Corporate Governance in India: Case for Safeguarding Minority Shareholders Rights

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Abstract
Corporate governance is defined as "the system by which companies are directed and controlled" [2]. The separation of ownership and control in corporations with dispersed ownership structure highlights the agency issue due to conflict between agents (managers) and principals (shareholders). The endeavor of the corporate governance mechanism in such a context is to monitor the management and ensure that it functions to maximize shareholder wealth. Corporate governance issues in India are, however, due to a different agency problem that arises on account of the conflict between dominant and minority shareholders. Therefore, the corporate governance mechanism in India should focus on safeguarding minority shareholders from expropriation by dominant shareholders. Assessment of protection given to minority shareholders in India under the current regulatory framework suggests that on this attribute country does not fare well. There exist laws on minority shareholder protection, but either they are not efficacious or not well enforced. Commensurately, there exists a significant gap in Indian corporate governance regulatory framework, which warrants utmost safeguards of minority shareholder rights. Policy makers possibly can do this by creating a conducive environment and promulgating laws for protection of their rights. The issue has serious ramifications on Indian economy that is looking for greater foreign capital and investment to boost its economic growth.

Keywords
Corporate Governance, Minority Shareholders, Promoters, Agency Issue, Related Party Transactions

Acknowledgment
The earlier version of this paper was presented at Third International Conference on Corporate Governance: The Road Ahead organized by Sri Ram College of Commerce, New Delhi on March, 27-28, 2012. We kindly acknowledge comments received in the conference for further improving the paper.

I. Introduction
The concept of corporate governance is deeply embedded in corporate law and jurisprudence. The term though only two decades old, has evolved with the incorporation of modern day business structure albeit in latent form [20]. Corporate governance is often defined as "the system by which companies are directed and controlled" [2]. Shareholders are owners of the corporation and efficacy of a corporate governance mechanism depends upon how the shareholder wealth and rights are protected. The separation of ownership and control in corporations with dispersed ownership structure (prominent in the US and the UK) highlights the agency issue due to conflict between agents (the managers- who control the corporation) and principals (shareholders- who own the corporation). Endeavor of corporate governance mechanism in such a context is to monitor the management and ensure that it functions to maximize shareholder wealth. A number of corporate scandals like Enron, Tyco, WorldCom and the recent financial crisis had a significant impact on shareholders and investors view on corporate governance in Anglo-American countries in with a question, as to how their voice may be heard in directing and controlling the management.

India, though not much adversely affected by the global financial crisis has been unnerved by the largest corporate accounting scandal at Satyam Computers Limited. According to an estimate shareholder and investors have lost not less than $2.8 billion [23]. The Satyam fiasco has espoused critical lacunae of corporate governance in India. In contrast to developed Anglo-Saxon countries like the United States and United Kingdom that epitomize outsider system of corporate governance, India is a typical example of the insider system [25]. The agency issue in India is quite different from these countries, where most of the firms are either state controlled or family controlled. Here, the conflict between controlling shareholder of the corporation and other minority shareholders is the main agency problem [11]. Corporate mechanisms devised in the developed countries to minimize the conflict between managers and shareholders are therefore of not much efficacy in India, considering its agency problem. Varma has also raised the pertinent issue of corporate governance in India as a prerequisite for disciplining the dominant shareholder and protecting minority shareholders [24]. Emphasizing the same view, we posit that safeguarding minority shareholder rights will improve Indian corporate governance standards. We, therefore in this paper, endeavor to analyze Indian corporate governance system from the perspective of minority shareholders and suggest measures to improve it.

II. Indian Corporate Governance System-Case for Minority Shareholder Protection
The Indian corporate governance system, as mentioned earlier, has peculiarities of insider system. Indian corporate sector similar to many other Asian countries, demonstrates "concentrated stock ownership and a preponderance of family-controlled businesses while state- controlled businesses form an important segment of the corporate sector" [4]. Furthermore, dominant foreign shareholders control a number of multinational companies [24-25]. According to the Prowess database of the Centre for Monitoring Indian Economy (CMIE), in BSE 500 companies that approximately accounts for 93 % of the market capitalization of all BSE listed companies, the average promoter holding is 51.52 %, and companies in which promoters have less than 25 percent stake is only 7.8 %. In the BSE 500 index, percent of firms controlled by foreign promoters (MNC) and state are 9% and 9.4 % percent respectively. Rest of firms are predominately owned and controlled by families and business groups. In India, companies with dispersed shareholding only exist as an exception. In addition to direct stake, the ownership concentration by promoters in the firms is further augmented by several other mechanisms like cross holding, pyramiding and tunneling [4, 16].

The relative strength of shareholders and their influence in a corporation depend upon its ownership structure. The above paragraph clearly implies that promoters are the insiders, which are most dominant shareholders in the Indian corporate sector. Promoters, the majority shareholders, have ability to control the

 ISSN : 2230-9519 (Online) | ISSN : 2231-2463 (Print)

affairs of the company by virtue of their controlling rights. The other shareholders of the company form the fraction of minority shareholder segment. Apart from direct ownership, promoters, due to widespread tunneling, cross holding and pyramiding in corporations acquire voting rights more than that of their ownership rights [3]. In companies with dominant shareholders, dominant shareholder can expropriate wealth from minority in several ways. Dominant shareholders can divert firm resources by selling assets, goods, or services to the company through self-dealing transactions [12]. Further, they can obtain loans on preferential terms. Scholars have referred that significant amounts of tunneling in Indian business groups occur via non-operating part of the profits [1, 4]. This helps controlling shareholders to tunnel firm's resources for their private benefits. In addition, Goswami point promoters behave in subversive manner that "deprives minority shareholders of their de jure ownership rights without adversely affecting corporations profits, including issuing preferential equity allotments to promoters and their allies at discounts or transferring shares through private buy-outs deals at price well below those prevailing in the secondary market" ([10], p. 93). There are several other instances, where promoters, due to their dominant position and control over the company management extracted more benefits at the cost of minority shareholders (Purohit [17], lists number of cases). The Satyam case is a typical example in which promoters, due to their position and control on management diverted firm resources for their private benefit and instigated a huge fraud [21]. More recently, SEBI has taken action to cancel Initial Public Offerings (IPO) of seven companies [9]. Promoters of these companies were involved in manipulating the IPO that resulted in huge losses to public. All these instances implicate that ownership concentration in hand of controlling shareholders , the promoters, give significant powers and raise the potential corporate governance problem of protecting minority shareholder rights.

Safeguarding minority shareholders have also other important implications. Protection of minority shareholders is considered as an important determinant of success of its capital market. Countries that do not provide sufficient protection to investors and shareholder have marginal debt and equity market. In contrast countries that have better protection to minority shareholders and investors' rights have more valued and broad equity market [15] and valuation of firms is also higher [5]. India, in the contemporary scenario, needs to have greater protection to minority shareholders and investors to attract foreign capital and investment, necessary to sustain and propel its economic growth.

III. Minority Shareholders Protection: Assessment and Challenges

This section appraises issues related to minority shareholders' rights and their protection. Before proceeding further, it is important to establish, the identity of minority shareholders. They are shareholders (or investors), who are not in a controlling position of the company and dependent upon the wishes/actions of dominant majority shareholders. One of the important objectives of corporate governance is that all the shareholders should be treated equally, also taking into consideration minority shareholders [18]. Majority shareholders are well positioned, as either being in the management or control of the management, to protect their rights. Minority shareholders are not in the same position as that of dominant shareholders. Therefore, minority shareholders require protection of law and that decrees effective basis of corporate governance in India. Corporate governance should give sufficient opportunity to minority shareholders for protection of their rights and redressal in case of violation of rights.

This section assesses current Indian practices and benchmarks it on the OECD Principles of Corporate Governance that postulates that all the shareholders should be treated equally including all the minority and foreign shareholders. The World Bank Report on the Observance of Standards and Codes [27], which yardsticks India's status on with OECD principles has not rated India very well in the treatment of minority shareholder and the protection of their rights. Table 1, shows India's status on protection of minority shareholder rights on scale prescribed by the OECD.

Table 1: Equitable Treatment of Shareholders–OECD Principles

(Observed = O, Largely Observed= LO, Partially Observed = PO, Materially Not Observed = MO, Not Observed = NO)		
1.	All the shareholders of the same class should be treated equally. (i) Within any class, all shareholders should have same voting rights. All the investors should be able to obtain information about voting rights attached to all the shareholders before they purchase. Any changes in voting rights should be subject to shareholder vote (ii) Votes should be cast be custodians or nominees in a manner agreed upon by custodians of nominees in a manner agreed upon with the share's beneficial owner.	PO
2.	Insider trading and abusive self-dealing should be prohibited	PO
3.	Members of the board and managers should be required to disclose any material interest in transactions or matters affecting the corporations	PO

Assessment of Indian Legal framework in Protecting Minority Shareholders (in relation to OECD Principles)

A. Equitable Treatment of Shareholders Particularly in Reference to Minority Shareholders and Opportunity to Get Effective Redressal for Violation of their Rights

Minority shareholders have been given protection under the Companies Act, 1956. Under Section 397 and 398 of the Act, minority shareholders in case of oppression or mismanagement by controlling shareholder/ management may seek relief by approaching the Company Law Board (CLB). However, minority shareholders may seek redressal from CLB only under condition of at least 100 shareholders or hold at least 10% of shares under section 399 of the Act. Minority shareholders if not satisfied may file a petition in the High Court or Supreme Court of India. Varottil, however, points these provisions for minority shareholder's protection are inadequate and inefficacious [25]. "Minority shareholders are required to satisfy certain prerequisites from substantive point of view before can espouse their cause" [25]. Further, irregularities exist in share registration and transfer, hindering minority shareholder to get their proper redressal of grievance. Varma also suggest that the provisions of the Companies Act, 1956 for safeguarding minority shareholder are effective only under extreme cases of mis-governance and winding [24]. World Bank report points that shareholders may file derivative and class actions suits to dominant shareholder/ management only under certain cases [27]. Moreover, the delay in court proceedings and judgment hinders safeguarding shareholder rights. Courts in India have a massive number of pending cases, with case adjudication extending from 5 to 20 years and even beyond 20 years in some stances ([4, 13, 27]). Clause 49 of the Listing Agreement (Section VI (C)), mandates listed companies to have a "Shareholder Grievance Committee". Non-executive director should be the Chairman of this committee to redress the grievance of shareholders and investors. However, the efficacy of such committees is still questionable due to possible allegiance of non-executive director with management. Such committee has not proven very successful. SEBI has also been very to slow take actions on companies for shareholder grievance redressal [27].

B. Insider Trading and Self-Abusive Dealing Should be Prohibited

In India, insider trading is prohibited and regulated by SEBI's Prohibition of Insider Trading Regulations, 1992. Further, from 1995 onwards stock exchanges have to establish a surveillance unit to keep check on insider trading as directed by SEBI. Under Clause 49of the Listing Agreement, senior management has to make disclosures to the board relating to all material financial and commercial transactions, where they have a personal interest that may be potentially conflicting with the interest of the company at large. Directors have also to disclose their shareholding if it exceeds beyond a given threshold limit. World Bank Report suggests promulgated law prohibits insider trading, but still it is not uncommon in India [27]. Though, insider trading in India is limited mostly to junior employees, but in certain cases of mergers, dominant shareholders have often been involved in insider trading through friends or relatives [24]. Recent Satyam fraud further gives some evidence that dominant shareholders and some employees were involved in insider trading [21-22].

C. Directors and Managers of the Company Should Disclose any Material Interest in Transactions or Matters Affecting the Corporation

In India, related party is defined as senior management directors, and their close family members. There exist a number of provisions to deal with the issue of related party transactions in India. Sections 297, 299 and 300 of the Companies Act, 1956 have provisions on related party transactions, but without teeth and come with regulatory hurdles. However, Accounting Standard (AS18), which requires companies to disclose all the related party transactions, has somewhat improved the situation. Under Clause 49 of the Listing Agreement , audit committee should review and approve all the related party transactions. Further¸ Auditing and Assurance Standard 23 makes it necessary on the part of auditor to identify and disclose the related party transaction in the financial statements. In India, therefore, plethora of laws exists for related party transactions. However, World Bank report [27] and OECD [19] regard abusive related party (where dominant shareholders/ promoter are involved) as one of the major corporate governance issues in India. Promoters through related party transactions use firm's assets for private benefits. In family managed firms, many of the transactions occur between controlling shareholder and firm that result in expropriation of shareholder wealth. Expropriation may come in several forms involving a series of self-dealing transactions through the sale of goods and assets and services, loan from the company on preferential basis, or through the transfer of assets from one company to another [12]. Indian companies majority of which are family controlled, strive only to comply with inescapable stipulations of law and always endeavor to get better of existing ambiguities [14]. Failed Satyam- Maytas deal resulting in exposure of Satyam scandal is a typical example ([21], [22]). Purohit, enlist many cases where promoters were involved in abusive related party transactions [17].

IV. Conclusion

The above discussion clearly establishes that the only way to improve the corporate governance in India is to give enough safeguards to minority shareholders. An assessment of minority shareholders rights and protection [27] implicates that India lags in giving adequate safeguards to investors. There exist laws on minority shareholder protection, but they are not adequate. Commensurately, there exists a significant gap in Indian corporate governance regulatory framework that warrants utmost safeguards to minority shareholder rights. Policy makers possibly can do this by creating a conducive environment and promulgating laws for protection of minority shareholder rights. The issue has also serious ramifications on Indian economy that is looking for greater foreign capital and investment to boost its economic growth. We suggest a number of measures to that certainly will give more safeguards to minority shareholders and help raise Indian corporate governance standards.

A. Appointment and Selection of Directors

Current legal provisions permit dominant shareholder control on the director selection and appointment process. This gives promoters significant say and control of the Board in addition to their influence on management. We propose the proportional representation of minority shareholders on the company Board linked to their shareholding. The nomination committee is currently only an option stipulate for companies to establish under Clause 49 of the Listing Agreement. We feel that constitution of nomination committee should be made obligatory.

B. Accountability of Board and Independent Directors

The provisions of Voluntary Guidelines require that the Board should review its every decision in relation to impact on minority shareholders [26]. This provision is critical for minority shareholder and certainly deserves to be a necessary stipulation. Any decision in board meeting requires disclosure in the corporate governance report with explanation as to how it affects minority shareholders. Independent directors are the main mechanism that may resolve the agency conflict between dominant shareholder and minority shareholders. But, critical examination is required so that independent directors remain independent of the promoters/ dominant shareholders. Accountability of independent directors towards minority shareholders needs deep review.

C. Monitoring and Approval of Related Party Transactions

Audit committee role needs more specification in monitoring related party transaction. The board should approve all transactions up to a certain threshold limit. Above that level, shareholder approval with at least 75 % majority should be necessary.

D. Independence of Auditor and Quality of Audit

Independent auditors can play important role in tracing related party and illegal transactions. Considering the inherent opaqueness in these transactions due to persistence of complex ownership structure, they are very difficult to trace from an audit point of view. Independence of auditor and quality of audits performed by them is significant in protecting minority shareholders'

ISSN : 2230-9519 (Online) | ISSN : 2231-2463 (Print)

rights. External auditor rotation, greater role audit committee/ independent directors, peer audit, banning auditors to give non-audit services, establishment of an audit review board and monitoring of payment to the auditors are some mechanisms to improve corporate governance.

E. Enforcement

In India, quantum of penalties for non-compliance with provisions is quite low. Stringent penalties and even rigorous imprisonment are required in case of non- compliance that seriously affect minority shareholder rights.

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