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THE EVOLUTION OF CORPORATE GOVERNANCE: A HISTORICAL ANALYSIS OF LEGAL REFORMS AND THEIR IMPACT ON MODERN CORPORATIONS

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1. INTRODUCTION

In recent years, corporate governance has achieved significance all over the world. The two most important aspects that have led to speedy progresses in this field, namely the amalgamation and globalization of financial markets and a flow of corporate scandals such as Enron, World Com and others. Recently, Brazil, Russia, India and China (BRIC) countries have also appeared as a significant economic power in the global economy. It is expected that the collective GDP of the BRIC countries is expected to be higher than the developed countries.[2]Undoubtedly, Corporate Governance is a hot topic across the globe.Not a day seems to go without press comment, conference or a launch of a new code, all on the subject of Corporate Governance.[3]The growing number of these corporate scandals in the recent past have affected the reputation of Corporate Governance and questioned the efficiency of its current structure.

India is among the very few developing countries with a long history of corporate governance institutions that dates as early as the origins of the corporate form in the

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[2] Padmini Srinivasan and Vasanthi Srinivasan, "Status of Corporate Governance Research on India: An Exploratory Study", Working Paper No: 334, 3, (2011), *available at:* http://www.iimb.ernet.in/research/sites/default/files/Status%20of%20corporate%20governance%20research%20on%20India%20WP%20334.pdf, accessed on May 2015

[3]Joffy George, "Corporate Governance Rating- A Research Perspective", *Chartered Secretary*, (A-25) January 2011, 41.

country. While the current corporate forms as these exists today can be traced back to the colonial period, the origin of the corporate form goes back to ancient times. As can therefore be expected, governance problem along with governance mechanisms and the associated institutions to alleviate such problems also have distant origins. Notwithstanding this, however, as in the case of developed countries, the issue of corporate governance formally came to the forefront since the inception of the structural reforms and liberalization process in India in 1991.

The Companies Act, 2013 is a move by the government to strengthen the corporate governance framework in a country where most of the businesses are characterized by concentrated shareholding and channelling of funds. The Act encourages good governance practices by placing the onus on independent directors to bring oversight in the functioning of the Board and protect the interest of minority shareholders.

The Indian corporate structure is influenced by a socialist mode and in that respect skewed towards the Japanese rather than Anglo-American model. Large Indian companies have a main bank, usually a government owned FI that holds both equity and debt. But these FIs have not been able to provide for effective governance as the nominee directors neither had the requisite expertise nor the power to appraise the performance of the corporations. That is the reason; the Rahul Bajaj committee criticized the need and role of nominee directors.

In the Indian management context, Kautilya's Arthashastra keeps that for good governance, all administrators, as well as the king were deliberated servants of the people. Good governance and stability were completely linked.

There is stability if leaders are approachable, answerable and can be removed.

Kautilya elaborates on the four-fold duty of a king as-

- Raksha- means protection, in corporate scenario it can be equated with the risk management aspect.

- Vridhi- means growth, it can be associated to stakeholder's value enhancement.
- Palana- means compliance, it can be associated to compliance to the law in letter and spirit.
- Yogakshema- means well-being, it is used in context of a social security system.

The companies in India should be governed by the provisions of Companies Act, The Securities Exchange Board of India (SEBI) guidelines, the Kumar Mangalam Birla Report, Accounting Standards issued by ICAI and the listing agreement with stock exchanges in which they are listed.The companies whose shares are listed must comply with requirements laid down in listing agreement on a regular basis.

After the liberalization of 90's, the position of Indian corporate governance has changed a lot. In 1994, a firm progress has been made in Indian economic reform. With to view to strengthen corporate governance, Confederation of Indian Industries (CII) published and promoted a code of corporate governance for achieving transparency within Business and Industry.

In developing countries like India corporate governance has been a central issue as it affects financial and economic development of the country. It is also proved that financial development depends on investor protection in a country- de jure and de facto. External financing by firms, higher growth and employment can be increased through corporate governance.

1.1. NEED FOR CORPORATE GOVERNANCE IN INDIA

India is changing into one of the fastest rising economies. Indian companies today are ranked amongst the best in the developing world.A number of Indian companies are restructuring to become the multinational by investing abroad and opening up their branches or subsidiaries. A corporation is a flock of various stakeholders, specifically customers, employees, investors, government and society. In this altered scenario an

Indian corporation, must be fair and crystal clear to its stakeholders in all its transactions. This has become commanding in today's business world over where corporations need to be access in global pools of capital, need to invite and preserve the finest human capital from several parts of the world, need to be partner with merchants on mega associations and also required to live in coherence with the community.

If a corporation holds and demonstrates moral conduct, it will not be able to succeed. However, corporations are required to identify that their growth needs the cooperation of all the stakeholders and such cooperation is enriched by the adhering to the best Corporate Governance practices. Incidentally, the management is also expected to act as trustees of the shareholders and prevent disproportionateness of benefits between several sections of shareholders, particularly between the owner-managers and the rest of the shareholders.

So the concept of 'Corporate Governance' has gained importance due recent frauds in corporate world, in spite of several protective measure may be the form of enactment, rules, regulations. The concern for compulsory of this concept in corporate domains is being raised became the growing level failure causing severe injury, not only to the interest of common investor's shareholders, but also to the whole economy.

In Indian context, corporate governance has not now merely a voluntarily virtue; law and other regulatory frameworks are now mandating it. On the basis of various studies/committee reports, conducted on international as well as national level, the Indian Companies Act, 1956 has been amended and other measures also been introduced in order to incorporate the theme of the corporate governance for Indian corporate sector.

1.2. HISTORICAL EVOLUTION OF CORPORATE GOVERNANCE IN INDIA

The Indian system of corporate governance is said to be a hybrid of the outsider dominated market-based systems of USA and UK and the insider- dominated bank-based system of Germany and Japan.[4]The historical development of Indian corporate laws has been marked by many exciting distinctions. At the time of India's independence, from colonial rule in 1947, the corporate landscape of the country was dominated by managing agency system which was recognized as a formal institution for the first time in the Companies Act, 1936.Along with the several foreign owned and controlled managing agencies, there were large numbers of Indian agencies. In fact, every large business group such as Tatas, Birlas and the Dalminas had a number of managing agencies, some managing only one company, while others managing multiple ones, the latter helping to realize economics of scale and scope.

Till its abolition in 1969, the managing agency system, despite reported dissatisfaction with its functioning, continued to play a critical role in consolidating family ownership and control in corporate sector.[5]Before independence India inherited one of the world's pitiable economies but one which had a factory sector accounting for a tenth of the national product.Therefore, in terms of corporate laws and financial system, India has emerged far enhanced capable than most other colonies. The Companies Act 1956, governed the functioning of joint-stock companies and safeguard of investors' rights.

Before the beginning of liberalization, the Indian organized sector was controlled by public enterprises and their performance was always found wanting and the performance of private sector was also not up to the mark.Both the private and public sector enterprise had to brace up to meet the challenges of globalization.The demands of financial liberalization have developed in imparting greater control to the banks in their operations.This led to the banks extending external finance in lieu of some control rights. Ever since the structure of corporate finance in India is highly at the mercy of on the banks' financial resources, some authors argue that legal structures should be so developed that banks are free from excessive portfolio restrictions like priority sector

[4] Jayati Sarkar and Subrata Sarkar, "Large Shareholder activism in corporate governance in developing countries: Evidence from India", Thomas Clarke (ed.), Corporate Governance: Critical Perspective on Business and Management, Vol. IV: Asian Corporate Governance, 1st ed., (2005), 229.

[5] *Ibid*

lending, and governance mechanisms be so devised that bank representation on boards become a reality.Wide-ranging opinions were expressed in India in response to corporate scandals like, making secret payments to the politicians, violation of foreign exchange regulations involvement in illegal activities and shady deals by the top industrial houses.

In India, the interest on the subject acquired momentum in later half of the 1990s with the publication of CII code of Corporate Governancewhich acted as a guide to enable corporates to adopt the practices on voluntary basis. Securities and Exchange Board of India (SEBI) constituted a committee under the chairmanship of Kumaramangalam Birla to study the subject and make recommendation.

Pre- Independence period to the 1970

Corporate India owes its genesis to the managing agency system that emerged as the bedrock on which Indian economy developed. The genesis of the managing agency system cannot be decisively rooted to some exact date but it is believed that the system evolved as soon as the East India Company was dissolved and ceased to trade in 1833.Managing agency system was a miniature replica of the limited liability company and was so designed that the promotion, finance and administration of companies would be taken care of buy the agents in return for a small share of ownership and/or agency fees.At a time when Indian capital markets were not organized and when the banking system was not developed, in befell the managing agencies to play the role of specialized institutions like that of the investment bankers of the United States, issue underwriters of the United Kingdom, industrial credit banks of Germany and modern day venture capitalists[6].

Changes since Liberalization: The period from 1990's onwards

Beginning in the late 1990s, the Indian government began to accept an important refurbishment of the nation's corporate governance system.After awareness raising by

[6]Kuchhal S.C, *The Industrial Economy of India*, 1st ed., 397, (1960).

large companies and prominent industry groups, SEBI in 2000 announced extraordinary corporate governance reforms via Clause 49 of the Listing Agreement of Stock Exchanges.

Corporate governance came under the prism of international pressure with the adoption of reforms in the country. While Part VI of the Companies Act of 196 extensively covered corporate governance issues, the degree of which they were to be complied with was found missing. Lax government regulations underhand dealings, business-politics nexus and inefficient judicial system encouraged bad governance practices in the industry. The general economic reforms brought about a change in formalizing the mechanism through announcements of stringent action in case of non-compliance with the provisions of the Act.[7]

Governance as a Concept in India

The concept of corporate governance in India, is brought about by a few companies themselves and in some other cases by foreign institutional investors, including venture capitalists. Firms that benchmark themselves internationally have opted for disclosure standards that are far more rigorous than those required in India.For instance, companies seeking to list on NYSE or NASDAQ practice functional convergence in corporate governance standards-that is, adopt standards of the foreign country on which it seeks to list, which may be stricter than home country requirements.Companies voluntarily started publishing' financial statements supposedly prepared under US GAAP.

The capital markets doesn't have much role as drivers of the process of convergence of corporate governance. On the contrary, Infosys and some other Indian software firms accessed global capital markets long after their exposure to global product and global talent markets had driven them to adopt good corporate governance practices. Finally, the standards of corporate governance at Infosys are the exception, rather than the rule

[7]Supra note 45, at 183

in India, with most firms in the so-called sunrise information technology industry also falling short of benchmark.

1.3. ROLE OF COMMITTEES

The development of the notion of corporate governance in India was with the compliance of the 'Desirable Code on Corporate Governance' by CII.The first formal attempt at formalizing a governance code for corporates came from the CII which in 1998 published the Desirable Code of Corporate Governance (FII, 1998).The CII document recommended several policies that could be adopted by Indian companies in line with international best practices. Further, several Indian companies proactively initiated in-house reviews of their existing governance practices, particularly their board structures, operational mechanisms and information disclosure norms.

CII Code of Desirable Corporate Governance (1998)[8]

The first of its kind code seen by the Indian corporate world, the CII Code of Desirable Corporate Governance based on the report prepared by the Rahul Bajaj headed National Task Force (NTF) submitted as on April 1998. The committee was driven by the conviction that good corporate governance was essential for Indian companies to access domestic as well as global capital at competitive rates.The first draft of the code was ready by April 1997, and the final document, Desirable Corporate Governance: A Code,[9]was in public inApril 1998. The code was voluntary, contained thorough provisions, and dedicated on listed companies.

Based on the committee report, the CII produced the 'Desirable Corporate Governance, A Code' putting forth following recommendations:

1. Minimum of six meetings in one year at an interval of two months for the Board of Directors.

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[8] Confederation of Indian Industry (CII), Desirable Corporate Governance: A Code (1998).

[9] Supra

2. Listed companies having a turnover of Rs. 100 crore or more, must have professionally capable and much-admired non-executive directors creating, at least 30 % of the board if the chairman of the company is a non-executive director, or at least 50 % of the board if the chairman and managing director is the same person.

3. Ceiling of ten on maximum directorships by a single person, while highlighting the role of non-executive directors and pressing on the need of better payment to them.

4. Detailed information to be provided to the board of directors.

5. Listed companies with a turnover of over 1000 crore or a paid up capital of Rs 20 crore whichever is less must set up an audit committee (consisting of three members) within two years.

6. Suggesting listed companies to give more information under the head 'Additional Shareholders Information'.

7. Voluntary consolidation of Group Accounts.

8. Gradual insistence on compliance certificate by the Chief Executive Officer and CFO by the Indian stock exchange.

Kumar Mangalam Birla Committee (May, 1999)

While the CII code was well-received and some advanced companies adopted it, it was fingered that under Indian situations a statutory rather than a voluntary code would be more focused, and significant. Therefore, the subsequent major corporate governance initiative in the country was undertaken by SEBI.

It was "felt that under Indian conditions a statutory rather than a voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance"

In early 1999, a committee was set up under Kumar Mangalam Birla to encourage and raise the standards of good corporate governance.In initial 2000, the SEBI board had also recognized and sanctioned significant recommendations given by this committee, and these were also incorporated into Clause 49 of the Listing Agreement of the Stock Exchanges.

First formal attempt to give India a code on corporate governance, this committee set forth a mix of mandatory and non-mandatory recommendations, proposing to be applied firstly to listed companies and later to the unlisted companies in a phased manner.

The major recommendation of Kumar Mangalam Birla Committee was constitution of Audit Committees and Remuneration Committees. Apart from that the committee recommended appointment of independent directors, recognition of the leadership role of the chairman, enforcement if accounting standards, and greater disclosure requirements in annual accounts.

Mandatory recommendations

1. Giving the definition of independent director, the committee insisted on an optimum combination of executive and non- executive directors with not less than fifty percent of the board comprising the non-executive director.
2. A non-executive director should be entitled to maintain a Chairman's office at the expense of the company and be allowed reimbursement of expenses incurred in performance of his duties.
3. Setting up of Audit committee, with details on composition of the committee (minimum three members, all being non-executive directors and at least one having financial and accounting knowledge), frequency of meeting (three in a year, and at least one in six months)and quorum, powers, functions.
4. Minimum four board meetings in a year with a maximum gap of four months between the two meetings.
5. Director not to be member in more than 10 committees or act as chairman of more than five committees across all companies in which he is a director.

Liability of Directors

Liability of the company and any officer in default for any contravention for which no specific penalty is prescribed, has been increased from INR 50,000 to INR 5,00,000.

Duties of Directors

The Act has attempted to codify the duties of directors. This attempt of codification cannot be said to be an exhaustive enumeration of the directors duties as in the codification of the concepts of "acting in good faith", "exercise of due and responsible care", "skill and diligence", "exercise of independent judgment", avoiding of conflict of interest are included. Hence the Common Law principles of duty as enunciated by the courts from time to time would still be relevant and the court may be inhibited by the codification of the general duties in dealing with this somewhat vexed question.

Disqualification of Directors

New criteria for the disqualification of directors have been introduced in the Act. Amongst others, a director is now disqualified from appointment as a director of any company if any of the companies on the board of which he is a director has not filed any financial statements and annual returns for three continuous financial years or has defaulted in payment of debentures, etc.

Vacation of office

In a major departure from the 1956 Act, the Act requires a director to vacate his office on a conviction of any offence involving moral turpitude or otherwise where he is sentenced to imprisonment of not less than 6 months irrespective of whether the director has preferred an appeal against such conviction.

Resignation of Directors

The resignation of a director (although effective from the date of receipt by the company) has to be placed before the next general meeting of members.Directors have to mandatorily forward their resignation to the Registrar of Companies, within 30 days of the date of resignation in such manner as may be prescribed.

Meetings of the Board and its powers

Notice of board meeting

The Act states that a 7 days' notice shall be provided for convening board meetings.A board meeting may be called at shorter notice subject to the condition that at least 1 Independent Director, if any, shall be present at the meeting. In case of absence of Independent Directors at a meeting with shorter notice, decision to be circulated to all directors and will be treated as final on ratification by at least 1 Independent Director. The infirmity caused by the absence of an Independent Director may thus be remedied by obtaining a post facto affirmative vote.

Circular Resolution

The Act requires that the circular resolution has to be approved by majority of directors, as opposed to consent of all directors present in India or by a majority of directors present in India.Further, where any resolution has been put to vote by circulation and not less than 1/3rd (one-third) of the total number of directors require that the same be decided at a meeting then the resolution shall be decided at a meeting of the board and not by circulation.

Board committees

Besides the Audit Committee, the Act has introduced separate criteria and incidental provisions for the constitution of the Nomination and Remuneration Committee,Corporate Social Responsibility Committeeand Stakeholders Relationship Committee.

Loans to directors

There is a blanket prohibition for a company for making any loan or providing any guarantee or security to any director or person in whom the director is interested in connection with a loan taken by any director or the person in whom the director is interested.The section explains the expressions "to any person in whom the director is interested".The giving of a loan to a managing or whole time director as part of the conditions of service or pursuant to any scheme approved by the members of the company by a special resolution are outside the scope of the section so are the loans made or guarantees or securities provided by a company which does so in the ordinary course of its business subject to the rate of interest charged not being less than the bank rate declared by the RBI.

Related party transactions

The new Act has broadened the opportunity of transactions involved in this category but has done away with the prerequisite of Central Government sanction.An arm's length transaction in the ordinary course of business remains an exception and would be outside the scope and might establish related party transactions. The Board's report to the shareholders need to comprise the particulars of all the related party transactions as well as all the explanations for entering into these transactions. In listed companies, the related party transactions are necessary to be revised and permitted by the Audit Committee.

Managerial Personnel

For companies with no profit or inadequate profits for remuneration, the remuneration shall be payable in accordance with a new Schedule, Schedule V and in case a company is not able to comply with this Schedule V, then the approval of the Gal would be required. In a major departure from the 1956 Act, provisions relating to appointment as contained in Schedule V will now be applicable to private companies as well and if conditions are not met, the approval of the Gal will be required.

Shareholders' meetings

Following are the new provisions with regard to the shareholders' meeting

Notice

The Act provides for clear twenty-one days' notice for all general meetings, which notice may be sent through electronic mode and should be served on directors as well.

Quorum

The quorum requirement for general meetings of members have been substantially altered by linking the number of members that will constitute a quorum to the total number of shareholders of the company.

·5 members personally present shall be the quorum for public companies, if the total number of members does not exceed 1000 15 members if the total number of members are up to five thousand and

·30 members, if the total number of members exceeds five thousand.

Proxies

The Gal has been vested with the power to prescribe a class of companies whose members shall not be entitled to appoint another person as proxy. Further, 1 (one) person cannot be proxy for more than 50 (fifty) members.

Voting through electronic means

The Central Government will specify class or classes of companies who will be allowed this option and the manner in which voting through electronic means is to be organized.

Poll

The distinction between private and public companies in terms of eligibility of members for making demand for poll has been omitted. Further, one member present in person or by proxy and having not less than one tenth of the total voting power or holding shares on which an aggregate of not less than INR 5,00,000 (Indian rupees five lakhs) or such higher amount as may be prescribed has been paid up can demand poll.

CONCLUSION

The idea of corporate governance has developed marvelous significance in contemporary corporate law. Corporate governance is apprehensive with direction and control of corporate bodies. These activities are very basic as compared to efficiency and performance of the companies. Corporate governance is the outline that ensures responsibility. When it is in place, the companies are permitted to go about their own way in generating shareholder value and registering progress.

In the developing nations, corporate governance is a precondition of capital market development. The investors may only be encouraged to participate in corporate securities only when there is a trustworthy corporate governance is effective. Lacking in it, stakeholders will not appear to stake their money in companies and also private limited companies shall not appear to list its shares on stock exchanges.

It is occasionally contended that corporate governance instrument is a substitute to competitive markets. The consequence is that competition in product and capital markets may frame for in corporate governance. However, this is a wrong notion. Markets might take insufficient time to react; they may be intentionally misinformed and their curative action might be very drastic. Previous evidence shows that well-organized, advanced markets do not promise good governance. Therefore, whether markets are developed or underdeveloped, corporate governance rests a priority area.

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