant had written to the board expressing their

[9]Moneylife, *Infosys: All for Vishal Sikka's Fat Paycheck, but…*, July 12, 2014, available at https://www.moneylife.in/article/infosys-all-for-vishal-sikkas-fat-paycheck-but/38131.html (last visited on Sep 19, 2019).
[10]Arakali-Forbes, *supra* note 8.
[11] Outlook 2017, *supra* note 7.
[12] Sen-Hindustan Times, *supra* note 1.

concerns regarding the substantial increase in the pay offered to the company's CEO.[13] They also questioned the bulky severance of INR.170.3 Million given to Mr. Bansal, a retiring top executive, which appeared suspicious to them and looked like "hush money".[14] However, Infosys's then-chairman, R. Seshasayee, defended the move adding that the Board had made this a standardized term in all employment contracts and was no longer going to be subjective about severance paid.[15] Narayana Murthy had also been critical of the increase in remuneration paid to the Chief Operating Officer of Infosys, Mr. Pravin Rao. The founder added that Infosys had always been fair while rewarding compensation which is not being reflected in the huge gap in salaries of Infosys' low rung employees and top executives.[16] Murthy expressed his discontentment regarding the lowering of corporate governance standards at the company that he co-founded.[17]Mr. Vishal Sikka was in fact not only among the highest received by an Indian CEO; it also was about 935.38 times

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[13]MyIndia, *Infosys Crisis: Founders Vs. Board*, Feb 13, 2017, available at https://www.mapsofindia.com/my-india/business/infosys-crisis-founders-vs-board# (last visited on Sep 19, 2019).

[14] The Hindu, *Infosys Defends CEO Sikka's Salary Increase*, Feb 8, 2017, available at https://www.thehindu.com/business/Infosys-defends-CEO-Sikka%E2%80%99s-salary-increase/article17264025.ece (last visited on Sep 19, 2019).

[15] Gaurav Kokardekar, *Mr. Big Money' at Infosys: The Entry and Exit of Vishal Sikka*, IX JOURNAL OF CASE RESEARCH 24 (2018) ["Kokardekar"].

[16] *Id.*

[17] The Asian Age, *Infosys CEO Vishal Sikka's Salary Slips to $6.7 Million*, Apr 14, 2017, available at https://www.asianage.com/business/companies/140417/infosys-ceo-vishal-sikkas-salary-slips-to-67-million.html (last visited on Sep 19, 2019) ["Asian Age 2017"].

the median salary of Infosys employees.[18] While the founders did not have issues regarding Sikka's performance, his compensation was scrutinized by the founders and received flak.

The Infosys board offered unwavering support to Sikka and did not concede to Murthy's allegations of failing governance and compensation woes. The Chairman remarked that:

"*The board is fully aligned with the strategic direction of Dr Vishal Sikka and is very appreciative of the initiatives taken by him in pursuance of this transformation*".[19]

An independent director of the company, Ms. Kiran Mazumdar-Shaw remarked that there was no breach in governance but there were "judgment calls" on which the board members and promoters had opposing views.[20] Mr. Sikka himself initially responded to this situation by stating that despite the distraction resulting due to this

[18]MyIndia, *Infosys Crisis: Founders vs. Board*, Feb 13, 2017, available at https://www.mapsofindia.com/my-india/business/infosys-crisis-founders-vs-board# (last visited on Sep 19, 2019).

[19] Financial Express, *Infosys to Begin Talks with Founders to resolve Differences Over Corporate Governance*, February 10, 2017, available at https://www.financialexpress.com/industry/infosys-to-begin-talks-with-founders-to-resolve-differences-over-corporate-governance/545281/ (last visited on Sep 19, 2019).

[20] Outlook 2017, *supra* note 7.

corporate crisis, Infosys remained devoted "to governance, to rules, and to its core integrity".[21]

In the subsequent quarter however, when Infosys' profits were not satisfactory as expected, demands regarding reduction in Sikka's total compensation were reignited. His variable pay was reduced by 54% and he was paid only $3.68 million of his target variable compensation of $8 million for 2016-17.[22] Variable pay assesses and monitors an employee's performance and is accordingly paid. In 2018, he received a fixed remuneration of $3 million and his total pay for the year is $6.68 million as opposed to the envisaged amount of $11 million and substantially lower than even his earnings of $7.45 million in 2015-2016.[23] However, despite this, the criticism of the founders persisted and Vishal Sikka ultimately stepped down from the role as the CEO and MD citing "personal attacks" as one of the reasons for his sudden decision.[24]

Shareholders of Infosys did not react positively to this change and share prices witnessed the steepest fall in past four years. Sikka

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[21]MyIndia, *Infosys Crisis: Founders Vs. Board*, Feb 13, 2017, available at https://www.mapsofindia.com/my-india/business/infosys-crisis-founders-vs-board# (last visited on Sep 19, 2019).

[22] Asian Age 2017, *supra* note 17.

[23] *Id.*

[24]Shobhit Varma, *Vishal Sikka resigns as CEO and MD of Infosys: 10 key things to know*, Aug 18, 2017, available at http://indiatoday.intoday.in/technology/story/vishalsikka-resigns-as-ceo-and-md-of-infosys-10-key-things-to-know/1/1028474.html (last visited on Sep 19, 2019).

pointed out how the company's performance had turned around for the better since his appointment in 2014. He remarked that:

"*It is clear to me that despite our successes over the last three years, and the powerful seeds of innovation that we have sown, I cannot carry out my job as CEO and continue to create value, while also constantly defending against unrelenting, baseless/malicious and increasingly personal attacks*."[25]

The Infosys Board in a press release to Bombay Stock Exchange directly held Mr. Narayana Murthy responsible and stated that his "continuous assault" led to this premature resignation.[26] The release also stated that the Board is not influenced by Mr. Murthy's "misguided" campaign and would continue to observe the highest standards of corporate governance.[27] Moreover, Murthy allegedly even demanded that certain individuals be inducted in the Board, and certain operational and management changes be made.[28] This bolsters the belief that Murthy was still interfering in the company's business and attempting to regulate governance in Infosys. This

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[25] Outlook, *Can't Work While Defending Unrelenting, Baseless Personal Attacks: Former Infosys CEO Vishal Sikka*, August 18, 2017, available at https://www.outlookindia.com/website/story/cant-work-while-defending-unrelenting-baseless-personal-attacks-former-infosys-c/300476 (last visited on Sep 20, 2019).

[26] Business Standard, *Murthy's continuous assault led to Vishal Sikka"s exit Infosys board*, August 18, 2017, available at http://www.businessstandard.com/article/companies/murthy-s-continuous-assault-led-to-vishal-sikka-sexit-infosys-board-117081800358_1.html (last visited on Sep 19, 2019).

[27] Infosys, Company Statement, August 18, 2017, available at https://www.infosys.com/newsroom/press-releases/Pages/company-statement-18aug2017.aspx (last visited on Sep 19, 2019).

[28]Kokardekar, *supra* note 15, at 26.

paper will examine the corporate governance issues inherently involved in this scenario, in light of the background provided above.

III. REGULATIONS GOVERNING EXECUTIVE COMPENSATION

The Companies Act, 2013, and Securities and Exchange Board of India's ('SEBI') code provide a framework to deal with the interplay between corporate governance and the directors' remuneration.[29] Section 2 (51) of the Companies Act lays down a definition of 'managerial personnel' of a company for purposes of executive compensation.[30] The Companies Act, 2013 ("CA") stipulates the maximum cap of 11% of net profits of the company in the given fiscal year, for managerial remuneration that can be paid by a public company to its directors, including the managing director, whole-time director, and manager. Remuneration beyond the 11% cap can be paid on authorization by the shareholders in a general meeting.[31] Earlier, the approval of the Central Government was needed to exceed this limit, however subsequent to an amendment a special

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[29] P Saravanan, M Srikanth,., & S. M. Avabruth, *Executive compensation, corporate governance and firm performance: evidence from India,* International Journal of Corporate Governance, 7(4), 377 (2016) ["Saravanan"].
[30] The Companies Act, 2013, §2(51).
[31] The Companies Act, 2013, §197.

resolution is sufficient approval for the same, subject to Schedule V of the Act.[32]

Section 197 however does not extend the remuneration cap to CEO or CFO compensation, unless they concurrently hold positions as managing director, whole-time director, or manager. This provision, therefore, confers wide discretion to determine the remuneration package of executives, provided it falls within the stipulated cap. This is in sync with classically capitalist economies like the USA, where there isn't regulatory control over decisions regarding the compensation package to be given to an executive, but rather it is left to commercial wisdom of the company.[33] Federal securities laws only mandate that unambiguous, succinct, and comprehensible disclosures are made regarding pay rendered to CEOs, CFOs, and certain other high-ranking executive officers of public companies.[34]

Similarly, in India, the Act as well as the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 require a listed company to make relevant disclosures in the board's report on (i) the proportion of the remuneration of each director to the median remuneration of other employees for a fiscal year, (ii) the

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[32] The Companies (Amendment) Act, 2017.

[33] Soumya Kanti De Mallik &DebarupaAgarwala, *Executive Compensation In India: Summing up the Infosys Controversy*, available at https://hsalegal.com/2017/06/09/executive-compensation-in-india-summing-up-the-infosys-controversy/ (last visited on Sep 19, 2019) ["Kanti&Agarwala"].

[34] *Id.*

percentage rise in pay of each director, CFO, CEO, company secretary or manager, if any, in a fiscal year, and (iii) declaration that the remuneration is in accordance with the remuneration policy of the firm, amongst other requirements.[35]

Section 196(4) of Companies Act, 2013 lays down that approval must be obtained at the shareholder's meeting for appointment of every director along with notice of details regarding their remuneration package including perquisites.[36] The appointment of the person deemed suitable and nominated by the NRC is thus subject to the approval of the Board of Directors and the shareholders.

Another corporate governance measure for listed companies is the compulsory constitution of a Nomination and Remuneration Committee ("NRC"), mandated by the Companies Act, the Rules made thereunder and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. The NRC must comprise of non-executive directors only, with the Chairperson and at least fifty percent of its members being independent directors.[37] NRC devises a policy that aims at attracting and retaining talent at board levels and ensuring that succession planning is robust and then suggests

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[35] Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, Rule 5.
[36] The Companies Act, §196(4).
[37] The Companies Act, §178.

such policy to the board. The significance of this committee has been acknowledged across various jurisdictions, with there being separate remuneration and nomination committees formed and emphasis being laid on its independence.[38] Even in India, the need for such a Committee had been long felt and as early as 2000, the Kumar Birla Committee advocated for formation for a remuneration committee, albeit as a non-mandatory recommendation, with a minimum of three non-executive directors, chaired by an independent directors and disclosure of remuneration information in the annual report.[39] The Companies Act 2013 ultimately took cognizance of this however it is argued that in India the NRC is not fully effective due to the interference of promoters, dominant shareholders and holding companies.[40]

IV. FINDINGS AND ANALYSIS

Against this backdrop, it is significant to study whether such exorbitant pay is legally justifiable and whether the Board of Directors at Infosys was empowered to grant such remuneration.

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[38] Ashish K. Bhattarcharyya& Nirmal Mohanty, *Nomination and Remuneration Committee- A Modest Proposal to Improve its Effectiveness*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, July 2018, available at https://www.nseindia.com/research/content/QB_July_2018.pdf (last visited on Sep 21, 2019) ["NSE Quarterly Brief"].

[39] REPORT OF THE KUMAR MANGALAM BIRLA COMMITTEE ON CORPORATE GOVERNANCE, ¶10.2, 1999, available at http://www.nfcg.in/UserFiles/kumarmbirla1999.pdf.

[40] NSE Quarterly Brief, *supra* note 38, at 6.

As per reports, the Nomination and Remuneration Committee of Infosys analyzed, fixed and recommended compensation payable to the Board. Part C of Infosys' nomination and remuneration policy elaborates on the responsibility of the Committees in reviewing and recommending compensation of directors, key managerial personnel and other employees.[41]The compensation package of Mr. Sikka was finalized subject to approval of shareholders and disclosures were made in the financial statements of the company. Infosys' annual report for the years 2015-16[42] and 2016-17[43] disclosed the exact amount of compensation to be paid to its top executives including Vishal Sikka, along with a detailed breakdown of different pay components. Additionally, necessary disclosures were also made quarterly to Indian stock exchanges where Infosys is listed. Infosys is also listed on the NASDAQ and complies fully with the disclosure requirements in the US.[44] Therefore, as far as the black letter of the law is concerned, the Infosys board was not in violation of the applicable laws while authorizing Mr. Sikka's pay. However, a corporate governance analysis cannot be based solely on fulfillment

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[41] Infosys, *Nomination and Remuneration Policy*, available at https://www.infosys.com/investors/corporate-governance/Documents/nomination-remuneration-policy.pdf (last visited on Sep 19, 2019).

[42] Infosys, *Annual Report 2015-2016*, Annexure 3- Particulars of Employees, available at https://www.infosys.com/investors/reports-filings/annual-report/annual/Documents/infosys-AR-16.pdf (last visited on Sep 19, 2019).

[43] Infosys, *Annual Report 2016-2017*, Annexure 3-Particulars of Employees, available at https://www.infosys.com/investors/reports-filings/annual-report/annual/Documents/infosys-AR-17.pdf (last visited on Sep 19, 2019).

[44]Kanti&Agarwala, *supra* note 33.

of procedural aspect of laws, but rather entails a deeper look into how morally justifiable this compensation was.

Infosys' pay structure for Mr. Sikka had been endorsed by proxy advisory organization Institutional Investor Advisory Services India Ltd ("**IiAS**"), though they had at the same time warned that Infosys could get caught up in confrontations regarding the compensation package.[45] They elaborated that Infosys has previously adopted a conservative attitude in fixing payment for both its promoter and non-promoter directors. Now, this proposed remuneration was a departure from the previous ethos of the company and IiAS was of the opinion that there might be demands from other executive directors to make their compensation also comparatively high.[46] Therefore, it is important to scrutinize the exact composition of Mr. Sikka's pay and examine how it compares with remuneration given to other executives in the industry.

As far as the components of Sikka's pay is concerned, more than 60 of his total compensation was variable and contingent on achieving set performance targets.[47] In fact, performance-based compensation

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[45] Institutional Investor Advisory Services, *Voting Advisory for Infosys Limited*, July 15, 2014, available at http://iias.in/downloads/IIASreports/InfosysLtd-EGM-30Jul14-IiASRecommendations_20140718141354.pdf (last visited on Sep 20, 2019) ["IiAS Voting Advisory 2014"].

[46] *Id.*

[47] Institutional Investor Advisory Services , *Infosys Is No Longer The Bellwether Of Corporate Governance In India*, February 13, 2017, available at https://www.iiasadvisory.com/single-

has been widely recognized as an effective tool to incentivize managers and induce risk-taking. Agency theory postulates that managers are motivated to produce better performance results if compensation is dependent on enhancing the company's profitability and shareholder wealth.[48] Various empirical researches[49] conducted over the years have reaffirmed the theoretical underpinnings of the agency theory.[50] Agency costs, essentially a consequence of prioritization of personal motives over company welfare by managers, are thus inversely linked to variable performance pay. A compensation agreement that provides for incentive pay will thus result in executives being paid increased salary only on achieving greater profitability and prevent a discord between managerial and organizational wealth.[51]In fact, when Infosys performance went down in last quarter of 2017, Sikka's variable pay was also cut by 54%.

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post/2017/02/13/Infosys-is-no-longer-the-bellwether-of-corporate-governance-in-India (last visited on Sep 20, 2019).

[48] Saravanan, *supra* note 29, at 377.

[49] J.E Core, R.W. Holthausen and D. Larcker, *Corporate Governance; Chief Executive Officer Compensation And Firm Performance*, 51 JOURNAL OF FINANCIAL ECONOMICS, 371 (1999).; M.J. Conyon& L. He, *Executive Compensation And Corporate Governance In China*, 17 JOURNAL OF CORPORATE FINANCE, 1158 (2011).

[50] A Ghosh, *Determination Of Executive Compensation In Emerging Economies: Evidence From India*, 42 JOURNAL OF EMERGING MARKETS FINANCE AND TRADE, 66 (2006).; N. Balasubramanian, Samir Kumar Barua& D. Karthik, *Corporate Governance Issues in Executive Compensation: The Indian Experience (2008-2012)*, IIMB Working Paper No. 426 (2013).

[51] A Parthasarathy, D. Bhattarcharjee& K. Menon, *Executive Compensation, Firm Performance and Corporate Governance: An Empirical Analysis*, Jaunary 2006, available at https://dx.doi.org/10.2139/ssrn.881730 (last visited on Sep 20, 2019).

IiAS thus opined that Infosys' pay package composition was commendable as it interlinks remuneration and company performance. Indeed, the appointment of Mr. Sikka did reflect positively on the company's financial statements as Infosys' net profit margin increased by approximately three percentage points in 2015 over 2014, followed by a 3.5 percentage point rise in 2016.[52] Moreover, Infosys' competitiveness with other IT companies also increased during this time. Therefore, it does appear that Mr. Sikka's expertise regarding this sector and his leadership did yield positive results for the company.

However, it is not certain if this growth could entirely be attributed to Vishal Sikka's performance as the entire IT industry witnessed a massive boom during this period.[53] Warren Buffet emphasized in his essays that while performance should be the basis of executive pay, the relevant indicator of performance should be individual performance as opposed to corporate performance.[54] Buffet in fact was critical about the inclusion of stock options in pay package in the first place, as they might not necessarily prevent the division of managerial and company interest as they can be easily divested or misused by merely retaining and reinvesting earnings to depict

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[52]Kokardekar, *supra* note 15, at 21.
[53] *Id.*
[54] LAWRENCE A. CUNNINGHAM, THE ESSAYS OF WARREN BUFFET: LESSONS FOR CORPORATE AMERICA, 11 (1997).

capital gain. Buffet's observations are of relevance as it is difficult to evaluate the performance of a CEO and thus there is a need of caution to ensure that profitability has risen due to efforts of the concerned individual and not due to a general industry boom.

The performance of Infosys is compared to other IT companies in India in the table[55] given below:

Company Name	**Net Sales (in INR Billion)**		**Net Profit (in INR Billion)**	
	2014-15	**2015-16**	**2014-15**	**2015-16**
Infosys	533.19	624.41	123.73	136.78
TCS	946.48	1086.46	198.52	242.92
HCL Tech	367.01	307.81	73.17	56.43
Wipro	469.50	512.48	86.61	89.60
Mphasis	57.95	60.88	6.75	6.69

While Infosys benefitted from a 17% increase in net sales in that fiscal year, Wipro and TCS also fared similarly with their profits and sales also being on the rise. Thus, a wider concern was that despite comparable performance growth the proposed remuneration was

[55]Kokardekar, *supra* note 15, Exhibit 5.

higher than not just other Indian IT peers, but corporate salaries in general. Indeed, a comparative study of compensation package of Mr. Sikka with others in the same industry in the years 2014-2016 reveals that even executives appointed before Sikka earned lesser than him in 2015-16. This could potentially be an indicator of ineffective corporate governance by the Infosys Board.

However, IiAS remarked that given that majority of Infosys' top management comes from the US and given that Dr. Sikka would operate mostly from California, US, while shuttling to and from company headquarters in Bengaluru, a better comparison would be with global counterparts like Adobe where the pay levels for CEOs were akin and in some cases, even higher.[56] Therefore, through such a high compensation package was not witnessed in the history of the company, IiAS recommended that the shareholders should approve these proposals and ratify the Board's decision.

In India, remunerations agreements entered into with individual directors have to be compulsorily ratified by shareholders in a general meeting.[57] They can ensure that excessive compensation is not being rewarded to the CEO and thus play a moderating role. The fact that effectively a proposal has little chance of being rejected, given the indifference of absentee shareholders, apparently

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[56]IiAS Voting Advisory 2014, *supra* note 45.
[57] The Companies Act, §196(4).

making this requirement a mere formality does not take away from the important entitlement of the shareholders to express their opinion regarding executive compensation.[58] It can keep managerial power in check incases wherein a weak Board is pressurized and influenced by the CEO or MD themselves to fix exorbitant remuneration. In Infosys, the executive pay of Mr. Sikka was approved by the shareholders in an extraordinary general meeting. In fact, the shareholders seem to have been in steady support of Mr. Sikka and satisfied with his performance as stock prices witnessed a steep decrease after his resignation, implying a decrease in shareholder confidence in the firm.

Not only shareholders but the Board of Directors also had no qualms regarding Mr. Sikka's performance and constantly defended his pay. This could be because of satisfactory performance by Mr. Sikka or due to the imbalance in bargaining power between the Board and such top executives present, as explained by the managerial power approach theory. This theory postulates that managerial power tends to be influential enough to demand excessive pay and perquisites as there is scarcity in supply of suitable executive talent; thus comparatively weakly positioned board yields

[58] N. Balasubramanian, S.K. Barua& D. Karthik, *Corporate Governance Issues in Executive Compensation: The Indian Experience (2008-2012)*, IIMB Working Paper No. 426 (2013) ["N. Balasubramaniam"].

to the to their demands due to pressure of getting the right candidate for their company.[59] Thus, often instead of safeguarding the interests of shareholders and other stakeholders, they often become "captured by the CEO".[60] Executives are hence able to extract more 'rent' from the Board of Directors by exerting their power over the compensation structure. Independence of the Nomination and Remuneration Committee becomes critical here to ensure that weak governance structures do not lead to inefficient compensation agreements. At the same time, exceptional talent at the executive levels is scant, and hence often warrants a premium in a competitive market. Moreover, the fact that the majority of Sikka's pay was variable and dependent on performance perhaps justifies that the compensation structure was not prepared without diligence but was rather a strategic decision. The question thus arises whether Mr. Narayana Murthy's intervention and drastic measure of writing a public letter to express his opinion were justified.

On this issue, Shriram Subramanian, Managing Director of InGovern, a proxy advisory and research firm dealing with corporate governance issues commented that "*It's an orientation issue between the founders and the new professional board and CEO on issues*

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[59] *Id.*

[60] M.S. Wesbach, *Optimal Executive Compensation v. Managerial Power: A review of Lucian Bebchu and Jesse Fried's "Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, National Bureau of Economic Research , Working Paper No 12798 (2006).

pertaining to values and practices. Though they are out of the board they continue to have an emotional connection with the company, which in a way is bad."[61]

Regulating the participation of the company's promoters in the company's management becomes necessary in India due to the prevalence of excessive interference by promoters and flagrant disregard of separation between ownership and management.[62] Promoters of Indian companies acknowledge the beneficial impacts of professional management. Yet, they display contradictory behavior and try to impose their control on executives they themselves appointed to run the company. Caim Oil and Gas have in fact witnessed the departure of four CEOs in the past seven years due to continuous interference from the promoters and control exercised by them.[63]This stems from the fact that the promoter has a specific vision and conceptualization of how the company should grow. The emotional connection with the company is a natural consequence of having founded the company and led it to success and complete indifference to the company's continued functioning cannot be expected.

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[61]Arakali-Forbes, *supra* note 8.

[62] Priya Garg, *The Tata Corporate Governance Episode: The 'India-Specific' Issues and Concerns*, Sep 3, 2017, available at https://indiacorplaw.in/2017/09/tata-corporate-governance-episode-india-specific-issues-concerns.html (last visited on Sep 20, 2019).

[63] Kalpana Pathak, *CEO, CFO Resignations Cast Shadow On Cairn India's E&P Plans*, Apr 12, 2019, available at https://www.livemint.com/companies/news/ceo-sudhir-mathur-cfo-pankaj-kalra-resignations-cast-shadow-on-cairn-india-s-e-p-plans-1555021315201.html (last visited on Sep 20, 2019).

The discord between Narayana Murthy and Vishal Sikka was also a result of a conceptual divide between how they thought the company should function.[64] The exorbitant pay package of Mr. Sikka was against the ethos of the company as per Murthy and he was concerned about the stark contrast between Murthy's pay and pay of other employees. As stated above, the ratio between Sikka's salary and MRE is a whopping 935. This can be contrasted with TCS, on the other hand, where the ratio between N. Chandrasekaran's salary and MRE stood at nearly half- 459.84 and with Wipro where the ratio was 227.81.[65] Hence, maybe Mr. Murthy's concerns were not completely unfounded and he felt the need to blow the whistle on this remuneration practice. But while the importance of the founder's importance cannot be undermined, the unanimous opinion of the entire Board should also have some weight and their commercial wisdom should be respected. Beyond a level, therefore, the founder's interference might be uncalled for, especially when the move is considered beneficial by the Board of Directors and all shareholders.[66]Especially considering that Infosys

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[64] The Economic Times, *If A Promoter Wants To Run A Company, He Should Be The CEO*, Sep 10, 2017, available at //economictimes.indiatimes.com/articleshow/60442106.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst (last visited on Sep 20, 2019).

[65]Kokardekar, *supra* note 15, at 23.

[66]Mondaq, *Calling The Shots: Promoters Vs Managers–Getting The Right Mix*, Aug 24, 2017, available at http://www.mondaq.com/india/x/623294/Corporate+Commercial+Law/Calling+The

consciously invested in professional management while being cognizant of problems encountered with succession planning in the past, publicly attacking the CEO might not have been the best recourse. Therefore, many debates remain about whether Mr. Murty was justified in publicly raising these concerns or not.

In this context, it is interesting to examine whether the executive compensation packages rewarded to CEOs of Infosys altered after this fiasco. Salil Parekh was appointed as the CEO in January 2018 and he took home a package of INR 24.67 crores in the last financial year- comprising of a fixed component of INR 6.07 crores, variable pay of INR 10.96 and perquisites of INR 7.64 crores due to exercise of 1.03,604 restricted stock units.[67] This is substantially less- in fact, almost half of the Rs 42.48 crores maximum remuneration cap fixed for Mr. Vishal Sikka. Further, the ratio of executive salary to median employee salary was also reduced to 396.[68] While this was still more than TCS's CEO Mr.Gopinathan's salary of INR 16 crore,[69] a visibly drastic reduction

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+Shots+Promoters+Vs+ManagersGetting+The+Right+Mix (last visited on Sep 21, 2019).

[67] The Hindu BusinessLine, *Infosys CEO Drew ₹ 24.67 Cr Pay Package In FY19*, May 20, 2019, available at https://www.thehindubusinessline.com/info-tech/infosys-ceo-drew-2467-cr-pay-package-in-fy19/article27186488.ece (last visited on Sep 21, 2019).

[68]Debasis Mohapatra, *Infosys CEO Salil Parekh Took Home A Pay Package Of Rs 24.67 Cr In FY19*, May 19, 2019, available for https://www.business-standard.com/article/companies/infosys-ceo-salil-parekh-took-home-a-pay-package-of-rs-24-67-cr-in-fy19-119051900850_1.html (last visited on Sep 21, 2019).

[69] *Id.*

in remuneration package had taken place. Mr. Murthy's statements perhaps did have an impact on the Board despite them denouncing his interference publicly and brushing aside his allegations.

V. HOW CAN THIS BE PREVENTED IN FUTURE?

The drama surrounding Infosys goes on to show how complicated determination of corporate governance practice of a company is, especially in a conflict between insiders.[70] While it might be murky whether Infosys' extravagant pay package was a corporate governance red flag or not, this episode does highlight the need for having better framed and more transparent remuneration policies.

It is essential for improving NRC's efficacy that the dominant shareholders or founders of the company accord significance to the committee and recognize that a strong and independent NRC is necessary for selecting suitable talent at the board and management level. Further, from stakeholder's perspective and independent NRC is vital as the appointment of directors without excessive interference by dominant shareholders enhances the effectiveness of the Board. Board independence is a commonly used scapegoat for excesses in remuneration.[71] As per the New York Stock Exchange

[70]Kanti&Agarwala, *supra* note 33.
[71] P Brandes& P Deb, *Executive Compensation and Corporate Governance* in THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE (Douglas Michael Wright eds., March, 2013).

CG Rules, companies should not only constitute important committees but also make certain that these committees are comprised of independent members.[72] The Kotak Committee recommended that a minimum of two-thirds of the members of the nomination and remuneration committee should be independent directors, however, this was accepted. The authorities' rejection of the Kotak Committee's proposal to increase the constitution of the committee- from at least 50 percent independent to two-thirds- does not reflect well on the independence of the committee, although the decision to prevent a chairperson of the Board from chairing the NRC[73] is a step in the right direction.[74]

However, there may often be too much emphasis on the importance of independent directors in committees. In reality, in most Indian companies, independent directors are appointed by the management merely to fulfill the procedural requirements and do not have an effective say in monitoring the company.[75] Further, nonexecutive independent directors are mostly chosen from a limited and often socially inter-connected pool of current or past CEOs of other companies. They might have understandable empathy towards

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[72] *Id.*
[73] The Companies Act, 2013, Section 178.
[74] NSE Quarterly Brief, *supra* note 38, at 4.
[75] P Haldea, *The Institution Of Independent Directors: Does It Really Deliver?* in CORPORATE GOVERNANCE AN EMERGING SCENARIO 367 (N Balasubramanian & D.M. Satwalekar eds., 2010).

serving top-management and, thus, behaviorally not condemn higher levels of CEO remuneration.[76] However, independent directors are perhaps the best mechanism to used safeguard shareholder interest and arguably allow enhanced compensation to be paid when necessary to retain and encourage their CEOs to perform better and prioritize company interests.

Another important method of arriving at better remuneration policies would be to stress not just the independence of the committee but also focus on the expertise of the members. The prevalent practice of appointing celebrity independent directors who do not have enough bandwidth to effectively contribute to the company must thus be checked. Further, directors might perhaps have some basic knowledge regarding compensation structures; but formulating criteria to assess performance and devising incentive schemes that align managerial interests with the company, is a difficult task. Ashish Bhattacharyya and Nirmal Mohanty, while contributing to the NSE Quarterly Brief, recommended that India should follow suit of other countries such as the US, UK, Japan, and mandate two separate committees- one for nomination and one for remuneration.[77] This is because expertise involved in designing job profiles and appointing suitable candidates is quite different from

[76] N. Balasubramaniam, *supra* note 58, ¶5.3.
[77] NSE Quarterly Brief, *supra* note 38, at 4.

determining an executive pay that incentivizes but isn't disproportionately high. This would also reduce the workload of the NRC and enable them to focus on important responsibilities.

Moreover, while it is true that a socialist approach to executive compensation cannot be taken, there must be at least some regulatory control over CEO compensation as well in order to ensure that obscene amounts are not paid unjustifiably. A cap on the ratio of CEO to median employee compensation could perhaps be placed by the Ministry of Corporate Affairs, so as to create a balance between discretionary power of the management in rewarding CEO pay and fairness to all employees. This cap should not be as low as to disincentive top executives or to make it difficult for the company to retain or attract proficient managers.

Separation of the office of CEO and MD might also significantly benefit the company by diluting the power granted to an individual and his reducing his influence on the Board. The recent decision by SEBI to mandate the separation of the office of CEO/MD and the Chairperson in top 500 listed entities with a public shareholding of 40% by April 2020, is in line with this suggestion.[78] This would contribute towards bettering the formation and working of the NRC

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[78]TheHinduBusinessLine, *SEBI Asks Listed Firms to Split CMD post by 2020*, May 10, 2018, available at https://www.thehindubusinessline.com/markets/stock-markets/sebi-asks-listed-firms-to-split-cmd-post-by-2020/article23841146.ece (last visited on Sep 20, 2019).

in these companies, especially if the chairperson is an independent director, by creating a balance between the power of CEO and Board. This is consonance with theoretical theories that demand an unambiguous separation between the executive duties for operations and the supervisory duties such as monitoring and assessing executive performance.[79]

VI. CONCLUSION

As far as the black letter of the law is concerned, there are no restrictions regarding executive compensation in India besides the 11 percent cap on managerial pay in public companies, in reality, the Infosys fiasco showcases how easily seemingly legal and acquiescent decisions on executive pay can be questioned. Although the Infosys Board made complete disclosures and obeyed the regulatory procedural laws, these disclosures were not sufficient to address the deep displeasure of the founder group and led to a major public row, leading to a huge goodwill associated risks globally for a company listed on Indian and international stock exchanges and renowned for its good corporate governance practices. It definitely casts doubts on corporate governance practices of a company of the stature of Infosys and its global reputation when founders of the company itself question its practices publicly. There is little that

[79] N. Balasubramaniam, *supra* note 58, ¶5.3.

regulatory reforms can do to avoid scenarios similar to the Infosys episode when groundwork of executive compensation itself is based on corporate governance which itself intrinsically stems from ethics, fiduciary duties of the directors and self-regulation. However, the proposals made above should be given some consideration as they can help create a better culture of corporate governance in companies.

VII. <u>DIFFERENTIAL VOTING RIGHTS SHARES: A PATH-BREAKER OR OBSTACLE TO CORPORATE GOVERNNACE</u>?*

Abstract

In the past two decades, with the advent of technology, countless new companies have been founded by ambitious, quick-witted entrepreneurs with out of the box thinking. As these turned into moderate successes, they opened themselves to public investors through listing on stock exchanges. However, these promoters were faced with humongous obstacles in executing their vision for the company including volatile market emotions, scrutiny from shareholders who did not understand the business model, short term market pressures, and the most fatal challenge of retaining control from financially motivated investors. To prevail on the helm of their ships an innovative solution i.e. dual-class share structures were implemented which allowed the raising of capital without dilution of control. Over the years, stakeholders have over and again debated its merits unable to reach a definitive conclusion, admitting that young companies are more likely to succeed with their founders in control whilst recognising the threat such control poses to corporate governance. Countries around the world have adopted various frameworks to accommodate this instrument in a balanced manner setting examples through which India can learn and implement the positives and avoid the negatives of the dual-class share structure. Today, Indian start-ups have

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reached a point where the listing is the next necessary step for their growth and it is about time that regulatory authorities recognize this need and come up with plausible frameworks. In light of this, the Securities and Exchange Board of India (SEBI) has released a basic framework of Differential Voting Rights (DVR) Shares for companies aspiring to list on Indian stock exchanges. However, this has only provided an outline and needs substantial improvements which have been discussed in detail in this paper.

I. INTRODUCTION

"In the business world, the rearview mirror is always clearer than the windshield."

– Warren Buffett

On June 27, 2019, the SEBI issued a Press Release announcing the Framework for Issuance of DVR Shares. Earlier on March 20, 2019, SEBI had released a consultation paper on the same inviting public comments. This move has come in the backdrop of Indian start-ups reaching a mature stage where many are actively considering public listing but are hesitant due to the lack of proper regulatory safeguards for its founders.

In the life cycle of a company, the practice is for start-ups to establish themselves first, then grow into mature companies and at

an advanced stage, raise public capital by making an Initial Public Offering (IPO). Globally, and especially in Silicon Valley, USA an IPO is done after creating a dual class concentrated control structure which enables promoters to develop the Company without undue shareholder pressure. Some of the most successful venture capitalists, like Andreesen Horowitz, have been quite vocal about their strong preference for investing in businesses with founder CEOs in control, listing three major reasons: a) they know the detail of the business and have better instincts; b) they have a long-term perspective on investments and building a company that lasts, and c) founders have the moral authority to make the hard choices.[1]

Most of the great successful tech firms —Oracle, Intel, Microsoft, Apple, Dell, Google, Amazon, Facebook, and so many others — still have and had founder CEOs, often for a long time. Larry Page and Sergey Brin, the founders of Google while issuing their IPO argued that dual-class was necessary because "technology products often require significant investment over many years to fulfill their potential"; emphasizing that shareholders influenced by short term market sways jeopardize long term value of entrepreneurial

[1] Chris Zook, Founder-Led Companies Outperform the Rest — Here's Why, HARVARD BUSINESS REVIEW PRESS, (July 16,2019, 9:30 PM) available at: https://hbr.org/2016/03/founder-led-companies-outperform-the-rest-heres-why.

vision.[2]LinkedIn, the popular professional social network adopted the dual-class share structure prior also limiting public shareholders to less than 1% of the voting power, Square, the payment-processing company also adopted a dual-class structure prior to its IPO while Snap Inc. issued non-voting power stock reigniting the debate over dual-class shares.[3]

In India, innumerable start-ups have mushroomed and grown into mature companies needing public funding like Paytm, Ola, Flipkart, etc. Also, the recent shocking takeover of Mindtree by L&T Infotech revealed the vulnerable position of founder CEO sin such companies. With these thoughts in mind, the issuance of DVR shares for companies intending to list was released by SEBI recognising that this is the optimal way to let Indian entrepreneurs have some autonomous space for managing and growing their business without the suppliers of their capital over-supervising them.[4]

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[2] Larry Page, Sergey Brin, Letter from Larry Page, Google CEO & Co-Founder, and Google Co-Founder, to Google S'holders (Apr. 2012) [hereinafter 2011 Founders' Letter] ("For example, it took over three years just to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass.").

[3] Zoe Condon, A Snapshot Of Dual-Class Share Structures In The Twenty-First Century: A Solution To Reconcile Shareholder Protections With Founder Autonomy, 68EMORY L.J. 335 (hereinafter Zoe).

[4] SEBI Consultation Paper on Issuance of shares with Differential Voting Rights, Securities and Exchange Board of India (July 16,2019, 9:25 PM)(hereinafter SEBI

In this Article, a critical analysis of SEBI's DVR framework has been done. The paper has been divided into three parts. Part I explains the concept of DVR shares, followed by a comparison between DVR shares and the 'One share-One vote' rule. Part II examines the emergence, legal framework, and usage of the dual-class structures in the international jurisdictions of the United States, Hong Kong, Singapore, United Kingdom, and Canada. Lastly, Part III gives a brief on the current Indian start-up scenario followed by recommendations for filling the gaps in the newly released SEBI DVR framework.

II. DVR SHARES VIS-À-VIS ONE SHARE-ONE VOTE

1. CONCEPT: MERITS AND DEMERITS

Ordinarily, Shareholders' electoral representation is proportional to share ownership i.e. One share–One vote rule.[5] The One share-One vote rule is considered the cornerstone of corporate democracy since it is believed that concentrated control in the hands of a few leads to agency and entrenchment problems. One of the major advantages of the One share-One vote rule is that it gives large

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Consultation Paper) https://www.sebi.gov.in/reports/reports/mar-2019/consultation-paper-on-issuance-of-shares-with-differential-voting-rights_42432.html.

[5] Howard Bodenhorn, *Voting Rights, Shareholdings, and Leverage at Nineteenth-Century U.S. Banks*, 57:2THE JOURNAL OF LAW & ECONOMICS 431, 458(May 2014).

shareholders an incentive to monitor and influence management[6] while preserving managerial accountability and also permitting minority shareholders to elect directors and approve certain extraordinary transactions.[7]

Undoubtedly, corporate governance concerns are minimal in such a balanced power structure where the separation of power and ownership is nominal thus resulting in equitable distribution of the risk. Conversely, not all shareholders value their votes equally. Hedge fund activists accumulate shares to use their voting power and agitate for changes that would increase the financial value of their investment including a competitive bidder, while promoters vote to further their long term vision of the company. Some, including retail shareholders, value their vote so little that they rarely exercise it. For example: In the US, in 2014 (January-May) Institutional shareholders voted ninety percentage (90%) of their shares but retail shareholders voted just twenty-nine percentage (29%)[8] meaning that rationally apathetic investors must either incur

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[6] Henry Hansmann& Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, THE YALE L.J. (hereinafter Hansmann)
[7] Manning G. Warren, One Share, *One Vote: A Perception of Legitimacy*, 14 JOURNAL OF CORPORATION LAW 89 (1989).
[8]Mary Ann Cloyd, 2014 Proxy Season Mid-Year Review, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 26,2019, 9:30 PM) https://corpgov.law.harvard.edu/2014/07/17/2014-proxy-season-mid-year-review/

costs associated with voting or let their rights go unused, which dilutes the influence of other investors' votes.

DVR shares have rights disproportionate to their economic ownership[9] with respect to dividend, voting, or other rights. Disproportional ownership is a mechanism that allows some shareholders to control a proportion of votes larger than their capital investment in the firm or more than their proportion of the firm's cash flows.[10] A wide variety of such structures exist i.e. some companies have only two classes of shares with varying voting rights, while others have three; the voting power of high-vote shares can be sometimes transferred to family members, and sometimes not; some structures have a condition of winding up if high-vote shareholders own less than a pre-determined fraction of shares; other structures expire after a certain number of years from the IPO.[11]

DVRs have many advantages enabling the founder to create a long-term vision and utilize his special skills to produce superior

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[9] *Id.*

[10] Renee, *supra* note 6.

[11] Roberto Tallarita, *High Tech, Low Voice: Dual-Class IPOs In The Technology Industry*, JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS FELLOWS' DISCUSSION PAPER SERIES, Discussion Paper No. 77, 05/2018 (July 16,2019, 8.30 PM)(hereinafter Tallarita) http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Tallarita_77.pdf

returns.[12] It assists management in deterring potential rivals from winning over ownership and allows raising fresh capital for growth without giving up control.[13] Most importantly, it is a very effective defence against takeover since large/small shareholders with financial motives are bound to be influenced by the higher bidder rather than the long term vision of the management which is a matter of major concern especially if the promoter is a minority shareholder.[14] But dual-class corporate structures could present problems for public investors who may find themselves largely without a voice or vote.[15] It is also argued that it strips stockholders of the power to push through changes in management, when companies are poorly run.[16]

2. ECONOMIC PERSPECTIVE

One school of thought argues that if true economic sense were to prevail, shareholders who did not value their votes could sell them to those shareholders who do, without which voting rights would not be optimally distributed across shareholders, leading to

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[12] Zoe, *supra* note 3. See Also Thomas J. Chemmanur&Yawen Jiao, *Dual-Class IPOs, Share Recapitalizations, and Unifications: A Theoretical Analysis 2* EUROPEAN CORP. GOVERNANCE INST., Working Paper No. 129, 2006.

[13] Aditya Jadhav*, Dual Class Shares – Is India Ready for it?,(*July 23,2019, 9:45 AM)https://www.ar.cfa/up/post/791/Dual-Class-Shares-Is-India-Ready-for-it-AM-Copy.pdf (hereinafter Jadhav).

[14] Abhishek Nath Tripathi &Uttam Maheshwari, *Shares With Differential Voting Rights: A Legal And Economic Analysis*, 15 STUDENT BAR REVIEW pp. 74-89 (2003).

[15] Zoe, *supra* note 3.

[16] Jadhav, supra note 14.

inefficiencies that would depress the total value of the company[17] and hamper decision making powers of those who need to maintain control. They believe the value of a share with lesser voting rights is clearly depicted by investors through share price and that retail investors like pension funds would greatly be harmed by the reduced float in the market if companies were to stop issuing shares without equal voting rights.[18]

But does disproportional ownership create or destroy shareholder value?[19] Based on a sample of one hundred and seventy-six (176) US companies, it was found that a shift to a dual-class structure from a single class share structure resulted in an impressive twenty-three points eleven percentage (23.11%) increase in return[20]. Also, companies with dual-class structures paid more cash dividends than companies that adopt a single-class share structure.[21] Often the class of shares with lesser voting rights are given a higher proportion of dividends, for example Tata Motors DVR shares[22] thus attracting

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[17] Dorothy Shapiro Lund, *Nonvoting Shares and Efficient Corporate* Governance, UNIVERSITY OF CHICAGO LAW SCHOOL CHICAGO UNBOUND, 2017 (herein after Shapiro)

[18] Bernard S. Sharfman, *The Demonization of Dual Class Shares*, THE CLS BLUE SKY BLOG(July 23,2019, 9:30 PM) (hereinafter Bernard).

[19] Renee, *supra* note 6.

[20]V. Dimitrov & P.C. Jain, *Recapitalization of one class of common stock into dual-class: Growth and long-run stock returns*, 12:2 JOURNAL OF CORPORATE FINANCE pp. 342-366 (2006).

[21]Jordan, B. D., Liu, M. H., & Wu, Q., *Corporate payout policy in dual-class firms*, 26 JOURNAL OF CORPORATE FINANCE, pp. 1-19 (2014).

[22] Tata Motors issued DVR shares with 1/10th voting rights and 5% higher dividend.

certain class of investors primarily interested only in the economic benefits of a company.[23] But the literature on dual-class structure does not conclusively provide consistent evidence whether it is either beneficial or harmful for ordinary shareholders, dual-class share structures continue to be adopted by innovative young companies and preserved by companies in media and high-tech industries[24] wherein substantial control is necessary.

3. GLOBAL PERSPECTIVE ON DVRS

Dual-class companies are permitted and common in many jurisdictions around the world including Canada, Denmark, Finland, the Netherlands, Sweden, and Switzerland,[25] U.S., Canada, Hong Kong, and Singapore.[26]Several jurisdictions that prohibit dual-class IPOs, are Belgium, Estonia, Germany, Greece, Luxembourg, and Spain, though they allow issuance of non-voting preference shares not more than a certain percentage (usually up to 50%) of the company's outstanding shares[27] some countries like UK, Australia,

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[23] Jadhav, *supra* note 14.

[24] Ji Li, A Glance of Dual-Class Companies in the U.S, SEMANTICS SCHOLAR (July 22,2019, 9:45 PM) https://pdfs.semanticscholar.org/f006/8276daedb95ef51e85dc45d86e9276d2dfaf.pdf (hereinafter Ji Li)

[25] Report On The Proportionality Principle In The European Union (July 22,2019, 9:45 PM) https://perma.cc/4HDK-AFPU

[26] SEBI Consultation Paper, *supra* note 4.

[27] Lucian A. Bebchuk, Kobi Kastiel, *The Untenable Case For Perpetual Dual-Class Stock,* JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS, Discussion Paper No. 905, 04/2017.

Spain, Germany, and China do not permit issuers with dual-class share structure for listing.[28] For better understanding, certain countries' dual-class share policies have been discussed below.

A. United States of America – The Trendsetter

In 1898 the International Silver Company was the first to authorize twenty million shares as non-voting stock.[29] Dual-class stocks were first utilized in media companies as a means to protect the journalistic integrity of the news.[30] In the 1920s, firms like Dodge Brothers, Industrial Rayon Corporation, A&W Root Beer, and Fox Theatres began to issue two classes of common stock giving only one class the right to vote. This leads to huge public outcry, causing New York Stock Exchange (NYSE) to issue a disapproval statement against non-voting common stock, and a formal announcement of the same was made in 1940. However, firms such as J.M. Smucker, American Family, and Ford Motor Company listed shares on the NYSE with inferior voting rights instead of no voting rights.[31] In 1972, The American Stock Exchange (AMEX) also prohibited the listing of non-voting stock but firms continued to list stock with

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[28] SEBI Consultation Paper, *supra* note 4.

[29] Jason W. Howell, *Essays on the U.S. Dual-Class Share Structure*(July 22,2019, 9:45 PM) http://media.terry.uga.edu/documents/finance/howell_dual_class_share.pdf (hereinafter Howell)

[30] Katie Bentel and Gabriel Walter, *Dual Class Shares,* FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION https://scholarship.law.upenn.edu/fisch_2016/2/ (hereinafter Bentel)

[31] Howell, *supra* 30.

disproportionate voting rights. Subsequently in 1976, AMEX issued a policy statement containing the following coattail provisions; (a)the limited voting class must have the ability to select at least 25% of the board; (b) voting ratio should not be greater than 10 to 1; (c) no additional stock could be issued which diluted the limited voting shareholders stake; (d) superior voting rights would be lost if the number of shares fell below a certain percentage and (e) recommended dividend preference for limited voting stocks; this came to be famously known as the 'Wang formula'.[32]

During the 1980s, hostile takeovers increased making the dual-class share system an attractive and effective source of hostile takeover protection leading to their permissibility on all of the major stock exchanges[33] but safeguards against misuse of the structure were needed. In 1988, the SEC promulgated Rule 19c-4 directing the NYSE, AMEX, and National Association for Securities Dealers Automated Quotations (NASDAQ) to check for certain conditions before listing or continuing to list companies with disproportionate voting shares. It permitted issuers to issue new classes of non-voting stock, or a special class with limited voting rights, provided the issuance did not dilute the voting power of existing shareholders; it also permitted the issuance of the second class of stock in the

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[32] Ellie G. Harris, John C. Coffee, *Knights, Raiders, and Targets: The Impact of the Hostile Takeover,*THE JOURNAL OF FINANCE 45(1) Pg.311

[33] Bentel, *supra* 31.

context of a merger or acquisition with a bona fide business purpose. While the Securities Exchange Commission (SEC) asserted that it had the authority to issue such a rule, in 1990, the D.C. Circuit disagreed, ruling in *Business Roundtable v. SEC*[34] that § 14(a) did not give the SEC power to regulate substantive aspects of shareholder voting, but only to regulate disclosures mechanisms thus, leaving the responsibility to other interests, including the government and the exchanges themselves.[35] Despite the court's rejection of 19c-4, the NASDAQ, NYSE (Section 313A of the NYSE listing Rules[36]), and AMEX proceeded with implementing a 19c-4 type rule allowing firms to introduce inferior voting shares during IPO but barring it from reducing existing shareholders' voting rights.[37]

In 2004, Google became the first technology company to adopt a dual-class structure for the explicit purpose of keeping control of the company (founders voting power was 37.6%). Since 2004, several prominent tech companies, including Groupon, LinkedIn, Yelp, and Zynga, have gone public issuing only low-voting stock to the public while other companies, such as Under Armour and

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[34] Business Roundtable v. SEC , 905 F.2d 406 (1990)
[35] Bentel, *supra* 31.
[36]NYSE Company Manual, (July 21,2019, 8:45 PM) http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F12%5F4&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F
[37] Howell, *supra* 30.

Zillow, engaged in stock splits and issued nonvoting stock to retain the founding group's control.[38] Today, Public companies using dual-class share structures are worth more than five ($5) trillion, and more than fourteen percentage (14%) of the one hundred and thirty-three (133) companies that listed on U.S. exchanges in 2015 have dual-class voting.

In March of 2017, Snap Inc. became the first company to go public on a U.S. stock exchange offering only non-voting shares to the public forming a structure such that its two billionaire twenty something founders would have perpetual control over the company along with taking advantage of exemptions from certain disclosure obligations under federal securities laws.[39] In the direct aftermath of Snap's non-voting structure IPO, the stock indices felt that dual-class structure benefits had been stretched too far at the expense of investors. Consequently, the Standard & Poor's 500 Index (S&P 500) announced its ban on dual-class structures stating corporate governance concerns. Recently, in February 2018 SEC Commissioner Robert Jackson Jr. argued that an outright ban on the structure hurt investors, and suggested that that dual-class structures should be permitted to exist, though limited by some form of the

[38] Shapiro, *supra* note 18.
[39] Shapiro, *supra* note 18.

sunset provision.[40] On October 24, 2018, Council of Institutional Investors(CII) submitted a letter to NASDAQ and a letter to NYSE asking them to require newly-listed companies to either abide by the proportionality principle or wind-down their dual-class structure within seven years of IPO, unless shareholders vote, on a share-for-share basis, to extend that dual-class structure. This resulted in barring the addition of multi-class companies to the S&P Composite 1500 index and its components, which cover the S&P 500, MidCap 400 and SmallCap 600 indexes with existing constituents, being permanently grandfathered.[41]

B. <u>HONG KONG – The Newbie</u>

The Hong Kong Stock Exchange (HKEX) is perhaps the biggest competitor to U.S. indices, as it finds itself placed in a fast-growing economy.[42]Article 588(4) of Hong Kong Companies Ordinance (Cap 622) allows incorporation of companies with DVRs, however, since 1987, Hong Kong Listing Rules explicitly prohibited companies with a disproportionate setting between capital and

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[40] Hao Chen, One-Share, One-Vote Rule And Future Of Dual Class Shares Structure In China (July 17, 2019, 6:30 PM), https://lib.ugent.be/fulltxt/RUG01/002/213/688/RUG01-002213688_2015_0001_AC.pdf.

[41] Dual-Class Stock, COUNCIL OF INSTITUTIONAL INVESTORS, (July 26, 2019, 9:30 PM), https://www.cii.org/dualclass_stock.

[42] Ernst & Young, *Ipo Insights: Comparing Global Stock Exchanges* 10 (2009), (July 14, 2019, 9:30 PM), https://www.ey.com/Publication/vwLUAssets/ey-global-ipo-trends-q4-2018/$FILE/ey-global-ipo-trends-q4-2018.pdf

control to be listed in Exchanges, except under very special circumstances and no such case has occurred yet.[43] However, in 2014, after losing listing of Alibaba and Baidu the discussion on allowing dual class share structure listings was reignited by Charles Li, head of the HKEX, determined to not lose the next generation of such companies.[44] Consultation papers were released in 2015 and 2018 and there was strong opposition against dual-class listings with investors insisting on buying such shares at a significant discount and emphasizing that since exchanges are unfortunately run for profit, this move would set an example that companies the size of Alibaba can coerce a compromise from exchanges who will want to have their business.[45] While seen as a big win for corporations, the HKEX inserted Chapter 8A to its Exchange Listing rules which allowed dual-class share structures but imposed several entry requirements, structural limits, and enhanced disclosure procedures designed to maintain shareholder protection.[46]

Notably, as referred in Part I, the HKEX termed dual-class shares as "Weighted Voting Rights" (WVRs) and only allows "innovative" companies i.e. companies with new technology, research and

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[43]*Supra* note 41.
[44] Hong Kong and Singapore succumb to the lure of dual-class shares, The Economist, March 1, 2018.
[45] ACGA Survey on Alibaba and Non-Standard Shareholding Structures in Hong Kong, April 15,2014.
[46] Zoe, *supra* note 3.

development core component, demonstrating unique features or intellectual property, unusually high market capitalization or intangible asset value, to utilize the structure adding that the meaning of "innovative" shall change with time and hence each company will have to undertake its own application procedure. Only new applicants may use the WVR framework thus disallowing recapitalization through WVRs .The HKEX also only permits certain individuals who must be directors of the company to hold WVR shares, and that their shares will automatically convert to common stock upon cessation of directorship, death or incapacity, or share transfer. Finally, biotech companies using WVRs must comply with enhanced disclosure and corporate governance requirements. After the new framework went live in July 2018, Hong Kong won a series of high-profile IPOs including Xiaomi Corporation-the smartphone maker which raised $5.4 billion in its HKEX IPO shortly after the new rules took effect, and is now one of the most actively traded stocks on the exchange. Hence, the new rules seem effective in making HKEX more competitive with its rival US Exchanges.[47]

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[47] Zoe, *supra* note 3. See also HKEX, Consultation Conclusions, A Listing Regime For Companies From Emerging And Innovative Sectors, April, 2018 (July 14,2019, 9:30 PM), https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-(April-2018)/cp201802cc.pdf and Davis Polk, *Hong Kong Stock Exchange Launches New Rules for Dual Class and Biotech Listings*, 25 April 2018

C. SINGAPORE – The guy next door

In June 2018, motivated by the loss of Manchester United IPO in 2012, new HKEX rules, and a desire to reinvent itself as a new technology hub, the Singapore Exchange (SGX) introduced new rules that permitted dual-class shares. Already, in 2014, the Singapore Companies Act,1967 had been amended to facilitate a dual-class structure for public companies which took effect in January 2016, allowing public companies to issue shares of different classes that confer special, limited, conditional voting rights or no voting rights, subject to certain conditions being met. In 2017, SGX allowed dual-class structure companies with primary listings on a developed market exchange to list secondarily in Singapore.[48] But, SGX Primary Listing rules still predicated One share-One vote structure until the addition of Rule 210(10) along with the insertion of supporting rules similar to those of the HKEX on June 26, 2018. The exchange only allows 'permitted holder group' and appointed 'responsible directors' to hold WVR shares capped at ten votes. It requires sunset provisions and automatic conversion on events of a transfer outside holder group/retirement/death. The majority of corporate governance committees must have independent directors,

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https://www.davispolk.com/files/2018-04-25_hk_stock_exchange_launches_new_rules_dual_class_biotech_listings.pdf

[48] Douglas Appell, Singapore's stock exchange gives dual-class shares a secondary listing toehold,Pensions and Investments, July 31,2017.

a minimum of 10% ordinary voting shareholders to necessarily vote on every resolution, and have the power to convene a general meeting. In specific instances like winding up, changes to incorporation documents, a variation of rights of shares, etc. multiple voting rights cease and if the issuer is to issue multiple voting shares by way of rights/bonus issues(other than public listing) the proportion of two classes of shares must remain the same.[49] The Monetary Authority of Singapore noted that the "SGX's framework for dual-class share structures strikes a balance between supporting high-growth companies and has in place safeguards to mitigate governance risks associated with such structures and such listings will broaden the range of investment options for investors and add vibrancy to Singapore's capital markets."[50]

D. United Kingdom – The Dissenter

In the UK, DCS structures were used in the 1960s to protect corporations from hostile takeovers or for the Queen to have 'golden share', before institutional investors expressed strong

[49] Singapore Mainboard Rules, Listing Framework For Dual Class Share Structures (July 14,2019, 9:30 PM), http://rulebook.sgx.com/net_file_store/new_rulebooks/s/g/SGX_Mainboard_Rules_June_26_2018.pdf

[50] Angela Tan, SGX enters new era as it starts dual-class shares for qualifying IPOs, The Business Times, June 27,2018 https://www.businesstimes.com.sg/stocks/sgx-enters-new-era-as-it-starts-dual-class-shares-for-qualifying-ipos

opposition to such structures.[51] It is argued that dual-class share structures were common on the London Stock Exchange in the late nineteenth century, possibly because the exchange required that at least two-thirds of any security was made available to in a public issuance. Those new listing requirements ensured liquidity in the market but made it difficult for shareholders or management to form controlling blocks resulting in many companies utilizing dual-class structures but eventually, institutional investors were able to gain proportionally more in stocks, the percentage of companies utilizing dual-class structures decreased significantly by leveraging of institutional investors' shares to reduce dual-class listings. Taken together, their results suggest that by mid-1960s firms abandoned dual-class shares to cater to investor demand and the new norms of corporate governance of Companies Act, 1948.[52]

Most recently, in February 2017, the Financial Conduct Authority (FCA) published a discussion paper considering the possibility of opening U.K. markets to science and technology dual-class companies. The paper proposed creating an additional segment for mature international companies, with the express purpose of allowing those companies "to focus more on long-term

[51] SEBI Consultation Paper, *supra* note 4.

[52] Fabio Braggen and MariassuntaGiannetti, *Changing corporate governance norms: Evidence from dual class shares in the UK,* JOURNAL OF FINANCIAL INTERMEDIATION, Volume 37, January 2019, Pages 15-27

performance and less on short-term market pressures." However, it was also noted that institutional investors and shareholder representative groups in the UK have opposed dual-class shares structures due to the risk they perceive to high-quality corporate governance and the interests of minority shareholders.[53] Mainly, dual-class shares are unpopular in the UK owing to market pressure and successful opposition from institutional investors and the breakthrough rule which enables a bidder who has accumulated 75% of equity to break through the company's existing voting arrangements and exercise control as if the One share-One vote principle is upheld thus directly making dual-class share structure inconsequential.[54] Dual-class share structure was allowed in the UK for listing on Standard Listings but subsequently, the issuers with they were disallowed on standard listings or premium listings.[55]

E. Canada – A Matter of Balance

The use of dual-class shares as a corporate financing mechanism in Canada is largely rooted in the mid-19th century changes to corporate statutes. However, despite legislation permitting the issuance of all types of dual-class shares between 1874 and 1953,

[53] Financial Conduct Authority, Review of the Effectiveness of Primary Markets: The UK Primary Markets Landscape, February, 2017 https://www.fca.org.uk/publication/discussion/dp17-02.pdf

[54]Dr. Flora Huang, *Dual Class Shares Around the Top Global Financial Centres* , JOURNAL OF BUSINESS LAW [2017], vol. 2, pp.137-154

[55] SEBI Consultation Paper, *supra* note 4.

their popularity in Canada did not firmly take hold until the late 1970s. While increasing investor opposition (particularly from institutional investors) suggests that the use of dual-class share structures in Canada may be in decline, about 15 to 20% of companies have dual-class shares and the Toronto Stock Exchange (TSX) allows five classes of shares to be listed on the exchange – non-voting shares, multiple-voting shares, subordinate-voting shares, limited-voting shares, and restricted voting shares.[56] These equity structures can be created at the time of a company's IPO or can be implemented later through a recapitalization or reorganization.[57]

In 2015, eighty-five (85) out of almost fifteen hundred firms listed on the TSX – roughly five-point seventy-two percentages (5.72%) – had dual-class share structures. These dual-class share structures firms had an average market capitalization of almost four billion dollars ($3.39).[58]For companies issuing stock in Canada, there are no legal prohibitions on dual-class share structures by the TSX. The only restriction, by the Ontario Securities Commission (OSC), Rule 51-201 establishes the rights of holders of subordinated stock to

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[56] Jadhav, *supra* note 14.

[57] Daniel P. Cipollone, *Risky Business: A Review of Dual Class Share Structures in Canada and a Proposal for Reform, 21* DALHOUSIE JOURNAL OF LEGAL STUDIES pp. 62-92, 2012.

[58] Anita Anand, *Governance Complexities in Firms with Dual Class Shares,* Annals of Corporate Governance: Vol. 3, No. 3, pp 184–275.

receive the same information received by those holding superior classes, and the right to attend shareholders' meetings.[59] Reorganizations or reclassifications of common shares into restricted voting shares must have the approval of the majority of the minority shareholders.[60] In 1987, after the OSC ruling in *Re Canadian Tire*[61]the TSX through Section 624 of its Company Manual[62] demanded that issuers provide coattail protection to holders of subordinated shares that would require companies issuing superior voting shares to ensure that any offer made to purchase the firm's superior voting shares must be accompanied by a concurrent offer at the same terms and conditions to the other inferior classes of shareholders thus eliminating a key source of private benefits for controlling minority shareholders, namely, "the possibility for a controlling shareholder to sell the control of the company and pocket the large premium that usually comes with control, while all other shareholders would receive no benefit from the transaction"[63] thus ensuring that takeover bids offer the same terms to holders of

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[59] NATIONAL POLICY 51-201 DISCLOSURE STANDARDS, Ontario Securities Commission

[60] Shareholder Association of Research and Education , *Second Class Investors, The use and abuse of subordinated shares in Canada* (July 14,2019, 9:30 PM), http://www.share.ca/files/Second_Class_Investors_1.pdf

[61] Re Canadian Tire Corporation; Re CTC Dealer Holdings Ltd.; Re Billes et al, 1987 CarswellOnt 128, 35 BLR 56, 10 OSCB 857,

[62] Section 624, Toronto Stock Exchange Company Manual

[63]*Supra* note 53.

subordinate shares as they do to multiple voting shareholders.[64] Several studies conducted on dual-class firms in Canada have concluded that as a result of the coat-tail protections, Canadian superior voting shares trade at some of the smallest premiums in the world. [65]

III. SCRUTINIZING THE INDIAN SCENARIO

1. CONTROL ISSUES IN INDIAN START-UPS

In India, start-ups are facing control issues with their investors and have now reached a stage where they can consider listing as a viable source of raising capital. Since the end of 2016, Bhavish Aggarwal founder of Ola has been in a standoff with Softbank Group Corp. and Tiger Global Management LLC opposing their efforts to increase its 25-27% stake in Ola amidst persistent rumors about a merger between Ola and Uber (Softbank is Uber's largest shareholder). In 2017, Kunal Bahl and Rohit Bansal of Snapdeal were locked in a boardroom battle with SoftBank and Kalaari Capital, to prevent being sold off to their bigger rival Flipkart. In May 2018, Flipkart co-founder and then chairman Sachin Bansal was forced to leave the company ahead of its sale to Walmart Inc.

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[64] Julius Melnitzer, New IPOs renew dual class shares debate, September 16,2015

[65] John A. Willes & John H. Willes, *Contemporary Canadian Business Law: Principles and Cases*, 8th ed (Toronto: McGraw-Hill Ryerson, 2006) at 322.

after Tiger Global managing director Lee Fixel and other board members opposed Bansal's attempt to return to a bigger operating role at Flipkart. Most recently, following Softbank Vision Fund's move to increase stake to nearly 49% in Oyo Hotels through buyback of shares from other investors of the company (Greenoaks Capital), founder Ritesh Agarwal, is buying back shares from its early investors Sequoia Capital and Lightspeed Venture Partners to bulk up his ownership.[66] Another eye-opener has been the takeover of Mindtree by L&T Infotech which would not have been possible if the founders had control via DVR shares. In light of these developments and the attitude reflected by such funds, founders at mid-stage and late-stage start-ups have been discussing instituting a dual voting structure and setting thresholds on the ownership of individual investors.[67] Thus, in this scenario, SEBI has adeptly picked up the pulse of the market by releasing DVR shares framework recognising the fact that start-ups in India have now reached a stage where they considering the IPO route in order to raise further capital due to their high leverage/asset-light models and give their initial investors an exit. It is a welcome gesture that will go a long way in boosting the India Start-up ecosystem.

[66]Samidha Sharma, BiswarupGooptu, Oyo founder in talks to buy back $1.5 billion shares, July 9, 2019.

[67] Mihir Dalal, Varsha Bansal, The great Indian startup battle: Founders vs Investors, February 27, 2019

2. INDIAN LEGAL SCENARIO

In India, the concept of DVRs was legally introduced through the Companies (Amendment) Act, 2000 but since maximum Indian companies were family-controlled or had major promoter group shareholding, there was lack of demand and only five (5) out of approximately four thousand (4000) listed companies issued shares with fractional rights.[68] In 2009, after the Jagatjit Industries case,[69] SEBI prohibited shares with superior rights as to voting and dividend, fearing their misuse but listed shares with fractional rights were allowed until SEBI prohibited such issues in its latest DVR press release. Currently, Section 43 of the Companies Act, 2013 read with Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014 allows private companies to issue shares with differential (superior and inferior) voting rights along with the latest DVR Framework by SEBI which aims to address corporate governance concerns.

The present SEBI DVR Framework permits a company covered under the definition of Innovators Growth Platform having SR shares to issue an IPO of only ordinary shares (OV) provided the SR Shareholders are promoters in an executive position and the net worth of the promoter group does not exceed Rupees Five Hundred

[68] Tata Motors; Pantaloons Retails(Now: Future Enterprises Ltd.); Gujarat NRE Coke Ltd.; Jain Irrigation Systems Ltd. and Stampede Capital.

[69] Anand Pershad Jaiswal v. Jagatjit Industries Ltd., 2010 (1) Comp .LJ 509.

Crores (Rs. 500 Crores) excluding the value of shares held by them in the company. SR shares must have been issued by passing a special resolution and be held for a minimum of six months before the filing of the red herring prospectus. The ratio of voting rights of SR shares may be a minimum of 2:1 to a maximum of 10:1 and these SR shares will be listed on the stock exchange after the public issue and be under lock-in until conversion to OV shares. Neither transfer nor pledge or Lien of SR shares is allowed. SR Shareholders stake including OV shares must not exceed 74% post listing and SR shares are to be treated at par with OV shares in all aspects including dividends except voting. At least ½ of the Board and 2/3rd of the Committees (excluding Audit Committee) as prescribed under SEBI (LODR) Regulations, 2015 shall comprise of Independent Directors while Audit Committee shall comprise of only Independent Directors. A hugely restrictive coattail provision has been framed stating that SR shares shall be treated as ordinary equity shares in terms of voting rights in an extensive list of circumstances which include appointment or removal of independent directors and/or auditor; willing transfer of control by promoters, related party transactions, voluntary winding up, changes to Company's incorporation documents except those affecting SR shares, Resolution plan under Insolvency and Bankruptcy Code, 2016, utilization of funds for purposes other than business,

substantial value transactions, delisting and buy-backs and any other provisions that may be notified by SEBI. A Sunset Clause for SR shares of five (5) years from listing which can be extended by five years(5) through a resolution and automatic conversion to OV shares on events such as demise, the resignation of SR shareholders, merger or acquisition where the control would be no longer with SR shareholder, etc. Unfortunately, issuance of Fractional Rights (FR) Shares by listed companies has been disallowed though it may be reviewed in the future.[70]

3. RECOMMENDATIONS

While the brief framework that SEBI has given is a positive attempt, it needs to be more structured, detailed, and have a wider ambit. To this end, certain recommendations have been made to the SEBI DVR Policy.

- SR shares need not be listed on the Stock Exchange if they are not allowed to be traded. Since, a myriad of unexpected reasons for the exit of a promoter from the company may arise, at least inter promoters/Intra promoter group transfer of shares must be allowed albeit with the approval of shareholders through a special resolution (all shares to have 1:1 voting right *hereafter referred as 'ordinary voting'*). However, holders of SR shares must

[70] SEBI Board Meeting PR No.16/2019.

not be permitted to willingly sell their stake to any third party unless a concurrent offer to purchase OV shares on terms better than or equal to those of SR shares is made. In a takeover situation, this coattail shall protect the ordinary shareholders and prevent the promoter group from deriving unfair private benefits.

- Corporate Governance Committee should be created which will be the umbrella committee supervising over all the other committees instituted under Listing Obligations and Disclosure Requirements (LODR). It shall consist of 1/3rd Independent Directors of the Company, a representative appointed by SEBI, a compliance officer appointed by the company, and a Chartered Accountant/representative of the Company's Accounting firm. The Independent Directors on the Company's Board and the committees must rotate every two years. These measures will alleviate corporate governance concerns of investors.

- The terms of the DVR shares must be incorporated in the Article of Association (AoA) and the Company must publish a warning about DVR share structure on the first page of the prospectus. Also, fractional voting rights (FR) shares are an essential type of DVR and the same must be reinstated by SEBI in the future after conducting due research. SEBI must view

violations by DVR structure companies more seriously and impose higher penalties.

- Since tech businesses are asset-light, need to pledge/lien the SR shares can arise and the same should be allowed by ordinary resolution through ordinary voting (the promoter should still be able to exercise his SR voting rights) with the condition of conversion to OR shares in the event of default. Variation of dividend rights must also be permitted in order to balance the value of the share i.e. the higher the voting rights, the lesser the dividend. Conversion of DVR shares between classes higher and lower should be allowed by passing a special resolution (through ordinary voting). SR voting must be allowed on Substantial value transactions because sometimes founders may advocate certain high-value transactions that have strategic value to the business that shareholders may not see, Example: Facebook's acquisition of Whatsapp.[71]

- To maintain the ratio of the voting power at the time of IPO, Post-Listing any issuance of securities or corporate action should not cause voting rights of existing shareholders to be reduced or restricted either by way of the rights issue, bonus issue, buyback,

[71] Facebook acquired Whatsapp at an amount that was considered costly by shareholders, while strategically, the acquisition added immense value to Facebook for future expansion. If founder, Mark Zuckerberg had not had control via dual class shares with 10:1 voting power, the acquisition would not have been possible.

time-phased voting plans or any other manner i.e. such issuance may be done proportionately to all classes of shares. Also, automatic conversion/planned conversion of SR shares to Ordinary Voting rights (OR) shares must not trigger a public offer under Regulation 3 and 10 of SEBI Takeover Code unless the holder whose stake increased otherwise has control of the company.

- Additionally, the requirement of the collective net worth of the promoter group not exceeding ₹500 crores should specify the point in time when it is to be calculated i.e. at the time of issuance of such shares/at the time of filing Draft Red Herring Prospectus/Red Herring Prospectus/Red Herring Prospectus/the IPO; but preferably at the time of issuance of SR shares. Also, since the rationale is to make sure that SR shares are held by promoters who do not have the financial resources to retain control, it must be deliberated upon whether the increase in promoters' net worth beyond the threshold would cause the automatic conversion to OR shares.

- For flexibility, the time-based sunset provision should be left to the shareholders to decide with a cap of 5 years from listing.

- Presently, only companies falling under the Innovators Growth Platform have been allowed DVR Listing, but SEBI must also

evaluate various other sectors that would benefit from being covered under this scheme. In today's Indian environment, media companies could greatly benefit by retaining control and thus protecting the integrity of their reporting. In the US, 38 out of 44 industries have companies with dual class share structures with communications and printing/publishing industries having the most percentage of such companies (26.58% and 22.64% respectively)[72]. Also, keeping in mind the possibility of cross-listing being allowed in the near future, more types of companies should be allowed to have DVRs.

IV. CONCLUSION

Undoubtedly, SEBI's decision to allow the listing of DVR structured start-ups is a welcome move, correctly timed and well-intentioned but upon inspection, it is distrustful and narrow in its approach. This decision has constricted DVR shares into the singular function of limited promoter control instead of providing a passage for ingenious forms of instruments. It paints broad strokes missing vital details, leaving huge blanks that need to be filled; and

[72] HKEX, Consultation Conclusions, A Listing Regime For Companies From Emerging And Innovative Sectors, April, 2018 (July 14, 2019, 9:30 PM), https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Conclusions-(April-2018)/cp201802cc.pdf.

practical technicalities that must be clarified. Through the above recommendations, the author has attempted to do the same.

A careful reading of the dual-class share policies of various countries gives an insight of the various advantages and failings that this structure has, providing SEBI with the opportunity of eliminating the policies that did not work, borrowing the good provisions and adding a few innovative touches acclimatizing it to the Indian market ecosystem. It must be realized and accepted by all stakeholders that DVR shares cannot be straitjacketed into static structures to make them good or bad for a company. For a free and fair economy, Shareholders' Agreements with diverse rights must be permitted so that each company based on its stage of the lifecycle, immediate needs, future vision, and power structure can tailor-make a DVR instrument to cater to its specific needs provided corporate governance norms are met. While being cautious is important, the space to innovate is equally necessary, and hence, for the DVR policy to be a success, deeply informed policy decisions along with undertaking prudent risk is the need of the hour.

VIII. COMBATING CORPORATE IMPROPRIETY THROUGH SHAREHOLDER CLASS ACTION SUITS: INDIA AND BEYOND*

Abstract

Class Action suits have been the topic of much-heated debate and discussion recently. The Ministry of Corporate Affairs had in June 2016, notified the provisions of Class Action suits in India. This was considered to be an impressive move and did away with the after-effects of the Satyam scandal on Indian shareholders. The initiative serves two purposes, firstly, giving the minority shareholders, the potential to claim remedies; secondly, ensuring conscientiousness and diligence on part of the company and those in its power. In this article, the authors have explored the possibilities of class action suits in the Indian Regime and have analysed it with respect to the USA, UK, and France. In Part I, the authors have discussed what class action suits are and their key characteristics. In Part II, the authors have examined the relation between class-action suits and corporate governance. Under Part III, the basis for filing such suits has been reviewed, substantiating it with present-day examples from other jurisdictions. In Part IV, the authors have analyzed the Satyam scandal and explained the legal provisions in India for filing such suits. In Part V, the authors have compared Indian laws with corresponding provisions in the USA, the UK and France.

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The authors have then highlighted the loopholes in the Indian legal provisions and narrated the conclusion, along with suggestions for a favorable Indian corporate regime in the long run.

I. INTRODUCTION

Class Action Suit, often referred to as Representative Action Suit, is filed when a large number of people suffered the same or similar injuries and collectively wants to bring a claim through a representative. The introduction of the concept of "Class action suits" in India has been contemplated by various committees like the J.J. Irani Committee, 2005,[1] the 21st report of the Standing Committee on Finance on the Companies Bill, 2009[2] and the 57th Report of the Standing committee on Finance in the Companies Bill, 2011.[3] It gained momentum by the "India's Enron-Satyam Fiasco case."[4] Thereafter in Companies Bill, 2009, Class Action Suits were included as a measure to be available to the members and depositors of the company to approach National Company Law Tribunal (hereinafter "NCLT"), if the affairs of the company were conducted in a manner prejudicial to the interest of the company, or

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[1]Dr. JJ Irani, Report on Company Law, Ministry of Corporate Affairs 2005.
[2] 21st Report of the Standing Committee of Finance on the Companies Bill, 2009.
[3] 57th Report of the Standing Committee on Finance in the Companies Bill, 2011.
[4] In re: Satyam Computer Services Ltd. Securities Litigation, https://www.blbglaw.com/cases/00133/_res/id=Attachments/index=1/Consolidated%20Class%20Action%20Complaint%20Filed%20on%207-17-09.PDF.

its members and depositors.[5] The Companies Act, 2013 (hereinafter "the Act"), under Section 245,[6] has incorporated this concept. Despite these legislative developments, not a single class-action suit had been filed in India between 2012 and 2017.[7]

The paper begins by acknowledging the current rise in collective action being brought by shareholders worldwide against the misconduct of companies and seeks to examine the relationship of such suits with corporate governance. Furthermore, it elaborates on the basis of collective actions filed by aggrieved investors and shareholders and examines the scenario of shareholder class action suits in three other jurisdictions. The paper ends with analysing the gaps in the Indian regime.

II. SHAREHOLDER CLASS ACTION SUITS AND CORPORATE GOVERNANCE

A class action is a device to supply the "logic of collective action",[8] which is now being increasingly used by aggrieved shareholders worldwide to obtain damages and other remedies. From 2013 to 2018, the number went up dramatically by 238 suits in the U.S.

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[5] CS Professional Module, RESOLUTION OF CORPORATE DISPUTES, ICSI, https://www.icsi.edu/media/webmodules/FINAL_RESOLUTION_OF_CORPORATE_DISPUTES_BOOK.PDF.

[6] The Companies Act of 2013 § 245.

[7] Ashish Rukhaiyar, *Class Action Suits Ripe for Review?*, The Hindu, August 27, 2017, at 13.

[8] MANCUR OLSON, THE TITLE OF A SEMINAL BOOK ON THE THEORY OF GROUP BEHAVIOUR 117 (1971 Harvard University Press).

alone,[9] which is the birthplace of class action suits. This rise is global in nature[10] and explicitly underscores the risk of class action suits in which companies may land themselves in case of malpractice in their dealings with their shareholders. Apart from the numbers of these suits, the quantum of the price which the companies end up paying as settlement owing to the launch of a class action has gone up enormously.[11] In a recent instance of 2019, Petrofac faced a $400 million worth lawsuit, which filed by its shareholders, who claimed to have suffered a massive loss due to the Company's involvement in corruption.[12]

Representative actions are considered as an important weapon of accountability and corporate governance in the field of corporate litigation.[13] The keystone of such suits is to promote a mechanism whereby a number of 'have-nots' seek redressal against the 'haves', consequent to an injury or damage caused to the shareholders. The Act has brought about a number of changes from its iteration in

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[9] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 5 (Stanford Law School Securities Class Action Clearinghouse, 2019).

[10] Carol Zacharias, *Class Action Goes Global*, LEADER'S EDGE, (September 11, 2016), https://www.leadersedge.com/industry/class-action-goes-global.

[11] Erin L. Shelly &Theodre H. Frank, *Prospective Injunctive Relief and Class Settlement*, 39 HARVARD JOURNAL OF LAW & PUBLIC POLICY, 770, 771 (2015).

[12] SERIOUS FRAUD OFFICE, FORMER SENIOR EXECUTIVE CONVICTED IN PETROFAC INVESTIGATION (September, 2016), https://www.sfo.gov.uk/2019/02/07/former-senior-executive-convicted-in-petrofac-investigation/

[13] R. Romano, *The Shareholder suit litigation without foundation?*, JOURNAL OF LAW, ECONOMICS AND ORGANISATION, 55, 87(1991).

1956.[14] One such change was the inclusion of a provision[15] for filing of class action suits by shareholders.

The philosophy behind shareholder collective actions is that, apart from public sector offices like government, regulators, etc., private sector intervention too, through class action suits, can bolster the enforcement of corporate governance. The key actors of private enforcement include individual shareholders, shareholder associations, etc.[16] The OECD Thematic Review on Supervision and Enforcement[17] has observed that private supervision and enforcement can complement public supervision and enforcement.[18] In respect of facilitating corporate governance through class action suits, shareholder activism comes into play at the instance when the rights of any of the members are infringed or the conduct of the management is prejudicial to the interest of the company or its shareholders.[19] The same is regulated in India by the Act.[20]

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[14] *Legislative Brief, The Companies Bill, 2009*, PRS LEGISLATIVE RESEARCH (August 16, 2019), https://www.prsindia.org/uploads/media/Company/Legislative%20Brief--companies%20bill%202009.pdf.

[15] The Companies Act of 2013, §245.

[16] OECD, *Supervision And Enforcement In Corporate Governance*, OECD (November 4, 2013), http://dx.doi.org/10.1787/9789264203334-en.

[17] OECD, OECD THEMATIC REVIEW ON SUPERVISION AND ENFORCEMENT IN CORPORATE GOVERNANCE, 310 (Organization for Economic Co-operation and Development, 5th ed., 2013).

[18] SEBI, Consultative Paper on Review of Corporate Governance Norms in India (2013), https://www.sebi.gov.in/sebi_data/attachdocs/1357290354602.pdf.

[19] Mary Ann Cloyd, *Shareholder Activism: Who, What When and How?,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (April 7, 2015),

Corporations often enter into settlement for misconduct, but the cost of collective action by investors or shareholders runs much higher for companies after taking account of the number of derivative claims.[21] Even though these actions may not succeed on the basis of merits when actually litigated, but corporations have, time and again, been forced to settle for a plethora of commercial reasons. Interestingly, collective actions by shareholders prove to be expensive for companies as these actions often cost more money as compared to the fine levied by the regulators, thereby ensuring a check on corporate malpractices.

III. BASIS FOR CLASS ACTION LAW SUITS

The collective action often involves high costs and high quantum of damages in case of success.[22] Hence, it becomes pertinent to examine the bases on which class action suits are generally brought by shareholders. These bases broadly include two kinds of claims: (a) security frauds; and (b) derivative claims. The former involves shareholders alleging misleading and false disclosures by companies regarding potential violations of securities norms and actions by

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https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how/.

[20] The Companies Act of 2013 § 256.

[21] Chris Terwisscha van Scheltinga, *Rise of Shahreholder Class Actions in Response to Corporate Misconduct*, GAIN INTEGRITY (February 22, 2019), https://www.ganintegrity.com/blog/rise-of-shareholder-class-actions-in-response-to-corporate-misconduct/.

[22] Supra Note 11.

enforcement agencies of the respective jurisdiction.[23] As a matter of general principle, companies are required to make complete disclosures of all the relevant information pertaining to securities that might affect the decision of investors.[24] Class action suits involving security fraud claims seek to hold defendant company liable for losses sustained by the class of investors due to fall in stock prices owing to misstatements and/or omissions made by companies in their disclosures. Such misconduct of companies leads to investors and shareholders believing the artificially inflated prices of securities and acting upon the same.

The second category, i.e. derivative claims, involves those claims where aggrieved shareholders allege failure on part of directors or other officers of the company in undertaking actions against violation of internal control measures. Such claims are attributable to the fact that a director possesses liability for monitoring and overseeing the control system of the company and its implementation.[25] If the aggrieved class of shareholders succeeds to show that the director in question chose not to discharge his/her fiduciary obligations, liability for damages under class-action suits arise. There are specific examples and corresponding incidents flowing from the above two broad categories.

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[23] Id.

[24] A. Ramaiya, 3 GUIDE TO THE COMPANIES ACT, 4332 (18th ed. LexisNexis 2015).

[25] Id.

Misrepresentation in Prospectus: In order to paint a better picture than what it actually is, companies misrepresent information in their prospectus during Initial Public Offering ("IPO"). This has become common malpractice that undermines corporate governance. One such incident includes the much talked about the case of Facebook IPO,[26] which is a recent example of misrepresentation in the prospectus and selective disclosure. The U.S. based social media giant floated an IPO in the year 2012, amounting to USD 105 billion. Later, shareholders alleged that Facebook had failed to disclose in its prospectus the concerns about the reduction in growth owing to mobile devices. The allegations further asserted that the banks had been warned of the same and were told to cut their forecasts in an exclusive due diligence session held without shareholders' knowledge.[27] A shareholder association in California went on to file a class-action lawsuit against Facebook, wherein a settlement was reached in 2018 where Facebook offered compensation of USD 35 million.[28]

False forward-looking statements: Companies may indulge in issuing false forward looking statements, thereby misleading the investors and

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[26]IN RE FACEBOOK, INC., IPO SECURITIES AND DERIVATIVE LITIGATION (last visited November 14, 2019, 8:30 PM), http://securities.stanford.edu/filings-documents/1048/FB00_01/2018226_r01x_12MD02389.pdf.

[27] Id.

[28] Jonathan Stempel, *Facebook Settles Lawsuit Over 2012 IPO for 35 million*, REUTERS (February 27, 2018, 12:53 AM), https://www.reuters.com/article/us-facebook-settlement/facebook-settles-lawsuit-over-2012-ipo-for-35-million-idUSKCN1GA2JR.

the shareholders. A classic example where such an act fuelled a class-action lawsuit by shareholders was the Electronic Arts Inc. group litigation. In 2005, Electronic Arts Inc. faced class action litigation by its shareholders who claimed that the company issued materially misleading and false statements highlighting the purported strength of the Company's fourth version of its video game series called Battlefield.[29]The settlement of this class litigation cost $27 million to the company.[30]

Violation of Accounting Standards: Corporate bodies often indulge in window dressing, i.e., making false entries into accounts in violation of International Accounting Standards. One such incident which sparked class action litigation for such violation was the Petrobas case, wherein Brazil-based Oil Company was slammed with corruption charges in a deal.[31]A settlement was reached in 2018, which resulted in what has been called the largest class action settlement in U.S. history.[32]

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[29] In re Electronic Arts Inc. Securities Litigation (last visited November 14, 2019, 12:02PM), http://securities.stanford.edu/filings-documents/1034/ERTS05_01/200567_f15t_05CV01219.pdf.

[30] *Electronic Arts Settlement*, CLASS ACTION REBATES (Dec 23, 2018), https://www.classactionrebates.com/settlements/ea-sports/.

[31] In Re Petrobas Securities Litigation (last visited November 15, 2019, 12:01 PM), https://globalinvestigationsreview.com/digital_assets/ed1e72f5-737a-46f3-ba0e-f6dce90229e1/In-Re-Petrobras2.pdf.

[32] Brendan Pierson, *Petrobas to Pay $2.95 billion to Settle Class Action Over Corruption*, REUTERS (January 3, 2018, 3:12PM), https://www.reuters.com/article/us-petrobras-classaction/petrobras-to-pay-2-95-billion-to-settle-u-s-class-action-over-corruption-idUSKBN1ES0L2.

Internal control weaknesses: A failure to implement internal control measures results in malicious individuals taking leverage of security measures in companies, leading to under the table operations that affect the interest of shareholders and investors adversely. In such cases, class action suits are more feasible and pragmatic as compared to individual motions. One such example is that of Costco class action litigation. Costco Wholesale Corporation was slammed with class action litigation in the year 2018. Costco announced in October 2018 that it would report an internal control weakness in its upcoming Annual Report. This weakness was related to the controls in general information technology that supported Costco's financial reporting processes. However, the company made misleading statements in the market in respect of the said issue, as per the allegations.[33]

Delayed/Misleading disclosures: Misleading disclosures about the operations and default by the companies to its shareholders more often than not result in a loss for the latter, sparking a spree of collective actions. Yahoo Inc. failed to reveal two major data breaches to its shareholders. As a result, shareholders were shocked at the falling share price following the news of the said breaches. The belated announcement of the buying of Yahoo Inc. by

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[33] *GlancyProngay& Murray LLP Reminds Investors of the Deadline*, BUSINESS WIRE (November 28, 2018, 07:51PM), https://www.businesswire.com/news/home/20181128005872/en/Glancy-Prongay-Murray-LLP-Reminds-Investors-Deadline.

Verzonfurthered the sliding down of the prices. The shareholders brought a class action suit against Yahoo for not disclosing vital information and issuing misleading statements to the market leading to a settlement of $117 million.[34]

Related party transactions: It is a transfer of resources or obligations between related parties, regardless of consideration.[35] Companies often enter into arrangements with parties related to it by a pre-existing relationship. Although these transactions may not be illegal in themselves, they may lead to a conflict of interest or a consequence that is not legally sound.[36] When such transactions are entered into by the company through its directors without the approval of shareholders, a cause for shareholders to initiate collective action arises. Such claims are on a global rise since 2015.[37] In a recent case[38], Altisource Residential Corporation became a defendant in two class actions owing to an allegation of related party

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[34] Alex Zavaglia, *Yahoo! Cyber Breach Settlement Gives Shareholders Cause for Cheer*, MONDAQ (April 4, 2018), http://www.mondaq.com/canada/x/688852/trials+appeals+compensation/Yahoo+Cyber+breach+settlement+gives+shareholders+cause+for+cheer.

[35] *Guidance Note on Related Party Transactions*, ICSI WEB MODULES, https://www.icsi.edu/media/webmodules/Guidance_Note_on_RPTs_4-4-2019.pdf.

[36] Id.

[37] Supra Note 20.

[38] In re: Altisource Portfolio Solutions, S.A. Securities Litigation (last visited November 19, 2019, 07:02PM), http://securities.stanford.edu/filings-documents/1052/APSS00_01/201728_r01x_14CV81156.pdf.

transactions and conflict of interest.[39] The complaints inter alia alleged that the Company had failed to disclose issues associated with its relationship with ex-director and other related parties and ended with a settlement of $1.8 billion.[40]

IV. INDIAN REGIME

The need for class action suits was felt in the "India's Enron-Satyam Fiasco case."[41] In the U.S. District Court, the lawsuit was filed by Pomerantz Haudek Block Grossiman& Gross LLP law firm, against the Indian IT firm Satyam Ltd., its former Chairman B Ramalinga Raju, his brother and Satyam's outside auditors PricewaterhouseCoopers Pvt Ltd, Price Waterhouse and PricewaterhouseCoopers International Ltd. In 2011, Satyam agreed to pay $125 million and its auditor assented to pay $25.5 million to settle claims filed by shareholders.[42] The ruling specified that the investors could not file claims arising from stock purchases made on the National Stock Exchange of India, which restricted the

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[39] Trey Garrison, *Altisourse Slammed With Two Class Action Lawsuits*, HOUSING WIRE (April 4, 2015), https://www.housingwire.com/articles/33550-altisource-residential-slammed-with-two-class-action-lawsuits/.

[40] Christina Davis, *Altisource Call Class Action Settlement*, TOP CLASS ACTIONS (June 13, 2018), https://topclassactions.com/lawsuit-settlements/lawsuit-news/848924-altisource-unwanted-call-class-action-settlement-checks-mailed/.

[41] In re: Satyam Computer Services Ltd. Securities Litigation, https://www.blbglaw.com/cases/00133/_res/id=Attachments/index=1/Consolidated%20Class%20Action%20Complaint%20Filed%20on%207-17-09.PDF.

[42]VarottilUmakanth, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUSINESS LAW JOURNAL, 280,281.

investor's claim in U.S. Courts involving stocks bought on overseas exchanges. Further, due to an absence of reciprocity agreement between the two nations Indian shareholders could not place their reliance on the U.S. case.

In a parallel situation in India,[43] following the discovery of the manipulation of the past financial fraud, Mr. Raju admitted financial mismanagement on his part, as a consequence of which, Satyam board withdrew its decision to acquire Matyas firm. Thus, the price of the share shot down sharply, causing a huge loss to the shareholders of the company. A group of investors approached the National Consumer Dispute Redressal Commission (hereinafter "NCDRC") and Supreme Court (hereinafter "SC") but it was rejected on the ground that there was no law to deal with it and the NCDRC and SC do not have the infrastructure to deal with such petitions. The major issue before the court was whether India was suitable for an investor class action or whether it is a *forum non conveniens*. SC held that India was not suitable for a class action because there is no scope of the representative suit as it is just a procedural remedy given under CPC. In case a representative suit was valid, a new problem of enforceability of award comes into the picture. An investor, who is not a party to the suit, will be unable to enforce the claim.

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[43] Venture Global Engineering v. Satyam Computer Serviced Ltd. &Ors., AIR 2010 SC 3371.

The shareholders thus were unable to sue in India because of the lack of provision in the Companies Act, 1956, and thus by way of an amendment, class action suits were recognized under Section 245 of the Act.

1. LEGAL PROVISIONS

The Companies Act, 2013: Class actions come under oppression and management. Section 245 of the Act allows a certified number of members, depositors or any class of them to institute a class action before the NCLT if in their opinion the management or conduct of the affairs of the company is being conducted in a conflict of the interests of the company or its members or depositors. The section lists out remedies which can be granted, including restraining the company from committing an act *ultra vires* the Memorandum of Association, Article of Association, Companies Act or any other law for the time being in force or the resolution passed by the members. It also prescribes a claim for damages or compensation or suitable action from or against the company or its directors, auditors, any expert or advisor or consultant.

An application under the section, before the Companies (Amendment) Act, 2019,[44] could be filed by not less than 100 members or such percentage of the total number of members as may be prescribed, for a company having a share capital. In case of a

[44] The Companies (Amendment) Act of 2019.

company not having share capital, not less than a member or members holding at least five percent of the issued share capital can file for a class action. For listed companies, this would be two percent. The same threshold is applicable for depositors of deposit making companies. Sections 241-244 provide a mechanism for shareholders individually approaching the court alleging that the operation of a company is prejudicial to the public interest. However, Section 245 differs from Sections 241-244 on the ground of the array of remedies. The latter provisions failed to cover depositories; the class action suits cover them. The present position of law dictates that if claimants have initially approached the court under Sections 241 and 242, they cannot then invoke Section 245 because the latter is a complete code in itself and provides for the procedure post-admission too.[45]

Another provision for a "securities class action" is provided under Section 37 of the Act. A lawsuit, under this section, can be filed for a misleading statement or for the inclusion or omission of any matter in a company prospectus. This action can be filed by any person, group of persons or any association of persons affected by the statement/inclusion/omission

National Company Law Tribunal Rules, 2016(hereinafter "NCLT Rules"):

Rule 84 and 85prescribes accompanying regulations in relation to

[45] Shanta Prasad Chakravarty&Ors. v. M/s. Bochapathar Tea Estate Pvt. Ltd. &Ors., 2017 SCC OnLine NCLAT 335.

the right to make an application under Section 245 of the Act. The claims are assessed on a class-wide basis and the final outcome is binding on all the members of the class until a member decides to opt-out of the class action. Rule 86[46] allows a member of a class action to opt-out of the proceeding, with the permission of the NCLT.

No role has been prescribed or has been attributed to the regulators, professional bodies, and other third parties in representative suits under Order I, Rule 8 of the CPC, or under class-action suits under section 245 of the Act. The Section prescribes a limit for the fine that can be imposed for non-compliance with NCLT orders. However, it fails to prescribe a limit for the number of damages or compensation claimable. The scope of liability and damages under Section 245 could be tested and settled by the NCLT, NCLAT, or Supreme Court. The Act also allows the shareholders to not bring a class-action suit.

*Representative Action under the Code of Civil Procedure, 1908 (hereinafter "CPC"):*The CPC recognizes class actions under Order I Rule 8. It provides for a person to sue or defend on behalf of all in the same interest. The essentials of the provision are the presence of numerous parties, having the same interest, with the permission or

[46] The National Company Law Tribunal Rules of 2016 § 86.

direction of the court and notice is given to all the parties who are sought to be represented by the representative suit.

*Investor Protection and Education Fund, 2009:*SEBI (Investor Protection and Education Fund) Regulations, 2009[47] mentions that Investor Protection and Education Fund created by SEBI may, inter alia, be used for aiding investors' associations recognized by SEBI to undertake legal proceedings (not exceeding 75% of the total expenditure on legal proceedings) in the interest of investors in securities.

2. RECENT DEVELOPMENTS

NCLT Rules were amended in May 2019 and the threshold limits for filing such class-action suits were notified. The Ministry of Corporate Affairs, by exercising the powers conferred under the Act,[48] notified thresholds for filing class actions by way of amendments to the NCLT Rules. These have been effective from 8th May 2019. The rules laid down to amend the NCLT Rules are referred to as the NCLT (Second Amendment) Rules, 2019.[49] Sub-rule (3) and (4) were added to Rule 84 of the NCLT Rules. These rules read with Section 245(3) of the Act have brought clarity to the requisite number of applicants who need to file such suits.

[47] SEBI (Investor Protection and Education Fund) Regulations of 2009 § 5(2).
[48] The Companies Act of 2013 § 469(1), § 469(2).
[49] National Company Law Tribunal (Second Amendment) Rules of 2019.

Small and Minority Shareholders generally did not file class action suits. There was a risk of their loss and not getting compensated. They quite many times, ended up reimbursing the legal cost of the Company as well. Therefore, the SEBI took the initiative of creating the Investor Education and Protection Fund Regulation, as per the provisions of the Act.

V. CROSS-JURISDICTIONAL ANALYSIS

While class action suits were first introduced in the U.S., they have been in place in the U.K. for long now. France has introduced the concept quite recently. Analysing the trends in these three jurisdictions would present a fair picture as to how class action suits have fared in three different kinds of scenarios.

1. UNITED STATES

Numerous claimants, common questions of fact or law, and representatives that fairly represent the interest of the entire group are required in order to qualify as a 'class'.[50] In the US, a collective action suit does not end up being class action litigation unless the federal court gives the 'class certification' to the claimant, granted upon motion practice by the parties involving pleadings and

[50] Federal Rules of Civil Procedure § 23(a) U.S.C. (2014).

discovery.[51] Till the time this certification is granted, the absentees of the class are referred to as "putative class members".[52] These putative members are mandatorily required to allege and prove that their purported injury is not only "concrete" but also "particularized".[53] As per the recent trend in the U.S., class action litigation brought by shareholders has increased tremendously. In 2018 alone, 403 class-action suits were filed by shareholders regarding securities claims.[54] Since class action suits became popular since its inception in the U.S., the government is now on the path of regulating and limiting them by taking legislative measures to that end.[55] The courts are now supposed to delve into a rigorous analysis of nuances of claims before granting the class certification.[56]

2. FRANCE

France introduced class actions in the year 2014,[57] which can be initiated by "several persons" placed in a similar situation who incur a loss caused by the same person through a breach of legal or

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[51] Emma Walsh, *Class Action Suits in the U.K.: Overview*, REUTERS (October 1, 2019), https://uk.practicallaw.thomsonreuters.com/4-617-9264?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=.
[52] *Wal-Mart Stores, Inc v Dukes, 131 S Ct 2541, 2542 (2011).*
[53]Spokeo, Inc v Robins, 136 S Ct 1540, 1548 (2016).
[54] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 5 (Stanford Law School Securities Class Action Clearinghouse, 2019).
[55] Class Action Fairness Act of 2005, 28 U.S.C. § 1332(d).
[56] Comcast Corp v Behrend, 133 S Ct 1426 (2013).
[57] Law No. 2014-344 of 17 March 2014.

contractual duties.[58] The lawmakers deliberately attempted to design a different class action regime than that of the U.S.[59] Under the initial law, the class action suits could be initiated only in case of competition law and consumer law breaches. Later on, the applicability of the law was extended to environmental, health product liability,[60] data protection, and discrimination claims.[61] Class actions in France are governed by the Civil Procedure and are applicable only to the claims that arose after the law coming into force.[62]

The ordinary procedure involves the mandatory requirement of serving notice to the opposite party to stop and cure the breach and to proceed with the institution of the suit only in case of failure of such party to comply with the notice.[63] The entity filing the claim is not the class but a licensed association. The judge sets out the criteria to meet to take part in the class at the outset of the suit itself.[64] Such certification criteria are much more elaborate and

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[58] Law No. 2016-1547 of 18 November 2016, Art. 62.
[59] Kevin LaCroix, *Class Action Litigation Developments in France*, THE D&O DIARY (November 16, 2018), https://www.dandodiary.com/2016/11/articles/international-d-o/class-action-litigation-developments-france/.
[60] Law No. 2016-41 of 26 January 2016.
[61] Law No. 2016-1547 of 18 November 2016.
[62]Alexandre Biard, *Class Action Developments in France*, STANFORD.EDU (August, 2016), http://globalclassactions.stanford.edu/sites/default/files/documents/FRANCE_0.pdf.
[63] French Civil Code of 1804, Art.224 (2016).
[64] Xavier Haranger, *Class Actions in France: Overview*, REUTERS (August 1, 2019), https://uk.practicallaw.thomsonreuters.com/1-618-0240?transitionType=Default&contextData=(sc.Default)&bhcp=1.

complex in the U.S., where it varies depending on the nature of the relief sought and it is determined through litigation and discovery.[65] Unlike the U.S., France follows the opt-out model. In France, if any claimant chooses to opt-out of the class action and seeks relief individually, that claimant would be denied compensation for losses suffered that could have been compensated in that class action.[66] There are no specific provisions related to third party funding and lawyers' fees in class actions.[67]

Since the introduction of class action claims is recent, France has seen only eighteen class action suits being filed to date.[68] However, there has not been a single collective action suit filed by shareholders or investors because the law does not envisage corporate class-action suits. Interestingly, the legislature has introduced numerous revisions to the law in order to expand its scope from employment matters to data privacy violations but has omitted actions by shareholders and investors against corporate misconduct. The amendments have been consumer-oriented.[69] As per the commentators, it may take a securities or alike corporate

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[65] Supra Note 60.
[66]Id.
[67] Id.
[68]AlexandreBailly, *Class and Group Actions 2020*, ICLG (November 11, 2019), https://iclg.com/practice-areas/class-and-group-actions-laws-and-regulations/france.
[69] Supra Note 58.

scandal that would bring the French legislature's attention to shareholders' class-action suits.[70]

3. UNITED KINGDOM

In the U.K., a class action can be brought where more than one person has the same interest in a claim and the claim is brought by or against one or more of those persons.[71] Such actions are categorized into three types namely: the claims that are suitable for convenient disposal in the same proceeding, group litigations where several claims are clubbed together, and representative actions.[72] The parties should have the common interest right from the institution of the suit until the delivery of judgment.[73] However, the group is not frozen after the institution; fluctuations are allowed unless they do not alter the common ground held by the claimants. The representative bringing the suit on behalf of the claimants need not be directly affected by the outcome of the suit, even if the claimants are domiciled outside the U.K.[74] Third-party funding is prevalent, but such funders cannot step into the shoes of claimants as per the practice.[75]

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[70] Id.
[71] Civil Procedure Rules-Practice Directions of 2006 (2019).
[72] Supra Note 49.
[73] *Emerald Supplies Ltd v British Airways plc, [2010] EWCA Civ 1284.*
[74] *The Competition Act of 1998, § 47B(8).*
[75] The Association of Litigation Funders' Code of Conduct of 2011.

The opt-in procedure was not introduced until 2015.[76] Competition claims form the major chunk of the class action litigation in the U.K., followed by personal injury claims and pension disputes. However, the shareholders in the U.K. have time and again chosen different legal and regulatory recourses other than class actions despite many high-profile corporate collapses.[77] Jurists allege misrepresentation to be a common cause of action in suits in English law,[78] the most common claimants being investment banks or commercial banks,[79] shareholders of small private companies,[80] financial institutions[81], and wronged investors.[82] In all these cases, collective action would have been an easy recourse instead of mobilization of claimants. Despite this, the claimants do not view class action as a feasible option for seeking a remedy.[83] Even the official list of all the group litigation orders issued by the Government[84] paints a gloomy picture shareholder class actions, wherein claims giving a boost to class action suits are those by financial institutions and not aggrieved shareholders or investors,

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[76] Supra Note 63.
[77] Supra Note 49.
[78] Id.
[79] British & Commonwealth Holdings v. Samuel Montagu and Others, [1995] CA 12 (1996); Smith New Court Securities Ltd v.Scrimgeour Vickers (Asset Management) Ltd.[1996] UKHL 3 (1996).
[80] Platt v Platt,Ch. D.2 B.C.L.C. 745. (1999).
[81] Chase Manhattan Equities v.Goodman& Others, Ch.D. BCLC 897 (1991).
[82] Morgan Crucible v. Hill Samuel Bank and Others, CA [1991] Ch. 295.
[83] Supra Note 3.
[84] GROUP LITIGATION ORDERS, GOV.UK (last visited November 20, 2019), https://www.gov.uk/guidance/group-litigation-orders.

who are choosing other legal devices. The limitation period for the institution of class action suit is six years from the date on which the cause of action arose or the date on which the cause was discovered in case of fraudulent concealment.[85]

Comparison with India

One of the fundamental distinctions between India and the aforementioned jurisdictions is the criteria for identifying a 'class'. In India, the criteria have been quantified in terms of number and the percentage of a total number of shareholders of a particular company, while legislatures in the U.S., U.K. and other alike jurisdictions have chosen a pragmatism-driven approach, i.e. a group of claimants qualifies as a class where it would be impractical for them to bring individual actions. Law firms in other countries are allowed to advertise and take fees for class action litigation based on the results that they deliver.[86] This allows them to take up class action suits without any upfront payment, lowering the entry barriers for litigants. On the contrary, law firms in India are barred from advertising and soliciting funds through advertisements,[87] which acts as a setback for them taking up collective action cases. Another distinguishing feature is the licensing requirement for a

[85] *The Limitation Act of 1980*, § 2, 5, 32.

[86] Sachin P. Mampatta, *Lack of Timely Resolution, Legal Costs May Hold Back Class Action Suits*, BUSINESS STANDARD (August 13, 2019), https://www.business-standard.com/article/companies/lack-of-timely-resolution-legal-costs-may-hold-back-class-action-suits-119081301354_1.html.

[87] The Bar Council of India Rules of 1961, § 36.

class. In France, a class action can be filed only by duly licensed associations of claimants. Likewise in the U.S., there is a certification requirement for 'class' filing the suit. However, the Act is silent upon any certification or licensing of claimants.

VI. GAPS IN INDIAN REGIME

Absence of timely resolutions and Legal Costs: Class action suits catch on in cases where investors or interested shareholders pursue them to the logical conclusion and bear the costs of extended litigation.[88] Companies are inclined towards exiting the stock market in case of misadventures rather than going in for extensive legal battles which would affect the shareholder value adversely. A few instances substantiate these backtracks. Endurance Technologies, the automotive component manufacturer, decided to pursue expansion into tyre manufacturing. However, the share value tanked 20 percent and the company overturned its decision.[89] Jubilant Foodworks reversed its decision of withdrawing the payment of owners' royalty for the use of 'Jubilant brand', when subsequent to the decision,

[88] Shriram Subramanian, *Proxy Advisory Firms Push for More Changes in Corporate Boardrooms*, BUSINESS STANDARD (August 2, 2018), https://www.business-standard.com/article/companies/proxy-advisory-firms-push-for-more-changes-in-corporate-boardrooms-118080200029_1.html.

[89] *Endurance Technologies Rebounds 17% as Management Withdraws Expansion Plan*, BUSNIESS STANDARD (August 9, 2019), https://www.business-standard.com/article/markets/endurance-technologies-rebounds-17-as-management-withdraws-expansion-plan-119080900383_1.html.

stocks fell by 6.45 per cent.[90] Cases take so much time through the NCLTs, that it deters law firms to take up such matters to be redressed.

Third-party funding issues: There is no restriction in India on a third party (non-lawyers) funding the litigation and getting repaid after the outcome of a class-action suit.[91] The CPC under Order XXV Rule 3endorses the role of the third-party financier of litigation costs of a plaintiff, providing for the situations when such financier may be made a party to the proceedings. However, to date, there is no legislative instrument that regulates such funding. The class action regime has been in its nascent stage in India and the same is on account of the lack of a "Plaintiff's Bar" that established class action astride contingency fees in the West. The onset of third party funding will provide the framework for shareholders or investors in a company to approach the court by way of a class action with required financial support.

Minority Interests: Derivative action suits have been allowed by the courts in cases of fraud by those in authority. The same has been filed by the minority against wrong non-ratifiable decisions of the dominant ones. These actions are brought about by the shareholders on behalf of the company and in respect of the wrongs done to the

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[90] *Jubilant Foodworks flip-flops decision to Pay 0.25% Royalty for Trademark to Promoters*, CNBC (Dec, 2018), https://www.cnbctv18.com/retail/jubilant-foodworks-flip-flops-decision-to-pay-0-25-royalty-for-trade-mark-to-promoters-2195771.htm.

[91] Bar Council of India v. AK BalajiAIR 2018 SC 1382.

company. A shareholder thus files a representative suit, on behalf of the other shareholders, having the same *locus standi*.[92] These principles have been validated by the courts, time and again; however, there is a need for their recognition.

Defendant class action: While there exist explicit provisions and discussion around plaintiffs class-action suits, defendant class actions continue to remain an absent concept in Indian jurisprudence, even though they have been used with success and rather frequently for securities cases and constitutional challenges in the U.S., U.K., France and other countries.[93]The introduction of the same in India shall afford greater protection and fairness accorded to the defendants in a class-action suit that wishes to join as a class.

VII. CONCLUSION

Shareholders and other investors, who would have resorted to the earlier remedies, now have an effective and practical tool for redressal in the form of class action suits. With the inclusion of provisions for filing of class action suits under the Indian law, Indian shareholders are unlikely to face a conundrum similar to that of the Satyam case. They now have rights of restitution that will transform the principal-agent relationship and change the power

[92]Data & Reports, *Minority Interests*, MINISTRY OF CORPORATE AFFAIRS, http://www.mca.gov.in/MinistryV2/minority+interests.html.
[93]Francis X. Shen, *The Overlooked Utility of Defendant Class Action*, 88 DENVER UNIVERSITY LAW REVIEW(Issue 2, 2016).

balance between shareholders and those in control of the management. Legal costs, third party funding, minority interest, and defendant's class action are areas where a compelling stand has to be taken by the Indian legislature. The government is all set to formulate a scheme to provide reimbursement of legal expenses on class action through IEPF. Further steps in this direction are awaited, which shall make the picture even clearer.

IX. ANALYSIS OF INDIAN LAWS IN THE WAKE OF IL&FS CRISIS*

Abstract

The novel substitutes to traditional banks, the Non-Banking Financial Companies have lately dominated the Indian Financial sector profusely. Acting as rising propellants of ushering finances into the Indian economy, NBFCs have changed the course of Indian banking and financial sector. The ability to reach a larger audience at a swifter pace has driven the Shadow Banking sector in India to greater heights. Once soaring high in the sky, the Indian shadow banks system saw its decline when Infrastructure Leasing & Financial Services (IL&FS), one of the major NBFCs, became debt-laden. The main cause identified behind the fall of IL&FS was the downright failure of asset-liability management. Moreover, the dilapidated status quo of the laws which regulate NBFCs in India further drove the financial sector to a dead-end.

In this article, the authors have closely analyzed the IL&FS crisis which transpired in September 2018 and gave rise to a series of defaults in payments in the Indian economy. After having analyzed the events that led to the crisis the authors will take a thorough look at Indian laws and regulations governing the Non-Banking Financial Companies. In the ensuing chapters, the authors have assessed the far-reaching reforms essential for plugging the loopholes in the Indian

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regulations. Further, the authors have contrasted the laws of India with that of the United States and aimed to fathom new areas of law that require immediate modification. The authors have come up with a few recommendations which might help to mitigate the plight of the shadow banks in India.

Keywords: Non-Banking Financial Companies, IL&FS crisis, Banking and Financial sector.

I. INTRODUCTION

September 2018 witnessed the zapping horses of the Indian markets return back to the stables after being thrashed by the liquidity crisis in the economy. India's shadow banks are in the midst of a crippling liquidity squeeze that threatens to balloon into a full-blown crisis.[1] A full-fledged liquidity crisis hit the Indian Non-Bank Financial Institutions leaving them in tatters.

Who was to be blamed for such a crisis? To begin with, 'the first signs of trouble emerged in June when Infrastructure Leasing & Finance Services (a Non-Bank Financial Institution) defaulted on

[1]SanketDhanorkar, *Defaults aplenty: What is ailing India's NBFC sector?*, The Eco. Times, (Jul. 1, 2019, https://economictimes.indiatimes.com/wealth/personal-finance-news/defaults-aplenty-what-is-ailing-indias-nbfc-sector/articleshow/70001015.cms?from=mdr.

inter-corporate deposits and commercial papers (borrowings) worth about Rs 450 crore.'[2]

In order to understand the crisis better, let us walk you through the concept of shadow banks in India. The term refers to the practice of banking like activities performed by non-banking finance companies, which are not subject to strict regulation.[3] According to section 45-I (f) of the RBI Act, 'a Non – Banking Company carrying on the business of a financial institution will be an NBFC.'[4] A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 or 2013 engaged in the business of loans and advances, acquisition of shares, stocks, bonds, debentures, and securities issued by Government or local authority.[5]

The clouds of the massive financial crisis are looming over the NBFCs, owing to the unregulated working mechanism of the NBFCs and less-than-stringent laws present in India. The authors in the further chapters have pointed out how shortcomings of the Indian laws trailed into the failure of shadow banking in India. The

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[2]Beena Parmar, *Debt and defaults: What happened to IL&FS?*, (Sep. 14, 2018)https://www.moneycontrol.com/news/business/companies/debt-and-defaults-what-happened-to-ilfs-2952381.html.
[3]Shilpy Sinha, *What is shadow banking?*, The Eco. Times, https://economictimes.indiatimes.com/economy/what-is-shadow-banking/slideshow/18058541.cms.
[4] *NBFC: Non Banking Financial Corporations*, Clear Tax, (Jul. 17, 2019), https://cleartax.in/s/non-banking-financial-company-nbfc.
[5]*Id.*

concept of shadow banks has flourished immensely in the United States, 'the U.S. still makes up the biggest part of the sector with 29% or $15 trillion in assets'[6] In the later sections the authors went on to list down few regulations from the United States governing shadow banks, that might come in handy while drafting new laws for Indian NBFC sector. But prior to that, let us have some background on the IL&FS crisis.

II. THE IL&FS SAGA

Last year in September 2018, the IL&FS group & its subsidiaries defaulted most of its debt obligations. The main reason behind the IL&FS crisis (hereinafter 'The Crisis') is with the liquidity crunch arose because of providing long term debts against its short term obligations. IL&FS group owes liability of ₹99,354 crores.[7] Many media houses and newspaper agencies called it to be the Lehman

[6] Jeff Cox, *Shadow banking is now a $52 trillion industry, posing a big risk to the financial system*, (Apr. 11 2019), https://www.cnbc.com/2019/04/11/shadow-banking-is-now-a-52-trillion-industry-and-posing-risks.html.

[7]Jayshree P. Upadhyay, I*nside the audit lapses that led to IL&FS crisis*, (May 21, 2019), https://www.livemint.com/companies/news/inside-the-audit-lapses-that-led-to-il-fs-crisis-1558456079750.html [hereinafter *Jayshree P. Upadhyay*].

Crisis of 2008,[8] where the housing debt market suffered a setback and the whole global economy faced the brunt of it.[9]

IL&FS Ltd, or Infrastructure Leasing & Finance Services is registered under the Companies Act, 1956[10] in the year 1987 by late MJ Pherwani.[11] It is a core investment company that deals with various sectors like infrastructure, finance, social and environmental services. [12] IL&FS has 256 group companies as of 2018, including subsidiaries, joint venture companies and associate entities. It has 23 direct subsidiaries, 141 indirect subsidiaries (including special purpose vehicles for different projects), 6 joint ventures and 4 associate companies.[13]

The institutional shareholder has the largest share under IL&FS where state-run LIC and SBI owns 25.34 percent and 6.42 respectively, the other shareholders include Orix Corporation of Japan with 23.5 percent, Abu Dhabi Investment Authority with 12.5

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[8] *IL & FS: The crisis that has India in panic mode*, The Eco. Times, (Oct. 03, 2018), https://economictimes.indiatimes.com/industry/banking/finance/banking/everything-about-the-ilfs-crisis-that-has-india-in-panic-mode/articleshow/66026024.cms?from=mdr [hereinafter IL & FC].

[9] Anne Sraders, *The Lehman Brothers Collapse and How It's Changed the Economy Today*, (Apr. 22, 2019), https://www.thestreet.com/markets/bankruptcy/lehman-brothers-collapse-14703153.

[10] Companies Act, 1956.

[11] IL & FC, *Supra* note 8.

[12]*Id.*

[13] Press Trust of India, *Funds worth Rs 160 bn getting stuck led to this mess: IL&FS tells staff*, Bus. Standards, (Sept. 13, 2018), https://www.business-standard.com/article/economy-policy/il-fs-tells-staff-financial-mess-due-to-rs16-000cr-stuck-funds-118091201070_1.html.

percent, Employees Welfare Trust with 12 percent and Central Bank of India with 7.67 percent.[14]

Now the main question arises as to what eventually happened that led to such a big catastrophe.

Non-Banking Financial Company generally termed as *Shadow Banks* that basically engages in the business of loans and advances, acquisition shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities.[15] Similarly like other NBFCs, IL&FS uses instruments like non-convertible debentures (NCDs) and commercial papers (CPs) for short term borrowing at attractive rates. IL&FS defaulted as it failed to fulfill its commercial paper obligations because of serious liquidity crunch.[16]

The problem of *asset-liability mismatch* is considered to be the main reason for default where short term loans were taken to pay for the long term projects.[17] Consequently, the due dates of short term

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[14]*Id.*
[15]*All you want to know about the NBFC crisis*, Mon. Cont. News, (May. 13, 2019), https://www.moneycontrol.com/news/business/all-you-want-to-know-about-the-nbfc-crisis-3966551.html.
[16] Jayshree P. Upadhyay, *Supra* note 7.
[17] Surabhi, *IL&FS defaulted due to asset-liability mismatch*, The Hindu, (Oct. 03, 2018), https://www.thehindubusinessline.com/money-and-banking/ilfs-defaulted-due-to-asset-liability-mismatch/article25115186.ece.

obligations met while the assets were stuck in the long term projects.[18]

The three big *auditing firm* i.e. EY. Deloitte and KPMG undertook the audit of IL&FS and its subsidiary. There have been allegations of professional misconduct[19] against the auditors under the Chartered Accountant Act, 1949. The auditors in the case were unable to present the true picture of the IL&FS crisis by not highlighting the asset-liability mismatch, to the inappropriate valuation of assets and poor identification of NPAs.[20]

Let's put it this way that the *Rating Agencies* have their duty of representing the true value of the company's worth which they have failed to do so in the case of IL&FS. The series of default started in March 2018, however, the ratings of the IL&FS group was still AAA (the most secured ratings). Recently, it has been revealed by the special audit report by Grant Thornton that top executives of IL&FS and top rating agencies were aware of the serious liquidity

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[18] *IL & FS issue and Corporate Governance in India*, IAS Score, https://iasscore.in/current-affairs/mains/ilfs-issue-and-corporate-governance-in-india.
[19] Chartered Accountants Act, 1949, §22.
[20] *Pavan Burugula,Auditors raised red flags on IL&FS in past three years*, (Nov. 02, 2018), //economictimes.indiatimes.com/articleshow/66470544.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

crunch. However, only in September 2018, the AAA-rated IL&FS stocks were dropped to the lowest rating of junk.[21]

The *Government and the RBI* proved to be irregular with regards to IL&FS in the present matter. However, after the great scandal of Satyam, the government decisively used its extraordinary power provided under the company's act moved to NCLT for the ousted of the existing Board and appointed new six members to board under the chairmanship of Uday Kotak for the revival of the company from the debt crisis and liquidity crunch. The government was a major stakeholder in the case of the IL&FS crisis with a stake of 41 per cent.

Even though it was late, the government and RBI have taken very stringent steps for the situation and have managed to divert India's Lehman Crisis by open market operations and cash infusion in the market. The purpose of this is basically to deal with the liquidity crunch in the market. The IL&FS crisis was a result of grave mismanagement by the top executive bodies, the auditors, the rating agencies, the government, and the RBI. *It is the view of the authors that this all led to the failure of corporate governance in IL&FS.*

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[21] Press Trust of India, IL & FS crisis: *Sebi expands probe into role of 5 credit rating agencies*, Bus. Standards, (Nov 02, 2018), https://www.business-standard.com/article/pti-stories/il-fs-case-sebi-widens-probe-into-role-of-rating-agencies-119072100157_1.html. [hereinafter *IL & FC Crisis*].

III. LEGAL FRAMEWORK

1. LAWS GOVERNING NBFCS IN INDIA

A. RBI Regulations governing NBFCs

The business of a non-banking financial company is included under the business of a non-banking financial institution as provided under S.45 I A of the RBI Act, 1934.[22] Principal Business of NBFCs includes the receiving of deposits, deposits, under any scheme or arrangement or in any other manner, or lending in any manner. The main working and operations of the NBFCs are regulated by the Reserve Bank of India.[23] RBI from time to time provides guidelines regarding disclosure of quarterly, half-yearly and annual returns.[24] Since NBFCs are registered as companies under the companies' act, all the required obligations are to be followed as proved under the companies' act.[25]

B. Companies Act governing NBFCs

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[22]Reserve Bank of India Act, 1934, §45.
[23]Reserve Bank of India Act, 1934, Ch. III (B).
[24] Directive 8, The NBFC-D Directions, (1998); Directive 15, The NBFC-D Companies Prudential Norms Directive, (2007).
[25] Nishith Desai Associates, *Banking and Financial Services*, http://www.nishithdesai.com/information/areas-of-service/industry/bfsi.html#c299.

A non-banking financial company falls under the definition of a company as provided under the S.3 of the Companies Act, 2013.[26]The companies act contains provisions relating to board constitution, board meetings, board processes, independent directors, general meetings, audit committees, related party transactions, disclosure requirements in financial statements, etc. NBFCs being a company registered under the act have the mandate to adhere to the provisions of the act.

ICAI is an autonomous body, which issues accounting standards providing guidelines for disclosures of financial information. Section 129 of the New Companies Act *inter alia* provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under s 133 of the New Companies Act. It is further provided that items contained in such financial statements shall be in accordance with the accounting standards.

C. *SEBI Regulations governing NBFCs*

NBFCs deal with shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities. Furthermore, it is a listed company in the market thus bound to

[26]The Companies Act, 2013, § 3.

follow the regulations and guidelines issued by the Securities Exchange Board of India Act.[27]

In the present case of IL&FS which is a public listed company bound to follow the regulations of SEBI for the protection of Investors. However, regardless of laws governing NBFCs, such a big crisis of IL&FS shook the whole Indian economy and led to the total failure of corporate governance as per the views of the authors.

2. CORPORATE GOVERNANCE FAILURE IN IL&FS EPISODE

It is the view of the authors, a serious corporate governance miscarriage happened in the entire IL&FS episode. The *failure of auditors or auditing firms* to provide the true picture, the failure on the part of the *rating agencies* to show the risk associated, most importantly the *carelessness of the board of directors* and *the government and the RBI* to regulate properly led to the failure of corporate governance.[28]

Corporate Governance according to the famous Cadbury Committee is *the system by which companies are directed and controlled*.[29] The main purpose of corporate governance is to ensure

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[27] The Securities and Exchange Board of India Act, 1992.
[28]UmakanthVarottil, *Governance of Financial Institutions: Call for a Paradigm Shift*, (Oct. 8 2018), https://www.bloombergquint.com/opinion/governance-of-financial-institutions-call-for-a-paradigm-shift
[29]CADBURY COMMITTEE REPORT 1992.

accountability, fairness and, protecting interests of stakeholders by the organization's directors and managers.[30] The framework with regard to corporate governance in India is in consonance with the international best practices.[31]

The laws on corporate governance became very strict after the scandals of Satyam and Sahara however the history repeated itself in the present case of IL&FS, where the authors are of the opinion that a gross failure of corporate governance happened for the following three main reasons:

A. Asset-Liability Mismatch

B. The fault of Rating Agencies

C. The Board of Directors

D. The Auditors

A. <u>Asset-Liability Mismatch</u>

According to the regulations provided by the RBI under section 35 of Master Direction - Residuary Non-Banking Companies (Reserve

[30]Organisation for Economic Cooperation and Development

[31]Vaish Associates Advocates, *Corporate Governance Framework in India*, (Jan. 8 2016), http://www.mondaq.com/india/x/456460/Shareholders/Corporate+Governance+Framework+In+India

Bank) Directions, 2016[32] it was given that ALM is a very pertinent system for efficient management. However, in the present case of IL&FS serious negligence can be identified on the part of the auditors and the top executives of the company who failed to notice such a gross asset-liability mismatch which ultimately harmed the interests of stakeholders.

B. The fault of Rating Agencies

It is the duty of NBFCs to provide updated ratings by the agencies after the period of every six months. In the present case, it was identified by Grant Thornton in its special audit report[33] that the top executives and the rating agencies were aware of the liquidity crunch in the company but they intentionally kept silent for so long. Thus, it is the authors' view that it violated the principles of corporate governance by not informing the investors about the situations. Consequently, various mutual funds suffered a huge loss because of the sudden downfall of the debt market.[34]

C. The Board of Directors

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[32] The Master Direction - Residuary Non-Banking Companies (Reserve Bank) Directions, 2016§35.

[33] IL & FC Crisis, *Supra* note 21.

[34]Atmadip Ray &Saikant Das, *Mutual funds hit exit button after IL&FS crisis*, (Oct 04, 2018), https://economictimes.indiatimes.com/markets/stocks/news/mutual-funds-hit-exit-button-after-ilfs-crisis/articleshow/66076594.cms?from=mdr .

Certainly, it is not possible to believe that the top executives were sleeping when such a big crisis was knocking the door. The authors are of the opinion that there was a part of executives in the whole crisis, however as the matter is still pending before the appropriate forum. The government invoked section 241 (2) of the Companies Act-2013[35], appointed a new board under the chairmanship of Uday Kotak to revive back an important lender of the market. The act being negligent in not identifying the issue is in itself a failure of corporate governance by the board of directors.

D. The Auditors

Section 143 of the companies act, 2013 provides for the duties of the auditors to submit a true picture.[36] Basically it means whatever is the position of the company it needs to show in the audit report. Thus, it forms an important pillar of corporate governance.[37] In the present case of IL&FS, big names of auditing firms were involved like EY, Deloitte, and KPMG. Grave negligence on the part of the auditors as they were not able to present the true picture of IL&FS

[35]The Companies Act, 2013, §241 (2).
[36] The companies act, 2013, §143.
[37]*Auditing in India: Role of Auditors in Corporate Governance*, Pro School, https://www.proschoolonline.com/blog/auditing-in-india.

in the past three years.[38] The matter regarding the auditors of IL&FS is before the NCLT.[39]

NBFCs are regulated by both the RBI and the Companies Act, 2013 that always led to the conflict of interest and power between the government and the central bank. In the case of IL&FS for the very first time after independence, the government used its power provided under s.7 of the RBI act, 1934. This raises very pertinent questions as to whether RBI or government has the power to regulate the NBFCs sectors. This is a grey area where more laws are needed so as to no such crisis will arise in the future.

After understanding the problems and the loopholes of the present model of NBFCs, the authors present some models and recommendations to improve the prevailing conditions and to avoid such a crisis in the future.

IV. EFFICACY OF LAWS IN INDIA

It is a settled fact that the present laws are extremely ineffective in quelling the growing challenges in the NBFC sector. The feeble laws

[38] *IL&FS case: Auditors have many questions to answer says corp affair secretary*, Live Mint, (May. 5, 2019), https://www.livemint.com/companies/news/il-fs-case-auditors-have-many-questions-to-answer-says-corp-affairs-secretary-1557051262180.html.

[39] Press Trust of India, *NCLT stays its own order to prosecute IL&Fs auditors for 4 weeks*, The Eco. Times, (Jul 25, 2019), https://economictimes.indiatimes.com/news/economy/finance/nclt-stays-its-own-order-to-prosecute-ilfs-auditors-for-4-weeks/articleshow/70381250.cms.

and indecorous implementation have not only been futile in overcoming the situation but also has added to the recent misery India has been fronting. In the view of the authors, the Indian NBFC sector requires stricter regulations, which are free of any future mishaps.

Therefore, in lieu of the current situation, the authors would like to draw attention towards a more comprehensive set of laws prevalent in the United States which came into effect in 2010; known as the 'Dodd-Frank Wall Street Reform And Consumer Protection Act'[40] the laws have facilitated in making the sector more steady and reliable. The authors are of the opinion that some provisions from the act; if implemented, might change the course of the Indian NBFC sector for good.

We now contrast the Indian laws with the Dodd-Frank Act, in order to analyze the scope of improvement.

V. KEY TAKEAWAYS FROM THE DODD-FRANK ACT

Dodd-Frank Wall Street Reform And Consumer Protection Act came into the picture after the dreadful Lehman brother crisis. To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too

[40] Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010.

big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes,[41] the act astutely dealt with all major flaws in the system.

Primarily, the act instituted that 'U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S.'[42] This provision endeavors to provide an umbrella to the companies who were drowning in the heavy drizzle of liquidity crunch. The authors are of the opinion that after witnessing the cold war between the government and the RBI in the IL&FS case, it is high time for India to place the NBFC sector under the supervision of one definitive control. Regardless of the fact that the control over the NBFCs in India lies with the RBI; there have been times when the government has been very nosey in the affairs of NBFC, which further debilitated the condition. Therefore, in order to make peace with the current state of affairs, it is vital to define the regulatory authorities which govern the working of NBFCs in India.

Moving further, the Dodd-Frank Act provides that 'each nationally recognized statistical rating organization shall establish, maintain,

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[41] *Id.*

[42] *Id at*§ 113.

enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.'[43] The section of the act focuses on strengthening the credit rating agencies in the United States. The importance of credit rating system and its reliability was further discussed and it was said that 'because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial "gatekeepers" do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.'[44] The mandatory obligations imposed on the credit rating agencies further enhances accountability, leaving no stone unturned in making the market more secure for the investors. In contrast, India imposes no such mandatory provisions on the credit rating agencies. In view of the authors, it is mandatory for India to come up with provisions like the standard liability of the agencies, in order to protect the interests of the investors.

[43]*Id at*§ 932 (3)(A).
[44]*Id at* § 931 (3).

Amongst several other laws, one of the major regulations instituted in the act was related to the disclosure requirements of the Asset-backed securities. It stated that 'The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.'[45] The addition of this section further nipped in the problem of liquidation in the bud. India, on the other hand, lacks any such regulation. In the opinion of the authors, it is crucial for India to indoctrinate an aligned system of disclosure of asset-backed securities, in order to make the future of Indian companies debt-proof.

Due to the above-stated reasons, it can be effectively concluded that India needs to adopt certain provisions from the Dodd-Frank Wall Street Reform and Consumer Protection Act since it will be beneficial in streamlining the regulations over NBFCs. The standardized approach embraced by the Dodd-Frank Act shall also support NBFCs in expanding their productivity.

While the Dodd-Frank Wall Street Reform and Consumer Protection Act might be applicable to particular areas of Indian shadow banking, yet, this applicability does not eliminate the need of having a domestic law regulating the NBFCs.

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[45]*Id at*§ 942 (c).

Bearing in mind the current scenario of Indian shadow banks, implementing the sections from the Dodd-Frank Wall Street Reform and Consumer Protection Act might seem very distant; therefore, it is equally imperative to analyze the scope of improvement in current Indian laws as well. Now, we shall discuss a few recommendations which will help eradicate the discrepancies in contemporary Indian laws.

VI. RECOMMENDATIONS

After extensively studying the facts pertaining to IL&FS crisis in India and analyzing the laws, the authors have observed that in the present scenario India needs an overhaul in the legal structure regulating the NBFC sector. In order to rise above the current crisis, the authors have proposed a few recommendations that would assist in making the NBFC sector more secure altogether. The proposals might seem far-fetched, bearing in mind the recent crisis, but only then will the system of shadow banks in India be stable.

1. ASSET LIABILITY MANAGEMENT

Asset liability mismatch is one of those worms that ate up the fruits IL&FS toiled hard for. In order to understand the concept of asset-liability mismatch and how it drained the Indian economy, the

authors will first walk you through the definition of the term. To put it simply, the concept of asset-liability mismatch is nothing but a condition where the asset side of the balance sheet doesn't match the liabilities side. In the present case of Infrastructure Leasing and Financial Services company, the loan maturing which are on the asset side of the balance sheet are being outstripped by the sources of funds which are on the liabilities side. While infrastructure projects are taking longer to gestation, pegging interest on deposits to market-determined rates has resulted in a fall in the rates and deposits are now of shorter tenure.[46] The failure in taming the bolting of outflows and inflows lead to a heavy liquidity crisis.

In order to effectively deal with such a situation, economists have come up with Asset-liability management strategies time and again. On 24th May 2019, the Reserve Bank of India uncovered a draft named 'Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies'[47] which laid down certain guidelines on Liquidity risk management to be complied by NBFCs. The draft guidelines cover the application of generic ALM principles, granular maturity buckets in the liquidity

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[46] Jenny Daley, *Asset Liability Mismatch in the Indian Banks System* (August 22, 2016) https://www.indiainfoline.com/article/general-blog/asset-liability-mismatch-in-the-indian-banks-system-116082200182_1.html.

[47] Draft Guidelines on Liquidity Risk Management Framework for Non-Banking Financial companies and Core Investment Companies – Draft Guidelines for public comments, Reserve Bank of India, (May 24, 2019), https://rbi.org.in/scripts/Bs_viewcontent.aspx?Id=3678.

statements and tolerance limits, liquidity risk monitoring tool and adoption of the "stock" approach to liquidity.[48] The most striking move proposed by the RBI is the introduction to Liquidity Coverage Ratio, which is the proportion of highly liquid assets set aside to meet short term obligations for all NBFCs with an asset size of more than ₹5000 crores.[49] Reserve Bank of India pointed out that there is a need to have a broader framework that would enable NBFCs to tap funds from RBI against their HQLAs during periods of stress.[50]

However, it all looks good on the paperwork, but when it comes to the execution, India fails miserably. Given the fact that the adherence to the guidelines is voluntary in nature, most of the banks will refrain from making the appropriate changes. Granted that some banks might be willing to adhere to the guidelines released, the next issue that arises is that of the accountability of the board. It was further proposed in the draft that 'It will be the responsibility of the

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[48] FP Staff,*Reserve Bank releases draft circular on NBFC liquidity risk management framework after IL&FS, DHFL cash crunch,* (May 24, 2019), https://www.firstpost.com/business/reserve-bank-releases-draft-circular-on-nbfc-liquidity-risk-management-framework-after-ilfs-dhfl-cash-crunch-6697451.html

[49]Gopika Gopakumar, *RBI Releasedraft liquidity framework guidelines for ailing NBFCs,* (Jul. 26, 2019), https://www.livemint.com/industry/banking/rbi-proposes-to-introduce-liquidity-coverage-ratio-for-nbfcs-1558709520816.html.

[50]Saloni Shukla, *NBFCs ask RBI to relax timeline for liquidity coverage norms*, (Jun 24, 2019), https://economictimes.indiatimes.com/markets/stocks/news/nbfcs-ask-rbi-to-relax-timeline-for-liquidity-coverage-norms/articleshow/69920840.cms?from=mdr.

Board of each NBFC to ensure that the guidelines are adhered to'[51] and it shall be subject to a supervisory review, further adding to the abysmal condition of the Board's accountability and failure of the RBI to keep a supervisory check on the affairs of the company.

India necessitates a new set of laws that addresses the issues that the present laws are unable to, and it is the opinion of the authors, that primarily, the guidelines should be made a little stringent. This should be done by making compliance with such laws/guidelines mandatory for every NBFC. Secondly, an independent board must be appointed in order to check whether the company is adhering to the laws or not. Further, a report consisting of the assets and liabilities of the companies must be sent to the board on a regular basis. The board must ensure that the data provided is free from any discrepancies. Furthermore, the review process by the Reserve Bank of India must be taken up on a periodic basis of 12 months, which is the third suggestion by the authors.

2. RISK ASSESSMENT

A rating agency is a company that assesses the financial strength of companies and government entities, especially their ability to meet

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[51] Reserve Bank of India, **Draft Guidelines on** All Non-Banking Financial Companies (NBFCs) including Core Investment Companies (CICs), https://rbidocs.rbi.org.in/rdocs/Content/PDFs/DRAFT240520191328DA089BA641768EDAFC5BEF059150.PDF.

principal and interest payments on their debts.[52] These agencies primarily engage in assessing the ability of the companies to pay back their loans including the interest amount. Rating agencies, or rather their propensity to lock the stable doors after the horses have bolted, have been at the center of the recent credit crisis in the debt market.[53] In the case of IL&FS, rating agencies failed to pick up the signals, prima facie it seems.[54] The company saw a sudden dip in the credit rating after they started defaulting on their payments. So will it be reasonable to conclude that credit rating agencies failed in their jobs?

After analyzing the laws pertaining to credit rating agencies in India, the authors would like to recommend that the imposition of more stringent laws only can help India rise above this time of crisis. In the opinion of the authors, one of the main reasons for the failure of the credit rating agencies is the lack of information they receive. Therefore, the authors suggest that there should be a mandatory provision for the banks to disclose information regarding their debts in the form of a statement ensuring the rating agencies that they are

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[52] Rating Agency:*Evaluating the credit-worthiness of debt-issuing companies and organizations* ,CFI, https://corporatefinanceinstitute.com/resources/knowledge/finance/rating-agency/.

[53]*Time to crack the whip, Business Line*, (June 18, 2019), https://www.thehindubusinessline.com/opinion/editorial/time-to-crack-the-whip/article28067180.ece.

[54]Shilpy Sinha, *IL&FS fiasco: Why rating agencies need a reform,* (Oct 26, 2018), https://economictimes.indiatimes.com/industry/banking/finance/ilfs-fiasco-why-rating-agencies-need-a-reform/articleshow/66340528.cms?from=mdr.

stable enough to pay for their future loans and interests. Secondly, the information received must be probed into cautiously and it must be ensured by the agencies that information received is correct. If the company fails to provide the information in time with appropriate specifics, a proper investigation must be done by the regulators and if the company is found to be at fault, necessary penalties must be imposed. Lastly, the authors would like to suggest that instead of relying completely on the credit rating agencies, the investors should come up with their own risk-assessment mechanism under which the financials and business risks must be analyzed properly in order to avoid any future perils.

VII. CONCLUSION

A plethora of reasons and factors were involved that caused the collapse of the entire NBFCs sector because of the default and liquidity crunch that happened in IL&FS. Mismanagement, negligence, and disobedience of several laws and principles of corporate governance have led to a sudden and uncalled disaster. The government and the RBI trying too hard to improve the situation through various ways like new provisions in the budget and cash infusions to minimize the damages. Proper actions against the accountable persons are being taken by the appropriate forum. The models and recommendations suggested by the authors fill the

loopholes that caused the entire IL&FS episode. The IL&FS crisis is for sure a lesson in Indian financial history from which various things can be understood and improved.

X. FIDUCIARY DUTIES OF INDEPENDENT DIRECTORS: THE NEED FOR CORPORATE LITERACY?*

Abstract

The role of Independent Directors needs to be examined in way of adaptability and flexibility for their workings and their position to be beneficial for the workings of the company and in general to the economic health of the country via its markets. The markets to function effectively need to build confidence in the investment-community which mold it's a trajectory in reaction to the actions mainly emerging from the Board of Directors wherein the Independent Director has a cardinal role to play. This research strives to explain the underlying phenomena of the problems faced by Independent Directors and possible solutions for pre-emptive or reactionary remedial measures. The third chapter emphasizes the role in correlation to their fiduciary capacities to the organization and the emerging need and implementation of the concept of Corporate Literacy which is a favored reform in light of the current crisis, however, the measures cannot be short-term or merely bandages to fix a hole in a ship. A system of thorough checks and balances needs to be adopted by the Governance machinery to yield fruits. The chapter of the approach of a skeptic provides constructive criticism to the implementation of the Corporate literacy test leading to possible solutions and

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measures that deserve consideration on merit. The current stage of Independent Directors in The Indian market has been scrutinized dynamically.

I. A LEXICAL FALLACY OF INDEPENDENCE OF DIRECTORS

The object and rationale that maintain the need for Independent Directors need to be seen on a conjectural basis with the provisions delineating their role, responsibilities, remuneration and the paradigm in which they will operate along with the provisions of law traced historically through judicial interpretations supplemented with the role of advisory committees intertwined with their character.

The first thing any law sets out to expound is done in the way of defining it but the lacunae in this arena were felt explicitly when the inexplicable void of no specific definition of Independent Directors was provided in The Companies Act, 1956, which distinctly has borne brunt of excessive amendments and the definition can now be found in section (47) of The Companies Act,2013 stating "independent director" means an independent director referred to in section 149 and as per sub-section 6 of Section 149 of Act, Independent Director means a director other than a managing director or whole-time director or a nominee director which further

lays down various qualifications, characteristics for Independent Directors.

This does not necessarily mean that there is a lack of limelight on their importance. Their essentiality is evident with the need felt in governance matters and their role in fiduciary capacities with the growing importance of the role of governance in corporate structure and its effect on the health of the company as well as the market.

Essentially in rudimentary terms, an independent director is a non-executive director of a company who helps the company in improving corporate credibility and governance standards. He/ She does not have any kind of relationship with the company that may affect the independence of his/ her judgment. This definition serves as the fundamental basis for understanding the concept of 'Independent Directors' however, This research is oriented to trace the history of its development for a better understanding.

Presently, the provisions relating to the appointment of Independent directors are contained in Section 149[1] of the Companies Act, 2013.

The fiduciary Duties and corporate literacy have to be seen in the light of the pragmatic workings of the corporate governance

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

structure with deductions from the growing trends and market sentiments thereby leading to a process of logical amalgamation of facts to comment on the recommendations for improvisation. To do the same the actuality of Independence of Independent Directors needs to be examined from contours of law to make it not only workable but practical as well and an analysis of the fiduciary capacity and need for corporate literacy is analysed as well.

1. EVOLUTION: CONCEPT INDEPENDENT DIRECTORS IN INDIA

The roots of the foundation of Independent Directors in the Indian corporate arena can be found in the Kumar Mangalam Birla Committee[2] report that was initiated by SEBI to bring about reforms in the arena of corporate governance.

It soon found entry into corporate books, after Clause 49 was incorporated in Listing Agreement by SEBI in 2001.[3] The Birla Report stipulated,

"*Independent Directors are directors who apart from receiving directors' remuneration do not have any other material pecuniary relationship or*

[2] Kumar Mangalam Birla Report, *Available at:* https://archive.india.gov.in/business/corporate_governance/kumarmangalam.php, Last Accessed: 25th October 2019.
[3] *Available at:* https://www.sebi.gov.in/legal/circulars/oct-2004/corporate-governance-in-listed-companies-clause-49-of-the-listing-agreement_13153.htmlz Last Accessed: 18th October 2019.

transactions with company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment"[4].

The intention of the committee in strict interpretation defined the scope of the role and relationship of the independent director with that of the board and management of the company.

Subsequently, The Ministry of Corporate Affairs (MCA) went on to constitute the Naresh Chandra Committee[5] to further the cause of strengthening corporate governance. Corporate Governance in crux encompasses all the practices, rules and processes.

The main objectives of the committee were although restricted to audit and auditors, it still ventured to make recommendations on the idea of Independent Directors. It laid the recommendation for Independent Directors to not be less than fifty percent of the board and the Nominee directors of lending institutions should be considered as independent directors. It provided the motion for also setting the differentiation of personal liability of the Independent Directors i.e. either civil or criminal liability to not arise for the acts of the company.

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[4] Kumar, supra note 2.

[5] Naresh Chandra Committee Report, *Available at* :https://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf, Last Accessed: 15th November 2019.

This has positive implications as it is not possible for the Independent Director to be aware of the day-to-day functions of the lower level working of the company unless brought to his notice or is flagged by the management and his counsel is sought on the same.

However, there has been an ever-widening crisis for Independent Directors as the judicial stance has been unfavorable to their role and to mitigate their position with respect to potential liabilities there is hesitance amongst Independent Directors to readily join companies who do not have a good track-record which has consequentially led to an unfavorable view towards the position of being an Independent Director.

In 2003, the Securities and Exchange Board of India (SEBI) constituted the Narayan Murthy Committee[6] with the terms of reference similar to that of The Chandra Committee, and recommendations were incorporated in Clause 49 by amending it in 2004.

The Murthy report adopted the same definition of Independent Directors as formulated by the Chandra Committee, however, it also pondered on the qualification and remuneration of Independent Director and stressed on the need for evaluating the performance of

[6] Narayan Murthy Committee (2002), *Available at:* https://archive.india.gov.in/business/corporate_governance/narayana_murthy.php, Last Accessed: 24th October 2019.

non-executive directors. Non-Executive Director is also known as an external director who is not part of the executive management committee but takes part in the policy-making and planning in the company or organisation. The Murthy committee rejected the recommendation of the previous Chandra Report of treating nominee directors of financial institutions at par with Independent Directors.

The Companies Act, 2013 excluded Nominee Directors from the scope of Independent Directors as the prime aim is to have an independent judgment on the board which will not be possible with a Nominee Director that has been appointed by a Financial Institution to the board.

The implementation of Murthy committee recommendation in Clause 49, was followed by MCA constituting another committee in December 2004 under the Chairmanship of Shri J. J. Irani, to give Corporate Governance (CG) a legislative stamp by revamping the Companies Act, 1956.[7]

The era of Irani Committee came up with several recommendations in relation to the Independent Directors that were in conflict with the extant Clause 49 and the views of the Murthy Committee, e.g.

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[7] Irani Committee Report, *Available at:* http://mahavirlunawat.in/html/%5B2005%5D061SCL0047(MAG).html, Last accessed: 26th October 2019.

the mandatory requirement of Independent Directors to constitute one-half of the Board be weakened to one-third of the total members of the Board. The present Corporate Governance framework encompassing the Independent Director is through Clause 49 based on the Murthy Report. As per Clause 49,[8] for a company with an Executive Chairman, at least 50 percent of the board should comprise of independent directors. In the case of a company with a non-executive Chairman, at least one-third of the board should be independent directors

It has been decided in Central Government vs. Sterling Holiday Resorts (India) Ltd. and Ors.[9] that "*the Board of directors should be strengthened by appointing independent directors*". However, the huge loop-hole that remains here is that under section 173, a shorter meeting can be conducted and a resolution can be passed only needing final ratification of just One Independent Director defeating the purpose of increasing the number of Independent Directors.

2. WHO IS TO BE AN INDEPENDENT DIRECTOR

Section 149 (6) in The Companies Act, 2013 lays down the conditions for a person to become an Independent Director.

[8] Clause 49, Listing agreement, *Available at:* https://www.nseindia.com/getting_listed/content/clause_49.pdf, Last Accessed: 18th November 2019.

[9] Central Government vs Sterling Holiday Resorts (India), 2006 71 SCL 372 CLB.

It states that in relation to a company, Independent Director means a director other than managing director, whole-time director or nominee director who, in the opinion of the board, is a person of integrity and possesses relevant skill and expertise and experience.[10]

Further,

⇒ who is or was not a promoter of the company or its holding, subsidiary or associate company;

⇒ who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

⇒ who has or had no pecuniary relationship[11] with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

⇒ none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two percent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as

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[10]Dr. G.K Kapoor, Dr.Vipan Kumar Company Law 270 , Para 14.4.5 (2017).

[11] Pecuniary relationship not more than 10% of a person's income shall not debar him.

may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year; [12]

Section 149 (12) also states that Independent Director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.

II. THE DISMAL STATE OF AFFAIRS

The advent of realization relating to corporate governance was felt looking at the financial scandals that erupted in The US and that led to the development of favorable stand to the concept of 'Independent Directors' in the realm of Indian Corporate Governance.

The recent phenomenon in the corporate world has shown a worrying trend of Independent Directors leaving their jobs and for the most part without giving a reason altogether. A recent article[13] opined that in the Financial Year 2019, there were 316 Independent

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[12] Companies Act, supra note 1.

[13] *Available at:* https://economictimes.indiatimes.com/news/company/corporate-trends/more-independent-directors-take-the-exit-fearing-legal-scrutiny/articleshow/69883746.cms?from=mdr,Last Accessed: 10th November 2019.

Directors that left NIFTY 500 Companies out of which 50 assigned no reason for their departure which shows a straight 32% jump from Financial Year 2018.

One of the leading reasons for this phenomenon is the fact that law has expanded the personal liability of Independent Directors and there is a growing sentiment of lack of failure to identify negligence and wilful intent to make independent directors liable leading to this drop-out rate amongst Independent Directors. This needs to serve as a grim reminder of the debacle in 2009 after the enmasse-resignation of Independent Directors and remedial steps need to be taken.

Previously under Companies Act, 1956, independent directors were not considered to be "officers in default" and consequently were not liable for the actions of the board. Companies Act,2013 however, provides that the liability of independent directors would be limited to acts of omission or commission by a company that occurred with their knowledge, attributable through board processes, and with their consent and connivance or where they have not acted diligently.

⇒ A non-executive/independent director should be held liable only in respect of any contravention of any provisions of the Act which had taken place with his knowledge (attributable

through Board processes) and where he has not acted diligently, or with his consent or connivance.) Knowledge Test)

⇒ If the independent director does not initiate any action upon knowledge of any wrong, such a director should be held liable.

⇒ Knowledge should flow from the processes of the Board. Additionally, upon knowledge of any wrong, follow up action/dissent of such independent directors from the commission of the wrong should be recorded in the minutes of the board meeting.

Thus, the Liability can be affixed on the Independent Directors by the recourse to judicial stance on their position and the extent of their liability as interpreted by the courts.

III. THE DILEMMA OF FIDUCIARY DUTY AND CORPORATE LITERACY

The role of an Independent Director is that more or less of a guardian of the company who has to nurture it and keep it under vigil and overlook it's functioning , however, the ground realities of the day do not reflect that the standard has been met by the provisions kept in place to measure a yardstick for their

competency. This has led to an unprecedented debate on the need for a Corporate Literacy test and assessment of the Fiduciary role of Independent Directors.

1. CORPORATE LITERACY

Currently, the Schedule IV under Section 149 (8) provides for the only Evaluation mechanism which states;

(1) The performance evaluation of independent directors shall be done by the entire Board of Directors, excluding the director being evaluated.

(2) On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the independent director.

Thus, the onus of decision of suitability in the current provision rests solely on the Board and there is no fundamental prerequisite for the designation of an Independent Directors which has led to a depreciation of the quality in face of an absence of a regulatory measure. The major motivation for these Independent Directors then lies in not stoking a fire in the workings of the company and only draw their pay-checks to keep the house-kitchen lit. This has led to a mechanism of installation of 'Puppet Independent Directors' working in the direction as steered by the rest of the board.

This practice of weakened role of Independent Director and the myth that Independent Director have no Fiduciary Duty can only be countered by raising the awareness of candidates in relation to Company Law, Business Ethics and norm of Market Ethics which can only be effectively implemented by a system of Literacy test to create a fundamental yard-stick test for all Independent Directors irrespective of previous qualifications.

It still remains a defence for the Independent Director to plead ignorance on the basis of lack of understanding of basic functioning and terminology. Thus, the eventual goal of keeping a corporate literacy test is to make sure that the officials are not able to plead ignorance if they are confronted over a lack of oversight.

The main objective in contemporary frame of corporate governance is the main focus on the over-stressed idea that Independent Directors are to be seen merely as enabling assets for compliance whereas the assessment by a regulatory authority should be done on grading of the winning results of the Independent Director based on his efficiency of performance.

2. STATUS OF DATABANK ENTRIES

One of the unique features of the Companies Act, 2013 is that it provides for a databank of independent directors in section 150. It allows a regulatory mechanism with oversight of central government

for companies to select independent directors from such a databank, which will contain names, addresses and qualifications of persons who are eligible and willing to act as independent directors.

The MCA issued the *Companies (Creation and Maintenance of Databank of Independent Directors) Rules, 2019 (the "Databank Rules")*[14], the substantive portions of which are yet to take effect on 1[t] December 2019.[15]

These rules provide that the Indian Institute of Corporate Affairs ("IICA") would create and maintain a databank of independent directors, and they also prescribe the type of information it would contain. The individuals included in the databank must pass have passed an online proficiency self-assessment test for independent directors.[16]The test had been announced by the government on 23rd October[17] but is yet to see the light of day. The working of the test can only be seen once it is put in the field as sunlight acts as the best disinfectant similarly the flaws will be revealed in its workings and can be subsequently rectified.

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[14] *Available at:* https://ca2013.com/notifications/companies-creation-maintenance-databank-independent-directors-rules-2019-dated-22-10-2019-w-e-f-01-12-2019/, Last accessed: 10th November 2019.

[15]UmakanthVarottil, *The Foibles of a Databank and Proficiency Test for Independent Directors* (Nov. 13,2019) , https://indiacorplaw.in/2019/11/foibles-databank-proficiency-test-independent-directors.html.

[16] *Available at:* https://www.thehindubusinessline.com/companies/independent-directors-will-now-have-to-take-proficiency-test/article29777645.ece.

[17] *See* Id.

The MCA also issued the *Companies (Appointment and Qualification of Directors) Fifth Amendment Rules, 2019*[18](the "Amendment Rules"), which now stipulate that every individual who is, or desires to be, an independent director must apply for inclusion of their name in the databank for a prescribed period of time, and thereafter ensure that the same is renewed from time to time. This database has the distinction to be one of its kind implementations and exudes uniqueness.

The idea of a databank emerged from the need felt in the sector of medium and Small industries which generally do not most of the time have the required expertise or resources to go through with the process of appointment of Independent Directors and Thus, the creation of a databank repository for convenience was done.

The probability of the companies that have to mandatorily appoint Independent Directors will resort to scouring the databank is still bleak as the provision in section 150 of The Companies Act,2013 stipulates that "an independent director may be selected from a data bank".

[18] *Available at:* https://economictimes.indiatimes.com/news/economy/policy/qualify-with-60-marks-for-becoming-independent-director/articleshow/71939587.cms?from=mdr.

⇒ The usage of the term 'may' refers to a thorny question, whether all Independent Directors have to be mandatorily selected from the databank?

⇒ The statutory definition will be breached by the amendment rules if it was meant to act as a facility and not a definitive mandate.

⇒ The character of the databank will not remain optional but mandatory for Companies as the Database is inexplicably intertwined with the Online Proficiency test and companies will lose the right to select a candidate from outside the scope of the databank.

⇒ Another foremost reason for its failure will be the reluctance of the Board to merely go by the grading of the test unless personal acumen of the individual is established which will not be possible by constricting their choices and limiting their confidence in the electing mechanism.

⇒ However, the idea that a databank will reduce the favoritism to appoint Independent Directors who won't question the policymaking and act as vigil officers has little comfort to add.

3. ONLINE PROFICIENCY SELF-ASSESSMENT TEST

The Online Proficiency Self-Assessment Test will be put in motion from 1st December 2019and will be administered by the Indian Institute of Corporate Affairs (IICA).

The test is meant to cover areas such as company law, securities law, basic accountancy, and relates aspects relevant to one's functioning as an independent director. The pass percentage is fixed at 60% aggregate score, although it provides for candidates to take the test as many times as they possibly need to pass which makes it rather redundant to be a test but just a yardstick of additional qualification which may as well never materialize to even a real job. However, experienced independent directors are exempted from the requirement of the proficiency test.

The exemptions apply to individuals who have served for a period of no less than ten years as a director or key managerial personnel in a listed public company or, alternatively, in an unlisted company with a paid-up capital of rupees ten crores or more.[19]

The aim of this exercise form the perspective of MCA can be understood in the following ways:

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[19]Umakanth, supra note 15.

1. The proficiency requirement would ensure that all independent directors would be conversant with their roles and responsibilities on corporate boards before they take up such positions.
2. This consequentially is expected to increase the levels of monitoring and compliance by independent directors.

The approach of a Skeptic: Online-Proficiency Self-Assessment Test (Corporate Literacy)

The Literacy Test has to be seen in the light of the utility it can serve best and critical analysis from a skeptic /pessimistic scale will work for its benefit. It is reasonable to assume its role in a critical manner in the assessment of the quality of Independent Directors.

1. The test of experience holds good in any sector, position, or organization. Similarly, the ability to act effectively as independent directors arises through considerable experience in the corporate sector, either as directors or key managerial persons. In the absence of such experience, mere proficiency tests would hardly add any value and law only expounds exclusion of experienced directors from the ambit of the test and not any experience or induction requirements for those who pass the test.

2. Duality is a characteristic suitable to man and not a testing system. However, the proficiency testing system that the Ministry of Corporate Affairs (MCA) has introduced is both narrow and wide. The test is parochial in the sense that it strives on the role of company law, securities law, and compliance law which just accelerates the traditional notion of a compliance-based role envisaged for the Independent Director which is unsuitable for the need of markets today.

3. The only supporting argument remains that directors must be apprised of their duties and liabilities. The current test approach may fulfill that requirement but it has a drawback that it concentrates excessively on the monitoring and compliance functions of independent directors whereas their role tends to play a much larger role than mere watchdogs. The wide approach rests on the One-size fits all approach that One test is sufficient for grading the capabilities as an Independent Director.

4. There is no tailoring of the individual with regard to the specificities and nature of the company. It is only based mostly on rote knowledge. The decision is best left upon the Board and the Individual.

5. The emphasis should be on Induction by mentoring the novice-director by having a mentorship training program to make them better equipped to face real-life scenarios. This program can be conducted by the company that has hired the Independent Director. This would provide a great opportunity to acquire relevant knowledge, skills, and experience rather than a standardized test which opens a box for incompetency to creep in.

6. There is a reasonable assumption of a possibility of bureaucratic entanglements in the entire procedure making Red-tapism a reality in the selection procedure.

7. The test will also lead to a large number of population applying for this test and a huge number of applicants will be deemed as 'proficient independent directors'. This may lead to disincentivization for other experienced Independent Directors to take up the test. This will result in a scenario where able individuals will not be qualified to take up independent directors.

The market is seeing an unprecedented dwindling pool of independent directors and loss of confidence, The statistics show that a "total of 606 independent directors resigned from the National Stock Exchange-listed company boards in 2018.

In comparison, 412 independent directors resigned between January 1 and July 22 this year."[20]

The proficiency testing also has the implication of being a possible defense for the Independent Directors to opt-out from liability in courts. This also can lead to a false sense of confidence in the capabilities of the certification-holder whereas in reality he may not be experienced to handle the affairs of the company efficiently. However, the stance of courts has been lackadaisical in the enforcement of standards on Independent Directors.

IV. CONCLUSION: REALISATION OF IMAGINATION

The final scene on this stage is of patience and anxiety to see the result of the effective implementation of the Corporate Literacy Test for Independent Directors. It still remains tenuous to hold a contention against the sustained overhaul of the board independence system in India, for it still continues to play a vital cog in the machinery of corporate governance. However, the proficiency test regime remains far from a permanent solution but also might turn out to be a triviality along with unintended consequences. The idea is to limit the scope of bureaucratic interventions whereas the

[20] *Available at:* https://www.business-standard.com/article/companies/independent-directors-to-take-an-online-proficiency-self-assessment-test-119102201639_1.html.

current system is manifested brutishly by it with scope for further improvement.

The office of Independent Directors needs more than cosmetic changes but a sustained model lift to change the Role and Liability from the restricted and obsolete notions of passivity and 'vigil officers' to that of dynamic leadership. The resistance in the fraternity of Independent Directors is felt due to the disproportionate liability imposed on them for their rolein the company. However, immunity can result in the consequence of disregard and misuse of their privileged or elevated status. The foremost role has to remain in utmost loyalty to the shareholder and act as a dynamic overseer for the organization with the ability to adequately pull the reins of the company. All these qualities emanate from the fundamental basis of the envisaged actions of the Independent Directors and there needs to be a fine balance between the Liability and role of Independent Director wherein the law facilitates his easy discharge of duties and not make him uneasy for his prospects.