Have transplanted corporate governance standards been implemented effectively, or do they fail to capture the trajectory of specific corporate governance reforms required in India?

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1. Introduction

The need for enhanced and improved corporate governance standards has gained considerable traction in modern corporate law. Various corporate scandals and a greater global focus on corporate governance have been the catalyst, driving the effort to implement and enforce stringent reforms to improve the corporate landscape in jurisdictions across the world. In essence, corporate governance is a "system by which companies are directed and controlled ".[1] It strives to consolidate the relationship between different stakeholders associated with a company, which include, the directors, managers, owners and various other entities. The central focus of corporate governance is thus, to analyse the interrelationship between these entities. With the advent of several key defining developments[2] in the world of corporate law (such as, the concept of limited liability, differential voting rights, development of the board of directors and the emergence of rentier investors[3]), the importance of internal stakeholders has compounded and so has the need to create adequate checks and balances to ensure the protection of the best interests of the company as a whole.

In developed countries, such as the United States of America, corporate governance norms and standards have existed for more than 70 years.[4] In comparison, it is a relatively new practice in

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[1] Financial Reporting Council, *Report Of The Committee On The Financial Aspects Of Corporate Governance*, (1992) available at http://www.ecgi.org/codes/documents/ cadbury.pdf.
[2] Balasubramanian B N & Anand R V, *Ownership Trends in Corporate India 2001- 2011: Evidence and Implications*, IIM Bangalore Research Paper, No. 419 (2013).
[3] Shareholders that are not interested in the operational control or managing the day-to-day affairs of the company.
[4] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

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India. The first formal effort towards setting up efficient corporate governance practices came in as late as 1998, with the release of a Task Force report titled, "*Desirable Corporate Governance: A Code*", by the Confederation of Indian Industry (hereinafter "CII Code"). However, Indian regulators understood the importance to implement stringent reforms that would govern the activities of listed companies. As a result, regulators sought to draw inspiration from corporate governance norms around the world, both as a stimulus for reform in the wake of "high-profile financial reporting failures . . . in the developed countries," and also as guiding principle.[5] This led to the enactment of Clause 49 of the Equity Listing Agreement[6], which was primarily influenced by the Cadbury Committee in the U.K.[7] and the Sarbanes Oxley Act of 2002 in the U.S.A. More recently, the Companies Act, 2013 encapsulates these norms in a statutory form and is also a result of the 'transplant effect'.

However, while Clause 49 and the Company Law statutes try to transplant important corporate governance features – involving provisions related to the board of directors (including independent directors), disclosures to be made to the shareholders, and audit committees - there is seemingly an incongruity between their implementation and execution in India. This is proven by the continued misuse and abuse of these standards, despite seeking out solutions from developed economies such as the U.S. and the U.K (most famously with the Satyam crisis). This problem arises primarily due to the differences in the corporate governance models between India and other jurisdictions. While countries like the U.S. and U.K. follow the "*outsider"* model (characterized by widely-held organizations), India follows the "*insider*" model of corporate governance (characterized by closely held or concentrated shareholding

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[5] Shri Kumar Mangalam Birla et al., *The Securities Exchange Board Of India, Report of the Kumar Mangalam Birla Committee on Corporate Governance* (1999), available at http://www.sebi.gov.in/commreport/corpgov.html

[6] Circular, Securities And Exchange Board Of India, *AMENDMENTS TO CLAUSE 49 OF THE LISTING AGREEMENT* (Sept. 12, 2000), available at http://web.sebi.gov.in/circulars/2000/CIR422000.html

[7] B. Cheffins, *Corporate Governance Reform: Britain as an Exporter*, 8 HUME PAPERS ON PUBLIC POLICY: CORPORATE GOVERNANCE AND THE REFORM OF THE COMPANY LAW 10 (2000), available at http://ssrn.com/abstract=215950

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patterns).[8] As a result of this classification, India's requirement of corporate governance standards, arising out of concentrated shareholding, are different from that of jurisdictions that follow the outsider model of corporate governance.

2. Research Methodology

In this paper I would show that the Indian corporate framework has specific problems that are unique to its own corporate landscape - impact of concentrated shareholding on the role of directors and the subsequent effect on minority shareholders – *vis a vis* the insider and outsider model. Further, instead of emulating norms from other models and adding onto the already persisting eclecticism in Indian corporate governance[9], there is a strong need to implement and enforce norms that are tailor made to the specific problems arising in the Indian context. While, on a *prima facie* level, transplanting legislature and drawing inspiration from other jurisdictions is not impossible,[10] regulators and drafters have to be cognizant of harmonizing the laws between the host and the recipient country,[11] so that they resonate well with its legal, political, social and institutional factors.[12]

3. Historical context and the need for India to adopt stringent corporate governance reforms

Historically and predominantly, the corporate ownership in India has witnessed centralised control in the hands of business families, domestic individuals and the State. Like a lot of emerging economies[13], India too witnessed corporate governance challenges due to the

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[8] Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance* (January 22, 2009). National Law School of India Review, Vol. 21, No. 1, p. 1, 2009, Available at SSRN: https://ssrn.com/abstract=1331581

[9] Ibid

[10] A Watson, *Legal Transplant and Law Reform* (1976) 92 LQR 79.

[11] Rosaline Baindu Cowan, *The effect of transplanting legislation from one jurisdiction to another*, Commonwealth Law Bulletin, 39:3, 479-485 (2013) , DOI: 10.1080/03050718.2013.822316

[12] Afra Afsharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 NJILB 335, (2009)

[13] Jayati Sarkar & Subarata Sarkar, *Debt and Corporate Governance in Emerging Economies: Evidence from India*, 16 ECON. OF TRANSITION 293, 295 (2008)

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dominance of closely held organizations with concentrated shareholding in the hands of a select few shareholders. As a result of the degree of influence exerted by a controlling block in the company, minority shareholders suffered since the "large promoter shareholding is presumed to possess private information, leading to information asymmetry, and as a result, increasing the adverse selection cost."[14]

Before independence, one of the most dominant models of ownership in Indian companies was that of managing agencies or the managing agency model.[15] Managing agencies, which operated similarly to holding corporations, were commercial enterprises hired to oversee the operations of businesses that sold stock.[16] Then, these organisations used a variety of techniques to exercise control while promoting businesses.[17] Further, these agencies also made use of,

> "Their prestige, past performance and signature... to ensure massive over-subscription of shares. Given excess demand, most of these companies could split shareholdings into small enough allotments to ensure that nobody - barring the managing agency - had sufficiently large stocks to ensure their presence in the board of directors. Dispersed ownership, thus, facilitated managing agencies to retain corporate control with relatively low equity ownership."[18]

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[14]Dr. Pankaj Madhani, *Ownership Concentration, Corporate Governance and Disclosure Practices: A Study of Firms Listed in Bombay Stock Exchange* (2019) https://www.researchgate.net/publication/333775649

[15] Ananya Mukherjee Reed & Darryl Reed, *Corporate Governance in India: Three Historical Models and Their Development Impact, in CORPORATE GOVERNANCE, ECONOMIC REFORMS, AND DEVELOPMENT: THE INDIAN EXPERIENCE* 25, 31-36 (Darryl Reed & Sanjoy Mukherjee eds., 2004).

[16] Afsharipour, *supra* note 12

[17] Ibid

[18] Omkar Goswami, *Getting There-Pretty Rapidly: The State of Corporate Governance in India, in A COMPARATIVE ANALYSIS OF CORPORATE GOVERNANCE IN SOUTH ASIA* 130 (Farooq Sobhan & Wendy Wemer, eds., 2003) available at http://www.beibd.org/docs/cg 1 .pdf.

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Post 1991 Indian companies were attempting to expand beyond India,[19] while a lot of multinationals and foreign investors were taking strides to be involved in the Indian corporate landscape by owning Indian companies.[20] With greater access and relaxations provided to the foreign investment sector to engage with the capital markets in India,[21] and the aspirations of Indian companies to list their securities via Global Depository Receipts, there emerged a need to reform the corporate governance norms in India.[22] As most of the foreign investment flowed in from the U.S. and the U.K., it became favourable to also transplant norms from those countries.[23]

4. Impact of ownership structures on corporate governance challenges

As discussed above, the corporate landscape in India was dominated primarily by companies with concentrated shareholding. In fact, "concentrated ownership and control is the rule rather than the exception"[24]. The ownership and control structures of corporations, as well as the institutional framework in which these corporations are entrenched, have a significant impact on the nature of their corporate governance challenges.[25] The genesis of these claims arise from the contentions made by Berle and Means, wherein the separation of ownership and management leads to certain inherent problems between the managers (agents) and the shareholders (principal).[26] Due to the nature of the separation of ownership and management,

[19] Orit Gadiesh & Sri Rajan, *Looking at Acquisitive India: An M&A Scorecard*, ECON. TIMES, Dec. 10, 2007, http://economictimes.indiatimes.com/articleshow/2609678.cms

[20] Pitibas Mohanty, *Institutional Investors and Corporate Governance in India*, (2003) (unnumbered working paper), available at http://unpanl.un.org/intradoc/groups/public/documents/APCITY/UNPAN023823.pdf.

[21] R. Sachdev, *Comparing the Legal Foundations of Foreign Direct Investment in India and China: Law and the Rule of Law in the Indian Foreign Direct Investment Context*, COLUM. BUS. L. REV. 167, 200-04 (2006).

[22] Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firms' Market Value: Evidence from India* 9 (Univ. of Mich. Law Sch., Olin Working Paper No. 07-002, Oct. 2007), available at http://ssrn.com/abstract=914440

[23] Varottil, *supra* note 8

[24] Jayati Sarkar, *Ownership and Corporate Governance in Indian Firms* F-938-10 NSE Corporate Governance-9 Chapter.indd (indiacorplaw.in)

[25] Ibid

[26] Berle, A., & G. Means, *The modern corporation and private property* Thomas Clarke (ed.) Corporate Governance: Critical Perspectives on Business and Management, Routledge: London and New York, pp.173-189 (1932).

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managers may take undue advantage of the dispersed shareholders by misappropriating their funds to serve their own interests. However, this problem between the principal and the agent is inextricably linked to companies with a dispersed shareholder pattern. In concentrated ownership structures, these corporate governance challenges occur due to the conflict of interests between the principal-principal, i.e., the controlling shareholders or the insiders against the minority shareholders or outsiders. Reiner Kraakman in his work had distinguished between these two agency problems, i.e., the principal-agent (Type I agency) and principal-principal (Type II agency) problems.[27] The idea behind identifying and analysing these problems is for drafters and regulators to construct and implement reforms that address their specific issues and not merely export legislation that may not be applicable to the unique corporate environment they are in.

5. The *insider* and *outsider* models of corporate governance

Several concepts – like the independent director, disclosure standards and audit committees – were transplanted in India from jurisdictions that fundamentally follow a different model of corporate governance, making their implementation unsuitable for the unique Indian corporate sphere. On the other hand, Indian legislature has shied away from transplanting important aspects, like improved protection of minority shareholders, which arise specifically due to the problem of concentrated shareholding in jurisdictions characterized with the insider model of corporate governance. Thus, at this juncture, in order to understand the applicability and permissibility of transplanting standards from one jurisdiction to another, it is important to distinguish between the two broad models of corporate governance.

(i) The *outsider* model

[27] Reiner Kraakman et al., *The Anatomy of corporate law: A Comparative And Functional Approach* 22 (Oxford University Press, 2004).

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As per the work of Nestor and Thompson, the outsider model of corporate governance is a system which is characterized by dispersed or widely held organizations.[28] The emergence of the concept of a rentier investor and the subsequent development of the practice of separation of ownership and management, are key factors in the outsider model. Here, because of the relatively reduced involvement of shareholders (change in ownership trend from an active to a passive owner[29]) in the management of the company there is a more active role assigned to the directors, who tend to misuse their position. Due to this, corporate governance mechanisms that are able to mitigate this specific conundrum become useful and are usually in the form of market controls.[30] These market controls force companies to have high disclosure practices[31] (to reduce information asymmetry[32]), with a "market-oriented approach towards regulation and governance and less involvement by the State through regulation."[33]

Relating the outsider model to the agency problems identified by Kraakman, we can deduce that the outsider model correlates with the Type I agency problem, i.e., between the principal and the agent. Countries like the U.S. and the U.K. fall under the category of the outsider model[34] since they display characteristics of dispersed ownership. As a result, the aim of regulators and drafters in these jurisdictions to craft tailor made solutions for this particular agency problem. Their idea to draft strategies to reform corporate standards flows from the fundamentals present in their corporate landscape, which are keeping the management of companies in check so that they don't serve their own interest at the cost of the shareholders. For instance, one of the many ways in which regulators and drafters have tried to combat this

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[28] S. Nestor & J. K. Thompson, *Corporate Governance Patterns in OECD Economies: Is Convergence Under Way?* http://www.oecd.org/dataoecd/7/10/1931460.pdf.
[29] A. A. BERLE & G. C. MEANS, *The Modern Corporation And Private Property* 47 (Harcourt, Brace and World, 1932)
[30] Walsh J and Seward J, *On the Efficiency of Internal and External Corporate Control Mechanisms,* Academy of Management Review, Vol. 15, No. 3, pp. 421-458 (1990).
[31] Y. Listokin, *Learning Through Policy Variation*, 118 YALE L. J. 480, 501-02 (2008)
[32] Varottil, *supra* note 8
[33] Varottil, *supra* note 8
[34] Nestor, *supra* note 28

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problem is by the inclusion of independent directors, who can serve the dual purpose of keeping managers in control and meet the interests of the shareholders better.[35]

(ii) The *insider* model

On the other hand, the insider model of corporate governance is clouded by a controlling block of insiders or concentrated shareholders, who are the dominant or the majority shareholders in a company. Since they have excessive control over the affairs of the company, they are inextricably linked and involved in virtually controlling the entire board of directors. As a result, the management of the company is at the mercy of these majority shareholders, who can alter the composition of the directors at their whims and fancies. This can severely impact the minority shareholders in the company, who suffer due to the ability of majority shareholders to extract private benefits of control[36] at the cost of minority shareholders. Further, the directors who owe a fiduciary duty[37] towards the shareholders, may not uphold that duty since they owe their allegiance to the controlling shareholders who are primarily responsible for their appointment.

When the insider model is related to the agency problems, we can deduce that the insider model correlates with the Type II agency problem, i.e., between the principal and the principal. As already discussed, India is heavily dominated by companies with a concentrated shareholding pattern.[38] In fact, as of 2018 the promoter shareholding in all Indian listed companies, including both Indian and foreign promoters, was as high as 50.8%.[39] Thus, in insider models of corporate governance, the primary focus of regulators and drafters should be to protect the interests of

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[35] Kraakman, *supra* note 27
[36] Morck, R., & B. Yeung, *Special issues relating to corporate governance and family control*. World Bank Policy Research Working Paper 3406 (2004).
[37] Section 166, The Companies Act, 2013
[38] R. Chakrabarti, *Corporate Governance in India – Evolution and Challenges*, 14-20 (2005), http://ssrn.com/abstract=649857
[39] OECD (2020), *Ownership structure of listed companies in India*, www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf.

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the minority shareholders. By transplanting standards and law from the outsider model, the specific issues of the insider model are not addressed. This can be seen in the context of the independent director – one of the many aspects transplanted from the outsider model – who has been given great importance under Section 149 (6) of the Companies Act, 2013. However, the implementation of the concept of the independent director has not been made considering the specific requirements of the insider model. The statute provides for a negative list of people who cannot be appointed as independent directors, yet promoters are given the freedom to appoint any person apart from that list to serve as the independent directors in their companies. Thus, while their name suggests that they are independent directors, in reality they are mere 'puppets' of the controlling shareholders who exert substantial influence over their appointment.

The difference in the two models of corporate governance and the specific nature of their own set of problems, highlight that merely transplanting laws from one system to the other is not effective. Further, it "represents a perceptible gap in the theoretical underpinnings of Indian corporate governance, and hence requires careful reconsideration."[40] In the next part of the paper I will highlight a certain area that need careful reconsideration in context of India's unique corporate landscape.

6. Need for greater minority shareholder protection in Indian corporate law

As discussed above, one of the most primary issues faced in the Indian corporate landscape is the inability of directors to work for the best interests of a company as a whole in companies with a concentrated shareholding pattern. This inevitably calls for greater minority shareholder protection, since they are the one's affected by the expropriation and private benefits of control extracted by the majority shareholders or promoters of the company. While the Companies Act

[40] Varottil, *supra* note 8

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of 2013 has revamped extensively in the case of various provisions from its predecessor, minority shareholder rights are still not sufficiently safeguarded. This is due to the continued existence of certain common law principles (set out in *Foss v. Harbottle*[41]) and contradictory opinions of the Indian Judiciary on the particular problem.

Sections 241 and 242 provide remedies to the members of a company to take action for oppression, prejudice or mismanagement. However, this remedy can be described as a limited protection available to the minority shareholders. Recently, the Supreme Court's judgement in *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.*[42] elucidated how difficult it is for minority shareholders to avail relief under the statutory provisions of the Companies Act. This is because the standard or threshold of burden of proof is unreasonably high for minority shareholders[43]. In order to avail relief, the shareholders not only have to prove the how the acts of the company are oppressive and/or prejudicial, but also establish that the oppression was so grave that it is justifiable for the courts to wind up the company.[44] In such scenarios, the minority shareholders are discouraged or disincentivized from seeking redressal against the unjust acts of the majority shareholders or promoters.

One of the ways shareholders can be granted greater protection is by including the presence of derivative suits in a statutory form. These type of suits find their way embodied in the principles established by the *Foss* case and its "fraud on minority" exception. However, Indian Courts have been very contradictory in deciding such suits and offer little clarity over their maintainability. For instance, the Bombay High Court in *Darius Rutton Kavasmaneck v. Gharda Chemicals Ltd*.[45] adopted a "clean hands approach" to dismiss the matter at an early

[41] (183) 2 Hare 461
[42] 2021 SCC OnLine SC 272
[43] Varghese George Thekkel, *Tata v. Mistry: A Case for Greater Protection of Minority Shareholders' Rights* (2021) https://www.scconline.com/blog/post/2021/05/15/tata-v-mistry-a-case-for-greater-protection-of-minority-shareholders-rights/#_ftn2.
[44] Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd. (2021) SCC OnLine SC 272
[45] 2015 SCC OnLine Bom 4813.

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stage. On the other hand, the Delhi High Court in *Rajeev Saumitra v. Neetu Singh*[46] adopted a more liberal approach towards the suit to entertain it on the merits. Further, a derivative suit is generally brought under Order 1 Rule 8 of the CPC as a representative suit and in the absence of a clear statutory provision, gives the courts a wide range of discretionary powers to decide the matter.[47] As a result, these instances discourage minority shareholders to sue in case they suffer a personal wrong and provides the majority shareholders even greater freedom to extract private benefits of control.

There is thus, a need for regulators and drafters to adopt derivative suits in a statutory form, providing greater access and protection to minority shareholders. Transplanting standards and legislature in this context becomes useful, as it specifically addresses the unique issue faced in the Indian corporate landscape as a result of concentrated shareholding. Jurisdictions like South Africa[48], Australia[49], New Zealand[50] and Singapore[51] have implemented these derivative suits in a statutory form. Another instance is how Italy has been able to provide greater representation to minority shareholders is by introducing a mandatory voting list for listed companies. List voting mandates the election of at least one director and one statutory auditor backed by minority shareholders, and at least two of each such candidates if a company has more than seven directors.[52] Thus, these are some of the ways in which the transplant effect can be successfully implemented, considering the specific requirement it fulfils in terms of solving the Type II agency problem.

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[46] 2016 SCC OnLine Del 512.

[47] Ummakanth Varottil, *The Continued Influence of Foss v. Harbottle in India* (2021) The Continued Influence of Foss v. Harbottle in India - IndiaCorpLaw

[48] Companies Act, 2008, Chapter 7, Part B: section 165(1)

[49] Corporations Act 2001, Part 2F.1A: section 236(3)

[50] Companies Act 1993, Part 9: section 165(6)

[51] Companies Act, s. 216A

[52] Maria Lucia Passador, *List Voting and the Role of Minority Shareholders at Controlled Companies* (2019) https://clsbluesky.law.columbia.edu/2019/01/25/list-voting-and-the-role-of-minority-shareholders-at-controlled-companies/

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7. Conclusion

It can be observed that there is a stark need for Indian drafters and regulators to adopt measures that are not merely transplanted from other jurisdictions. There is a requirement for a sustained effort to address corporate governance challenges that specifically affect the Indian corporate landscape and adopt tailor made measures to tackle problems arising out of the concentrated shareholding pattern.

While seeking out measures and transplanting standards to enhance corporate governance norms may be considered as a laudable venture, those measures would not consider the inherent differences in the models of corporate governance, i.e., the insider and the outsider model. This has been observable in the failure of independent directors (useful in the context of Type I agency problem) as a solution to the Type II agency problem. Further, as shown above the transplant effect is possible in certain situations where it is possible to harmonize the laws and norms of the host and recipient country, keeping in mind the legal, social and institutional factors.

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