

ARTICLES

A CAUTIONARY TALE OF THE TRANSPLANT EFFECT ON
INDIAN CORPORATE GOVERNANCEUmakanth Varottil^{*}

During the last decade, there has been a sustained effort on the part of Indian regulators to strengthen corporate governance norms. This has been strongly influenced by developments that occurred in other parts of the world, particularly the Sarbanes-Oxley Act in the U.S. and the Cadbury Committee Report in the U.K. This study reflects upon whether the policies adopted by the Indian regulators are adequate or whether they require some mid-course correction. With that in mind, this Article adopts a revisionist approach with the help of two simple assertions, develops those further and leaves some food for thought leading to possible further detailed normative research. The twin assertions are: (i) the broad features of the Indian corporate governance norms have been transplanted from other jurisdictions such as the U.S. and U.K. that follow the “outsider” model of corporate governance, and hence those norms are not likely to be suitable for implementation in addressing governance problems in India, which follows the “insider” model; and (ii) recent events involving the collapse of several leading financial institutions provide evidence, at least anecdotal in nature, that the corporate governance norms followed in the U.S. and U.K. have not been effective in preventing large-scale corporate governance failures, thereby raising questions about the efficacy of that model in the Indian context. Through these assertions, this Article makes the case that the source for strengthening Indian corporate governance lies within. Seeking out other systems

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of corporate governance to emulate will only lead to further incongruity with the traditional business systems and practices that are replete in India, and unnecessarily add to the eclecticism that persists in Indian corporate governance. While the empirical evidence on the impact of corporate governance reforms in India is promising, the anecdotal evidence is less optimistic and the recent accounting irregularities at Satyam Computers bear testimony to that fact. This Article calls for a model of governance that resonates well with Indian business values and practices from the standpoint of economic, social, and political factors.

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“In proposing to apply the juristic rules of a distant time or country to the conditions of a particular place at the present day regard must be had to the physical, social, and historical conditions to which that rule is to be adapted”¹

I. INTRODUCTION

The concept of corporate governance has acquired tremendous significance in modern corporate law. The aftermath of corporate scandals at Enron, WorldCom, and Parmalat, the collapse of financial services giants such as Bear Stearns, Lehman Brothers and AIG, and more recently, the massive accounting fraud at India’s Satyam Computers, underscore the need for proper governance of companies so as to protect the interests of their owners and other stakeholders.

Corporate governance relates to the “system by which companies are directed and controlled”.² It represents the set of checks and balances within the corporate structure that helps create long-term value enhancement for stakeholders in a company.³ Delving deeper into the structure of a modern company, we find that corporate governance, in its simple terms, “concerns the relationships between a company’s owners, managers, board of directors (BOD), and other stakeholders”.⁴ The study of the interrelationship among these four constituencies strikes at the heart of corporate governance.

While the concept of corporate governance has been existent, albeit in different and possibly amorphous forms, in the developed world (particularly in the U.S.) for over half a century now,⁵ it is a relatively recent phenomenon in India. Corporate governance came to the fore in the Indian business context only in the late 1990s,⁶ and it was stipulated as a matter of law only in 2000.⁷ However, since then, there has been a sustained effort on the part of Indian regulators to strengthen corporate governance norms and to induce more stringent governance

¹ Srinath Roy v. Dinabandhu Sen, 42 I.A. 221, 241, 243 [Privy Council] cited from M.P. JAIN, OUTLINES OF INDIAN LEGAL HISTORY 441 (N. M. Tripathi, 1993).

² Financial Reporting Council, Report Of The Committee On The Financial Aspects Of Corporate Governance, ¶ 2.5 (1992) available at <http://www.ecgi.org/codes/documents/cadbury.pdf> [hereinafter “Cadbury Committee Report”].

³ See, R.A.G. MONKS & N. MINOW, CORPORATE GOVERNANCE 2 (Blackwell Publishing, 1995).

⁴ F. A. Gul & J.S.L. Tsui, Introduction and Overview in THE GOVERNANCE OF EAST ASIAN CORPORATIONS: POST ASIAN FINANCIAL CRISIS 3 (Palgrave Macmillan, 2004).

⁵ See, 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).

⁶ The first formal effort towards enhancement of Indian corporate governance is embodied in Confederation of Indian Industry, Desirable Corporate Governance: A Code (1998) available at http://www.acga-asia.org/public/files/CII_Code_1998.pdf [hereinafter “CII Code”].

⁷ Securities and Exchange Board of India, SMDRP/POLICY/CIR-10/2000 dated Feb. 21, 2000, available at <http://www.sebi.gov.in/circulars/2000/CIR102000.html>.

practices among Indian listed companies. These initiatives have been strongly influenced by developments that occurred in other parts of the world. Clause 49 of the Equity Listing Agreement [hereinafter "Clause 49"] encapsulates India's corporate governance norms,⁸ and owes its genesis to the Cadbury Committee Report in the U.K. from which it drew broad principles.⁹ Subsequent revisions to Clause 49 can be primarily attributed as a reaction to the Sarbanes Oxley Act of 2002 [hereinafter "SOX"] in the U.S.¹⁰

With ten years having elapsed since the initial concrete efforts to enhance corporate governance in India and given the wide-ranging nature of discussions regarding corporate governance reforms stemming from the Satyam crisis, it is an opportune time to review the impact of various measures on the Indian corporate sector. Of course, it is hard to argue against the need for enhanced governance in Indian companies (and that is not at all my goal here), but it is worthwhile to reflect upon whether the policies pursued by the Indian authorities are adequate or whether they require some mid-course correction. With that in mind, I adopt in this article a revisionist approach with the help of two simple assertions, develop those further in the course of this article and leave some food for thought leading to possible further detailed normative research. My twin assertions are:

- (i) The broad features of Indian corporate governance norms have been transplanted from other jurisdictions such as the U.S. and U.K. that follow a particular model of corporate governance, *viz.*, the "outsider" model¹¹ of

⁸ The Equity Listing Agreement [hereinafter the "Listing Agreement"] is a contractual document that is executed between a company desirous of listing its securities and the stock exchanges where the securities are to be listed. The execution of the Listing Agreement is a pre-condition of listing securities on a stock exchange. Since the format of the Listing Agreement is prescribed by India's securities regulator, the Securities and Exchange Board of India, all stock exchanges are required to follow the standard Listing Agreement, and hence its terms do not vary from one stock exchange to another. The standard form of the Listing Agreement is available at http://www.nseindia.com/content/equitieseq_listagree.zip. See also, Section 21, Securities (Contracts) Regulation Act, 1956, which provides that a company that applies for listing of securities on a stock exchange shall comply with the provisions of the Listing Agreement.

⁹ See, 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>.

¹⁰ It is a different matter that both the Cadbury Committee Report and SOX have heavily influenced corporate governance norms in other countries around the world. See, J. Dahya & J.J. McConnell, *Board Composition, Corporate Performance, and the Cadbury Committee Recommendation 1* (2005), available at <http://ssrn.com/abstract=687429>, S. Harter-Bachmann, *Sarbanes-Oxley Act: Have the Americans Set Capital Market Standards 27*(2) COMP. L. 35 (2006).

¹¹ The outsider model of corporate governance is represented by companies with diffused shareholding whereby a large number of shareholders hold a small number of shares each, with none of them holding a dominant or controlling stake in the company. For a detailed discussion on this model, see, *infra* Part IIIA.

corporate governance, and hence those norms are not likely to be suitable for implementation in addressing governance problems in India, which follows the "insider" model.¹²

- (ii) Recent events provide evidence, at least anecdotal in nature, that the corporate governance norms followed in the U.S. and U.K. have not been effective in preventing large-scale corporate governance failures,¹³ thereby raising questions about that model itself. Therefore, even assuming that model of corporate governance is suitable in the Indian context, its efficacy may still be in considerable doubt.

Through these assertions, I argue that the source for strengthening Indian corporate governance lies within. Seeking out other systems of corporate governance to emulate¹⁴ will only lead to further incongruity with traditional business systems and practices that are replete in India, and unnecessarily add to the eclecticism¹⁵ that persists in Indian corporate governance. What is required is a model of governance that resonates well with Indian business values and practices from the standpoint of social, cultural and political factors. A model that meets with the understanding of Indian businesses may be implemented more optimally compared to other models.

¹² The insider model of corporate governance is represented by companies with concentrated shareholding whereby a single shareholder or group of shareholders holds a dominant and controlling stake in the company. For a detailed discussion on this model, see, *infra* Part IIIB.

¹³ During the year 2008 alone, several U.S. corporations such as Bear Stearns, Lehman Brothers, Freddie Mac, Fannie May, Merrill Lynch and AIG saw a massive fall in their stock prices thereby severely hurting the interest of their investors. Similarly, the U.K. witnessed the collapse of the Northern Trust Bank. Allegations are rife that the boards of directors and the corporate governance mechanisms established within these companies did not foresee the oncoming financial crisis and take measures to ameliorate its impact. See, for e.g., Julie MacIntosh, *Lehman Insiders Question Clout of Board*, FINANCIAL TIMES, Sept. 16, 2008, John Schnatter, *Where Were the Boards?*, THE WALL STREET JOURNAL (EASTERN EDITION), Oct. 25, 2008, at A.11.

¹⁴ There have been several calls in academic literature for India to adopt a more stringent regime including by appropriately borrowing from SOX, although with a caveat that these have to be tailored to suit Indian needs. See, S. Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 NEW ENG. J. INT'L & COMP. L. 231 (2006), T. Mazumdar, *Where the Traditional and Modern Collide: Indian Corporate Governance Law*, 16 TUL. J. INT'L & COMP. L. 243 (2007).

¹⁵ Eclecticism refers to the practice of drawing (usually the best aspects) from various doctrines, methods or styles. See, K. Yoshino, *The Eclectic Model of Censorship*, 88 CAL. L. REV. 1635, 1638 (2000) (referring to the "historical use of that word to denominate the class of philosophers who adopted whatever philosophical doctrines pleased them without much attention to the distinctions between the schools from which the doctrines emanated").

Part II of this Article outlines the current system of corporate governance in India and sheds light on some key developments. Part III discusses the concepts of the outsider model of corporate governance (with the U.S. and U.K. being prime examples) and the insider model (with India being the subject matter of study). Part IV studies the concept of, and problems with, legal transplants, and analyzes the outcome of transplants in Indian corporate governance. Part V examines the concept of convergence in corporate governance, reviews the plausible reasons for the recent failure of governance in several U.S. companies and contrasts that with the position subsisting under Indian corporate law (much of which predates Clause 49). Part VI concludes with some pointers towards possible further research.

II. A PRIMER ON INDIAN CORPORATE GOVERNANCE

A. Key Developments¹⁶

Since its independence in 1947, India's corporate governance regime has witnessed two distinct eras. The first is the pre-1991 era, which is embodied in company law that was inherited from the British. Company law was substantially overhauled about a decade after independence when it took the form of the Companies Act, 1956. During this era, the focus was predominantly on the manufacturing sector. The then prevalent license-raj and industrial capacity quota system ensured that only a few businesses thrived.¹⁷ This led to the growth of certain business families and industrial groups (largely to the exclusion of others) that held large chunks of capital in publicly listed companies as well. Finance was essentially available only through banking channels (as opposed to the capital markets). The banks and development financial institutions took up large shareholdings in companies and also nominated directors on the boards of such companies. During this era, due to concentrated ownership of shares, the controlling shareholders, which were primarily business families or the State, continued to exert great influence over companies at the cost of minority shareholders. Governance structures were opaque as financial disclosure norms were poor.

¹⁶ For a more detailed analysis on the historical developments in Indian corporate governance, see, R. Chakrabarti, *Corporate Governance in India – Evolution and Challenges*, 14-20 (2005), available at <http://ssrn.com/abstract=649857>, N Balasubramanian et al, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India*, 5-6 (2008), available at <http://ssrn.com/abstract=992529>, V. Bhat, *Corporate Governance in India: Past, Present, and Suggestions for the Future*, 92 IOWA L. REV. 1429, 1437-40 (2007).

¹⁷ The origins of this approach can be traced to the Industries (Development and Regulation) Act, 1951 and the Industrial Policy Resolution of 1956. See, R. Chakrabarti et al, *Corporate Governance in India*, 20(1) J. APP. CORP. FIN. 59, 62 (2008).

Signs of change, however, rapidly emerged with the 1991 reforms through economic liberalisation¹⁸ that led to a new era in Indian corporate governance. The year 1992 witnessed the establishment of the Securities and Exchange Board of India [hereinafter "SEBI"], the Indian securities markets regulator.¹⁹ SEBI rapidly began ushering in securities market reforms that gradually led to corporate governance reforms as well. Curiously, the first corporate governance initiative was sponsored by industry. In 1998, a National Task force constituted by the Confederation of Indian Industry [hereinafter "CII"] recommended a code for "Desirable Corporate Governance," which was voluntarily adopted by a few companies.²⁰ Thereafter, a committee chaired by Mr. Kumar Mangalam Birla submitted a report to SEBI "to promote and raise the standard of Corporate Governance in respect of listed companies".²¹ Based on the recommendations of the Kumar Mangalam Birla committee, the new Clause 49, containing norms for corporate governance, was inserted in 2000 into the Listing Agreement that was applicable to all listed companies of a certain size.²² Although both the CII Code as well as the Kumar Mangalam Birla Committee Report expressly cautioned against mechanically importing forms of corporate governance from the developed world,²³ several concepts introduced by them were indeed those that emerged in countries such as the U.S. and U.K. These include concepts such as an independent board and audit committee.

¹⁸ Radical reforms were occasioned in 1991 due to the exceptionally severe balance of payments crisis and dismal growth. See, M. S. Ahluwalia, *Economic Reforms in India Since 1991: Has Gradualism Worked?* in INDIA'S ECONOMIC TRANSITION: THE POLITICS OF REFORMS 87 (R. Mukherji ed., Oxford University Press, 2007), A. O. Krueger & S. Chinoy, *The Indian Economy in Global Context in ECONOMIC POLICY REFORMS AND THE INDIAN ECONOMY* 21 (A. O. Krueger ed., University of Chicago Press, 2003).

¹⁹ SEBI was established under the Securities and Exchange Board of India Act, 1992.

²⁰ CII Code, *supra* note 6. The CII Code, which was directed at large companies, contained some of the measures that continue to date, such as the appointment of a minimum number of non-executive independent directors, an independent audit committee, the unimpeded flow of key information to the board of directors and norms for corporate disclosures to shareholders.

²¹ See, Securities and Exchange Board of India, *Report of the Kumar Mangalam Birla Committee on Corporate Governance* (2000), available at <http://www.sebi.gov.in/commreport/corpgov.html> [hereinafter "Kumar Mangalam Birla Committee Report"]. This report built upon the pattern established by the CII Code and recommended that "under Indian conditions a statutory rather than voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance". *Id.*, at ¶ 1.7. For a detailed discussion regarding the transition from the CII Code to the Kumar Mangalam Birla Committee Report, see, B.S. Black & V. S. Khanna, *Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India*, 4 J. EMPIRICAL STUD. (2007), available at <http://ssrn.com/abstract=914440>.

²² Securities and Exchange Board of India, SMDRP/POLICY/CIR-10/2000 dated Feb. 21, 2000, available at <http://www.sebi.gov.in/circulars/2000/CIR102000.html>. Clause 49 contained a schedule of implementation whereby it was applicable at the outset to large companies and newly listed companies, and thereafter to smaller companies over a defined timeframe.

²³ CII Code, *supra* note 6, at 1; Kumar Mangalam Birla Committee Report, *supra* note 21, at ¶ 2.6.

Thereafter, following Enron and other global scandals, SEBI decided to strengthen Indian corporate governance norms. In the wake of the enactment of SOX in the U.S., SEBI appointed the Narayana Murthy Committee to examine Clause 49 and recommend changes to the existing regime.²⁴ Following the recommendations of the Narayana Murthy Committee, SEBI, on October 29, 2004, issued a revised version of Clause 49 that was to come into effect on April 1, 2005.²⁵ However, since a large number of companies were unprepared to be fully compliant with such stringent requirements, SEBI extended the date of compliance to December 31, 2005.²⁶ Hence, detailed corporate governance norms were introduced into Indian corporate regulations only from January 1, 2006.²⁷ Clause 49 in its present form provides for the following key features of corporate governance:²⁸

- (i) boards of directors of listed companies must have a minimum number of independent directors, with independence being defined in a detailed manner;²⁹

- (ii) listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent;³⁰ the roles and responsibilities of the audit committee are specified in detail;³¹
- (iii) listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency;³²
- (iv) the CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls,³³ and
- (v) annual reports of listed companies must carry status reports about compliance with corporate governance norms.³⁴

However, there are some existing proposals to reform some of these corporate governance provisions, specifically those relating to independent directors, under the Companies Bill, 2008, which is pending in Parliament.³⁵

B. Motivating Factors behind the Corporate Governance Drive

The drive towards a more stringent corporate governance regime over the last decade can be attributed to two factors, *viz.*, (i) the internationalization of Indian capital markets, and (ii) cross-listings by Indian companies. Beginning with the phenomenon of internationalization, a review of the pre-1991 era indicates that the capital markets were heavily regulated,³⁶ thereby impeding

²⁴ Securities and Exchange Board of India, *Report of the SEBI Committee on Corporate Governance* (2003), available at <http://www.sebi.gov.in/commreport/corpgov.pdf> [hereinafter "Narayana Murthy Committee Report"]. The need for a review of Clause 49 was in part triggered by events that occurred in the U.S. at the turn of the century, such as the collapse of Enron and WorldCom. See, Narayana Murthy Committee Report, *id.*, at ¶ 1.6.1. Considerable emphasis was placed in this report on financial disclosures, financial literacy of audit committee members as well as on chief executive officer (CEO) and chief financial officer (CFO) certification, all of which are matters similar to those dealt with by SOX.

²⁵ Securities and Exchange Board of India, SEBI/CFD/DIL/CG/1/2004/12/10 dated Oct. 29, 2004, available at <http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf>.

²⁶ Securities and Exchange Board of India, SEBI/CFD/DIL/CG/1/2005/29/3 dated Mar. 29, 2005, available at <http://www.sebi.gov.in/circulars/2005/dil0105.html>.

²⁷ These norms have been subjected to some periodic amendments and clarifications thereafter. See, Securities and Exchange Board of India, SEBI/CFD/DIL/CG/1/2008/08/04 dated Apr. 8, 2008; Securities and Exchange Board of India, SEBI/CFD/DIL/CG/2/2008/23/10 dated Oct. 23, 2008; Securities and Exchange Board of India, SEBI/CFD/DIL/LA/2009/3/2 dated Feb. 3, 2009.

²⁸ Clause 49 applies to all listed companies (or those that are seeking listing), except for very small companies (being those that have a paid-up capital of less than Rs. 30 million and net worth of less than Rs. 250 million throughout their history). While several requirements of Clause 49 are mandatory in nature, there are certain requirements (such as remuneration committee, training of board members and whistle blower policy) that are merely recommendatory in nature. See, SEBI Circular dated Oct. 29, 2004, *supra* note 25.

²⁹ Where the Chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should comprise independent directors; in other cases, independent directors should constitute at least one-third of the board size. Clause 49(I)(A) of the Listing Agreement. In order for a director to qualify as "independent", the general test is that apart from receiving

director's remuneration, the person does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director. There are additional circumstances detailed in Clause 49(I)(A) of the Listing Agreement where a director would be presumed not to be independent if certain conditions are attracted.

³⁰ Clause 49(II)(A) of the Listing Agreement.

³¹ Clause 49(II)(D) of the Listing Agreement.

³² Clause 49(IV) of the Listing Agreement.

³³ Clause 49(V) of the Listing Agreement.

³⁴ Clause 49(VI) of the Listing Agreement.

³⁵ The concept of "independent director" is proposed under the Bill to be introduced in the Companies Act for the first time. Companies that have a prescribed minimum share capital are required to have at least one-third of their board consist of independent directors. This will be a uniform requirement and the distinction between companies with executive chairman and non-executive chairman will be removed. See, section 132(3), Companies Bill, 2008.

³⁶ All securities offerings to the public required the approval of the Controller of Capital Issues [hereinafter "CCI"], which effectively micro-managed offerings including by reviewing the details such as price at which securities were to be offered rather than leaving those to the market forces to determine.

foreign investors from investing in the Indian markets. However, with the liberalization of the Indian economy in 1991 and the consequent promotion of capital market activity by SEBI, a simplified process became available to Indian companies to access capital from the public.³⁷ Simultaneously, the foreign investment regime was relaxed thereby increasing the avenues available to foreign investors to participate in Indian capital markets.³⁸ These measures signify the objective of the Indian Government during the turn of the century to attract foreign capital so as to make its securities markets more competitive among emerging markets.³⁹

In addition, Indian companies themselves found it essential to issue securities to investors in other countries to meet their capital needs. When Indian companies undertook public offerings of securities in India with listings on Indian stock exchanges, a significant portion of the investments came from offshore investors. Due to this phenomenon, Indian companies (at least those raising capital market finance) were persuaded to comply with corporate governance norms that most investors around the world understood in order for the securities offerings to be successfully marketed overseas.⁴⁰ Companies therefore had to depart from their own norms and meet standards in other countries from where they received investments. Since a large portion of such foreign investment came from the developed world (primarily the U.S. and U.K.), it became convenient for companies to adopt standards with which investors from those countries were familiar.⁴¹ Such a move was aided by the Government through imposition of corporate governance norms (in the form of Clause 49) that met with industry demands.

³⁷ The office of the CCI was abolished in 1992 by the Capital Issues (Control) Repeal Act, 1992. Furthermore, SEBI effected a series of capital market reforms in the late 1990s streamlining the public offering process. Significant measures include the introduction of the bookbuilding process for price discovery, dematerialization of securities (and the consequent availability of scripless trading) and the use of “shelf prospectus”. All of these helped stimulate greater capital market activity in India. See, J. Armour & P. Lele, *Law, Finance, and Politics: The Case of India*, 18-20 (ECGI Working Paper Series in Law, Working Paper No. 107/2008, 2008), available at <http://ssrn.com/abstract=1116608>.

³⁸ Significant changes in the foreign investment regime include the enactment of the Foreign Exchange Management Act, 1999 and the availability of the automatic route for foreign investment in most sectors up to specified shareholding percentages. Government of India, Ministry of Industry, (Department of Industrial Policy & Promotion, Press Note No. 2, 2000 Series). See also, 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).

³⁹ See, Mazumdar, *supra* note 14, at 253.

⁴⁰ See, R. Gupta, *Reforms Made and Reforms Needed in India's Capital Markets: Issues Facing U.S. Investors*, 1650 PLI CORP. 85 (2008).

⁴¹ Several U.S. pension funds, who are activist investors, began investing significant sums of money in the Indian stock markets. Vikas Dhoot, *Pension Funds from Across the World Flock to Dalal Street While India Still Waits*, Indian Express, Jan. 13, 2008

Moving on to the cross-listing factor, while the Indian capital markets were becoming international, Indian companies began listing overseas in order to raise capital. By the late 1990s, it was common for Indian companies to issue their securities through global depository receipts (GDRs) that were listed on the London or Luxembourg stock exchange. The event that marks a watershed in cross-listings by Indian companies is the listing of American depository receipts (ADRs) by Infosys, the Indian information technology bellwether, on the NASDAQ Stock Market [hereinafter “NASDAQ”] in 1999.⁴² As a result of its NASDAQ listing, Infosys submitted itself to the full-blown corporate governance requirements applicable to foreign listings on NASDAQ.⁴³ Apart from seeking capital at better valuations, overseas listings were also driven by the desire of companies to build credibility and reputation in international markets.⁴⁴ Greater numbers of offshore listings by Indian companies compelled such companies to adhere to norms and practices of corporate governance applicable to markets where they listed their securities. Consequently, those norms and practices permeated into the general Indian corporate scenario, at least among the leading and more reputable companies.

(noting that “as many as 152 global pension funds from 18 countries are here and the number is growing fast”). Even the California State employees’ pension fund (referred to as CalPERS), renowned for its activism in instilling corporate governance standards in its portfolio companies, commenced investment in the Indian stock markets in 2004. Dhammika Dharmapala & Vikramaditya Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India*, available at <http://ssrn.com/abstract=1105732>, 18-19 (2008). This phenomenon is not peculiar to India, but generally applies to most emerging markets. Further, there also tends to be competition among emerging markets to make their regimes attractive to foreign investors so that foreign capital is not diverted to other countries. Professors Gordon and Roe note that the result of internationalization of capital markets to emerging market economies is that “investment flows may move against firms perceived to have suboptimal governance and thus to the disadvantage of the countries in which those firms are based” CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 2 (J.N. Gordon & M.J. Roe eds., Cambridge University Press, 2004).

⁴² T. Khanna & K. Palepu, *Globalization and Convergence in Corporate Governance: Evidence from Infosys and the Indian Software Industry*, 35 J. INT’L BUS. STUD. 484, 489 (2004).

⁴³ This sparked off somewhat of a trend, and as of December 2008, there are 16 Indian companies listed on the U.S. stock exchanges (3 on NASDAQ and 13 on NYSE) and hence subject to SOX and other U.S. corporate governance requirements. See, NASDAQ International Listing, available at <http://www.nasdaq.com/asp/NonUsOutput.asp?page=I®ion=asia>; NYSE Euronext, available at http://www.nyse.com/about/listed/lc_all_region_7.html?country=3.

⁴⁴ Khanna & Palepu, *supra* note 42, at 484 (commenting that “[t]he success and generally positive reputation of India’s software firms ... provides at least surface credence to the idea that the global markets to which these firms are exposed has affected their governance systems”). See also, A. N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT’L L. 141, 142 (2003) (referring to this concept as the “bonding thesis” and noting that “cross-listing on a foreign stock market can serve as a bonding mechanism for corporate insiders to commit credibly to a better governance regime”).

These motivating factors reveal that apart from the general desire to enhance governance and transparency among Indian companies, the developments in Indian corporate governance since 1991 were also largely driven by the need to attract foreign capital into the Indian markets which indicates the trend to borrow, willy-nilly, well-understood concepts of corporate governance from the developed economies such as the U.S. and U.K.⁴⁵

III. MODELS OF CORPORATE GOVERNANCE

As we have seen, several concepts in corporate governance (such as independent directors, audit committee and CEO/CFO certification, just to name a few) originated largely in the U.S. and U.K., and were thereafter exported to other countries such as India.⁴⁶ A key question that arises for consideration is whether these concepts can be implemented across various jurisdictions with

⁴⁵ Admittedly, the direct evidence of borrowing by the Indian regulators from the U.S. or U.K. corporate governance regimes is scanty. In fact, both the CII Code as well as the Kumar Mangalam Birla Committee Report expressly cautioned against borrowing from other regimes keeping in view the special circumstances that are applicable to the Indian corporate sector. See, *supra* note 23 and accompanying text. However, that is not to say that connections do not exist. Due regard must be had to the fact that the recommendations of the committees that advised SEBI on this issue were likely influenced by developments that occurred throughout the world (but primarily in the U. S. and U. K.) during the period between 1998 and 2004 when the initial round of corporate governance reforms in India were underway. These include the sustained discussion surrounding the Cadbury Committee Report in the U. K. and the enactment of SOX in the U. S. As one commentator observes, the “similarities [of Indian corporate governance norms] with Sarbanes Oxley and other governance reforms around the globe should be obvious.” George S. Geis, *Can Independent Blockholding Play Much of a Role in Indian Corporate Governance?* 3 CORP. GOVERNANCE L. REV. 283, 284 (2007).

In fact, the review of corporate governance norms by the Narayana Murthy Committee was occasioned by the developments in the U. S. following Enron. See, *supra* note 24 and accompanying text. Given these circumstances, the fact that the committees recommended (and SEBI adopted) measures such as independent directors, audit committees and CEO/CFO certification, all of which constitute the fulcrum of corporate governance norms in the U. S. and U. K., provides ample support to the borrowing or transplant argument. In a recent interview, Mr. Narayana Murthy stated:

My committee on corporate governance came out with a set of recommendations based on the best practices in many parts of the world and India. We talked about the whistle-blower policy, related-party transactions, need for independent directors to be truly independent, tenure of non-executive directors, CEO-and CFO-certification on the lines of Sarbanes-Oxley, oversight of subsidiaries.

Subir Roy, ‘We Have to Make Respect Respectable’ – Q&A: N R Narayana Murthy, Chairman and Chief Mentor of Infosys Technologies, BUSINESS STANDARD, Feb. 27, 2009.

⁴⁶ *Id.*

ease or whether there are any fundamental differences in jurisdictions so as to make them conducive for implementation in some (primarily the countries where they originated), but not in others. That naturally leads us in this Part to a study of the differences in corporate governance systems in various countries, which develops my first assertion that norms of corporate governance from jurisdictions such as U.S. and U.K. will not be entirely suitable for addressing corporate governance problems in India.

There is a growing body of literature that focuses on systems of corporate governance that has shaped an intense debate on whether there is likely to be global convergence of corporate governance⁴⁷ or whether individual legal, social and political factors would drive countries away from such convergence⁴⁸ and compel them to maintain distinct systems resulting in divergence. Before examining issues of convergence or divergence, it would be essential to review the types of corporate governance models. For this purpose, I draw upon the bifurcation of corporate governance systems made by Nestor and Thompson into two basic models: the “outsider” model and the “insider” model.⁴⁹

A. The Outsider Model of Corporate Governance

The outsider model displays dispersed share ownership with large institutional shareholdings.⁵⁰ This essentially tracks the Berle and Means Corporation wherein dispersion in the ownership of companies is inherent in the corporate system,⁵¹ due to which “the position of ownership has changed from that of an

⁴⁷ H. Hansmann & R. Kraakman, *The End of History for Corporate Law in GORDON & ROE, supra* note 41, at 33 (predicting and arguing for a convergence of corporate governance regimes around the world on the lines of the model that exists in the U. S. and U. K.).

⁴⁸ L. A. Bebchuk & M. J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance in GORDON & ROE, supra* note 41, at 69 (arguing that ownership structures in economies with controlling shareholding will have persistence due to efficiency reasons and owing to internal rent-seeking that might impede changes to the structure of corporate rules); Z. Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT’L & COMP. L. 99, 102 (1998) (stating that “it is reasonable that the corporate law of a given country would contain provisions aimed at solving the agency problems which are characteristic of that particular country”); MONKS & MINNOW, *supra* note 3, at 298 (“observing an agreement among commentators that there can be no “one size fits all” standard, and that other countries’ practices cannot be transplanted or imposed on a country and that “individual companies and markets will always be subject to local cultures, pressures and practices”).

⁴⁹ S. Nestor & J. K. Thompson, *Corporate Governance Patterns in OECD Economies: Is Convergence Under Way?* available at <http://www.oecd.org/dataoecd/7/10/1931460.pdf>.

⁵⁰ *Id.*

⁵¹ A. A. BERLE & G. C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 47 (Harcourt, Brace and World, 1932).

active to that of a passive agent"⁵². There is therefore a "separation of ownership and control" in which the individual interest of shareholders is made subservient to that of managers who are in control of a company.⁵³ The model is referred to as the "outsider" model because shareholders typically have no interest in managing the company and retain no relationship with the company except for their financial investments — the separation of ownership and control is at its best.⁵⁴

Another key characteristic of the outsider model is that it is a market-based system (with less reliance on mandatory rules, and greater emphasis on default rules) that provides a significant role to market players as opposed to regulators and the State. This regime, which focuses heavily on capital markets, can be characterized as information-forcing⁵⁵ whereby high disclosure standards require companies to disclose information and leave decision-making on investment matters to the various players in the market. It also presupposes the existence and predominance of proper market systems and sophisticated players (such as knowledgeable professionals, being lawyers, accountants and investments bankers, a competent judiciary and other important fiduciaries such as a cadre of independent directors with a strong foundation in corporate laws and practices).⁵⁶ The depth of the markets and sophistication of market players enable a market-oriented approach towards regulation and governance and less involvement by the State through regulation.

The U.S. and U.K. are classic examples of countries that follow the outsider model.⁵⁷ Looking at their ownership structures, it is found that in these two countries, "and unlike most of the remaining world, most large corporations are public and not family-controlled".⁵⁸ In these countries, shareholding is diffused and it

⁵² *Id.*

⁵³ BERLE & MEANS, *supra* note 51.

⁵⁴ *Id.* See also, B. R. Cheffins, *Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom* in CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 151 (Joseph A. Mcmahery, Piet Moerland, Theo Raaijmakers & Luc Renneboog eds., Oxford University Press, 2002).

⁵⁵ Information-forcing rules are default rules that compel parties with superior information to divulge that information to other parties they deal with so that the problem of information asymmetry is obviated, or at least reduced. See, Y. Listokin, *Learning Through Policy Variation*, 118 YALE L. J. 480, 501-02 (2008).

⁵⁶ See, B. Black & R. Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1912 (1996), B. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001).

⁵⁷ Nestor & Thompson, *supra* note 49, at 5.

⁵⁸ B. Black & J. C. Coffee, Jr., *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2001 (1994) [emphasis in original]. See also,

is not common to find companies that have a dominant or controlling shareholder.⁵⁹

At this juncture, it is appropriate deviate momentarily to examine the various agency problems that companies face.⁶⁰ In their seminal work, Kraakman, *et al.* identify three types of agency problems:⁶¹ (i) the conflict between managers (agent) and owners, being shareholders (principal), (ii) the conflict between controlling shareholders (agent) and minority shareholders (principal), and (iii) that between the company itself (agent) and other stakeholders with whom the company contracts, such as creditors, employees and customers (principal). Due to the ownership structure embodied in the outsider model, the economies that follow this model encounter the first agency problem, *i.e.*, the one between managers and shareholders. The role of corporate law in these jurisdictions is primarily to address this agency problem. Hence, the principal mechanisms that corporate law and governance norms employ in those jurisdictions are devised to address this problem. For example, one strategy used in those jurisdictions is to populate boards with independent directors so they can act as a check on managers and thereby protect the interests of the shareholders.⁶² Similarly, the certification of financial statements and internal controls is an attempt to curb the increasing powers of senior managers (such as CEO and CFO) to the detriment of the shareholders. The evolution of such corporate governance concepts is inextricably linked to this first agency problem as their genesis and rationale relate back to the need for protection of shareholders against managers.

B. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan to Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 7 (2000) (Noting that: A common feature in the United Kingdom and the United States is diffused ownership. In Britain, very few large companies are controlled by families, and fewer than one-fifth of the country's publicly quoted firms have an owner who controls more than twenty-five percent of the shares. Likewise, in the United States, large shareholdings, and especially majority ownership, are uncommon.)

⁵⁹ See, Cheffins, *supra* note 54, at 151. There are indeed exceptions in both the U.S. and the U.K. The U.S. does have companies that are family-owned, while the U.K. has companies that are predominantly owned by financial institutions, but that does not obviate the general character of ownership in these economies wherein shares are diffusely held.

⁶⁰ These agency problems can be examined in the light of the various corporate actors described earlier. See, *supra* note 4 and accompanying text. It is to be noted, however, that the agency concept is used by academics in corporate governance literature in a wider economic sense and ought to be distinguished from the legal (contractual) concept of agency. B. Cheffins, *The Trajectory of (Corporate Law) Scholarship* 26 (2003), available at <http://ssrn.com/abstract=429624>.

⁶¹ R. KRAAKMAN *ET AL.*, *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 22 (Oxford University Press, 2004).

⁶² *Id.*

B. The Insider Model of Corporate Governance

The insider model is characterized by cohesive groups of “insiders” who have a closer and more long-term relationship with the company.⁶³ This is true even in the case of companies that are listed on stock exchanges,⁶⁴ let alone privately held companies. The insiders (essentially the controlling shareholders) are the single largest group of shareholders, with the rest of the shareholding being diffused and held by institutions or individuals constituting the “public”.⁶⁵ The insiders typically tend to have a controlling interest in the company and thereby possess the ability to exercise dominant control over the company’s affairs. As to the identity of the controlling shareholders, they tend to be mostly business family groups⁶⁶ or the State.⁶⁷ This is particularly true of Asian countries such as India and China, which are “marked with concentrated stock ownership and a preponderance of family-controlled businesses while State-controlled businesses form an important segment of the corporate sector in many of these countries”⁶⁸. It is also otherwise referred to as the “family/State” model.⁶⁹

In this regime, the minority shareholders do not have much of a say as they do not hold sufficient number of shares in the company to be in a position to outvote or even veto the decisions spearheaded by the controlling shareholders. The dominant shareholders often improve their position in the company by seeking control and voting rights in excess of the shares they hold. In other words, their control rights far exceed their economic interests in the company. This is achieved through cross-holdings, pyramid structures, tunneling and other similar devices.⁷⁰ By virtue of their control rights, these dominant shareholders are in a

position to exercise complete control over the company. They are virtually able to appoint and replace the entire board and, through this, influence the management strategy and operational affairs of the company. For this reason, the management will likely owe its allegiance to the controlling shareholders. The controlling shareholders nominate senior members of the management, and even further, they often appoint themselves on the boards or as managers. It is not uncommon to find companies that are controlled by family groups to have senior managerial positions occupied by family members. Similarly, where companies are controlled by the State, board and senior managerial positions are occupied by bureaucrats.

Apart from ownership structures, the insider systems display other characteristics that are unique to them. They possess neither robust capital markets nor sophisticated market players; if at all; these are in an early stage of evolution in some countries that have experienced significant capital markets explosions in the last decade.⁷¹ For this reason, the State continues to perform a greater role in regulation of corporate activity by imposing mandatory standards and bright-line rules. There is a perceived reluctance on the part of the State to rely on market participants or a market-based regulation, perhaps owing to their lack of sophistication as compared to the outsider systems.

⁶³ Nestor & Thompson, *supra* note 49, at 9. See also, R. LaPorta et al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

⁶⁴ E. Berglöf & E. von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries* 17 (1999), available at <http://ssrn.com/abstract=183708>.

⁶⁵ Here again, as in the case of outsider systems, there could be exceptions whereby some companies demonstrate diffused shareholding. However, that does not dilute the general position that companies in the insider systems have concentrated shareholdings.

⁶⁶ There is a preponderance of family-owned businesses in developing countries. J. Sarkar & S. Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*, 1:3 INTERNATIONAL REVIEW OF FINANCE 161, 168 (2000).

⁶⁷ Rampant State ownership in several countries is unsurprising on account of the fact that privatization is yet to be completed in those countries. See, LaPorta et al, *Corporate Ownership Around the World*, 54 J. FIN. 471, 496 (1999).

⁶⁸ Chakrabarti, *supra* note 16, at 11.

⁶⁹ See, Nestor & Thompson, *supra* note 49, at 12.

⁷⁰ LaPorta, *supra* note 67, at 474. The concepts of pyramid structures and cross-holdings are described as follows:

Control in excess of proportional ownership can also be achieved through pyramid structures or by cross-holdings. In a pyramid structure, one firm owns 51% (for example) of a second firm, which owns 51% of a third firm, and so on. The owner at the top of the pyramid thereby has effective control of all the firms in the pyramid, with an increasingly small investment in each firm down the line. Cross-holdings exist when a group of companies maintain interlocking ownership positions in each other. To the extent that the interlocking of their ownership positions makes group members inclined to support each other, voting coalitions are formed.

D. K. Denis & J. J. McConnell, *International Corporate Governance*, 23 (European Corporate Governance Institute Finance, Working Paper No. 05/2003, 2003), available at <http://ssrn.com/abstract=320121>. Such pyramid structures are utilized by controlling shareholders to engage in tunnelling, which is the process by which such shareholders move profits or tunnel them across firms so that the profit finally resides in firms in which they have high cash flow rights (by virtue of a greater percentage of shareholding) as opposed to firms in which they have low cash flow rights. This scheme ensures that controlling shareholders receive a greater share of the profits than the minority shareholders, thereby creating discrimination among economic rights of shareholders. See, M. Bertrand, P. Mehta & S. Mullainathan, *Ferretting Out Tunneling: An Application to Indian Business Groups*, 117(1) QUARTERLY J. ECON. 121, 121 (2002). See also, Chakrabarti, *supra* note 16, at 7, 12, LaPorta, *supra* note 67, at 502.

⁷¹ The BRIC countries (Brazil, Russia, India and China) are apt examples of economies that have historically been bereft of developed capital markets, but that have more recently migrated at a rapid pace to adopt systems and practices from developed economies so as to ensure robustness of their markets and to attract not only greater number of investors, but also those with high quality and credibility.

India is a classic insider system where most public companies are controlled (by virtue of dominant shareholding) by either business families or the State.⁷² Business families predominantly own and control companies (even those that are listed on stock exchanges). This is largely owing to historical reasons whereby firms were mostly owned by families.⁷³ In addition, it is quite common to find State-owned firms as well.⁷⁴ Several listed companies are also majority-owned by multinational companies. However, diffused ownership (in the sense of the Berle and Means (Corporation) can be found only in a handful of Indian listed companies, where such structures exist more as a matter of exception rather than as the rule.⁷⁵

Examining the ownership aspect empirically, we find that even as late as 2002, “the average shareholding of promoters in all Indian companies was as high as 48.1%”.⁷⁶

⁷² For an analysis of India’s shareholding structure and controlling shareholder dominance, see, Chakrabarti, *supra* note 16. There is one strand of thought that describes India as a “hybrid of the outside-dominated market-based systems of the U.K. and the U.S., and the insider-dominated bank-based systems of Germany and Japan”. Sarkar & Sarkar, *supra* note 66, at 163. However, this observation (contained in a single study) does not find broader acceptance in the literature pertaining to ownership structures in India.

⁷³ Prior to 1991, Indian businesses were subject to tight control and regulation by the Government. For this reason, all businesses were concentrated in the hands of rich and influential business families and entities who had the wherewithal to obtain licenses and approvals from the Government, which were required for various aspects of running the business, including establishment, operation, expansion and closure. See, Mohanty, *supra* note 14, at 235.

⁷⁴ There are indeed several listed companies that are government-owned, where either the Central Government or the government of a State owns the majority (usually a substantial) ownership interest in the company. Such companies are also referred to as public sector undertakings (PSUs). See also, Section 617, Companies Act, 1956.

⁷⁵ Even though some companies have undergone metamorphosis from controlled companies to those with diffused shareholding structures over a period of time, primarily through repeated offerings of shares to the public to raise capital, it is expected that this would be a considerably slow process as a general matter. Further, despite the era of liberalization that was ushered in by the Government in 1991, ownership structures continue to be concentrated for the most part. After such liberalization, only very few companies have restructured their ownership so as to make the shareholding pattern truly dispersed in the U.S. sense of the term. More generally, even where there is a plausible scenario that “public ownership will become increasingly prevalent ... controlling shareholders will continue to play a dominant role”. Cheffins, *supra* note 58, at 35.

⁷⁶ Chakrabarti, *supra* note 16, at 11 [emphasis supplied]. In this context, it must be noted that the concept of “promoter” has specific legal significance in the Indian context. The expressions “promoter” and “promoter group” are defined to include (i) the person or persons who are in overall control of the company, (ii) the person or persons who are instrumental in the formulation of a plan or program pursuant to

A more recent study confirms this position, even in the case of listed companies.⁷⁷ That study is based on information available on the websites of the two main stock exchanges in India, the Bombay Stock Exchange and the National Stock Exchange,⁷⁸ and the shareholding pattern of “100 companies constituting the BSE 100, ... with a total market capitalization of nearly \$850 billion, and the 500 companies of the BSE 500, which represents nearly 93% of the total market capitalization of the entire Bombay Stock Exchange”.⁷⁹ The study found that:

[t]he average BSE 100 Company has a promoter who owns over 48% of the company. Only ten of the BSE 100 companies have promoters holding stakes below the critical 25% threshold Looking at the broader BSE 500 set of companies produces similar results: the average promoter owns roughly 49%, and fewer than 9% of promoters have stakes below 25%. This high average concentration of promoter holdings was consistent with the prediction of practitioners.⁸⁰

There is more to it than absolute ownership percentages. The power of concentrated ownership is bolstered by controlling shareholders through other

which securities are offered to the public, and (iii) the person or persons named in the prospectus as promoters. See, Explanation to clause 6.8.3.2 of the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000, available at <http://www.sebi.gov.in/acts/ipguidelines.pdf>. Controlling shareholders holding a substantial number of shares in the company would be treated as “promoters” or “promoter group”. In that sense, the expressions “controlling shareholders” and “promoters” are used interchangeably in this Article, because the former expression is familiar to readers of corporate governance literature in Western jurisdictions, while the expression “promoters” is familiar in the Indian context. Such promoters have additional disclosure and other obligations such as lock-in of shares when an Indian company engages in a public offering of shares.

⁷⁷ S. J. Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, (3) COLUM. BUS. L. REV. 800 (2007).

⁷⁸ The ownership structure of Indian listed companies can be ascertained through information filed by each of these companies with the stock exchanges. Under clause 35 of the Listing Agreement all public listed companies are required to file a statement indicating the shareholding pattern as of the end of each quarter. In such statement, the shareholding of the promoter and the promoter group are to be indicated separately.

⁷⁹ Mathew, *supra* note 77, at 832.

⁸⁰ *Id.* Similar conclusions emerge from another recent study of fifty large public companies on the NSE (the “S&P CNX Nifty”). Geis, *supra* note 45. As regards private companies, the ownership concentration among business families is even more acute. Phani, *et al.* note that “family firms or family owned firms in India constitute 99.9 percent of all private Indian companies” and that the “control of these family enterprises usually vests with a small group of shareholders, often belonging to the same family, with investments as low as 10% in the firm’s assets ...”. B.V. Phani *et al.*, *Insider Ownership, Corporate Governance and Corporate Performance* 4 (2005), available at <http://ssrn.com/abstract=696462>.

mechanisms such as cross-holdings, pyramid structures and tunneling.⁸¹ These phenomena “mark the Indian corporate landscape”.⁸² They often lead to greater benefits to the controlling shareholders at the cost of the minority shareholders.⁸³ Such practices can also have an adverse effect on the development of capital markets as minority shareholders are considerably exposed to the actions of controlling shareholders. This is because controlling shareholders are in a position to shape the composition of the board of directors. All directors owe their allegiance to the controlling shareholders as their appointment,⁸⁴ renewal and continuance in office (without removal)⁸⁵ are subject to the wishes of the controlling shareholders.⁸⁶ Managers who are not on the board also owe their allegiance to controlling shareholders as the board of directors that appoints managers are within the control of such shareholders. All these are evidence of ownership concentration in Indian listed companies, with significant powers to the controlling shareholders.

⁸¹ For an introductory discussion of these concepts, see, LaPorta, *supra* note 70 and accompanying text.

⁸² Chakrabarti, *supra* note 16, at 1. See also, Bertrand, Mehta & Mullainathan, *supra* note 70, at 126, observing the concept of cross-holdings in Indian family business groups: “As in many other countries, group firms in India are often linked together through the ownership of equity shares. In most cases, the controlling shareholder is a family; among the best-known business families in India are Tata, Bajaj, Birla, Oberoi, and Mahindra”.

⁸³ Chakrabarti, *supra* note 16, at 12, noting that:

Recent research has also investigated the nature and extent of “tunneling” of funds within business groups in India. During the 90’s Indian business groups evidently tunneled considerable amount of funds up the ownership pyramid thereby depriving the minority shareholders of companies at lower levels of the pyramids of their rightful gains.

⁸⁴ In India, the appointment of each director is to be voted on individually at a shareholders’ meeting by way of a separate resolution. Each director’s appointment is to be approved by a majority of shareholders present and voting on such resolution. Hence, controlling shareholders, by virtue of being able to muster a majority of shareholders present and voting on such resolution can control the appointment of every single director on the board. See, section 263, Companies Act, 1956. The position of the controlling shareholders further gets reinforced due to the dispersed nature of the remaining shareholding in the company. In most Indian companies, institutional shareholders do not individually hold a significant percentage shareholding, even though the aggregate shareholding of all institutional shareholders may be fairly substantial. Further, although establishment of coalitions of institutional shareholders is generally not subject to restrictions under law (unlike in the U.S.), institutional shareholders in practice rarely form coalitions except in dire circumstances, such as where the company is on the verge of bankruptcy or the promoters or managers of the company have been involved in egregious conduct. This factor adds to the vast powers already available to controlling shareholders in determining the board composition of an Indian company.

⁸⁵ Any director may be removed before the end of her term without cause by a majority of shareholders present and voting on such resolution. See, Section 284 of the Companies Act, 1956.

⁸⁶ This rule applies equally to the appointment and tenure of independent directors that are likewise subject to a majority vote of the shareholders, and hence subject to concurrence of the controlling shareholders.

Returning to the Kraakman, *et al.* paradigm,⁸⁷ we find that insider systems encounter the second agency problem, *i.e.*, the one between controlling shareholders and minority shareholders. The primary role of corporate law in these jurisdictions is to address this agency problem.⁸⁸ Minority shareholders are the constituency that requires the law’s protection.⁸⁹ The controlling shareholders are well-placed due to their control and dominance over the company to protect their own interests which are aligned with that of the company and the managers. Therefore, the first agency problem in the Kraakman *et al.* paradigm, *i.e.*, the one between the managers and shareholders, does not exist at all in insider systems. The role of the law is to curtail the powers and actions of the controlling shareholders and to provide remedies to the minority shareholders.

Examining the issue on a broader plane, there are a number of mechanisms that could potentially be employed under the insider model to address the agency problems between the controlling shareholders and the minority shareholders, although I confine myself here to the discussion of a few. *First*, minority shareholders can be conferred meaningful participation in crucial decisions pertaining to the company, such as determining the composition of the board of directors. The appointment of directors can be determined through proportional representation, such that minority shareholders are able to elect such number directors on the board correlative to the percentage of their shareholding in the company.⁹⁰ However, the system of proportional representation for appointment of directors, although available under Indian company law, is only optional.⁹¹ On the contrary,

⁸⁷ See, R. KRAAKMAN, *supra* note 61 and accompanying text.

⁸⁸ See, A. Shleifer & R. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

⁸⁹ Minority shareholders rarely have the benefit of board representation. For a description of how the board can tackle the agency problems between controlling shareholders and minority shareholders, see, P. L. Davies, *The Board of Directors: Composition, Structure, Duties and Powers*, (Paper on Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends, 2000), available at <http://www.oecd.org/dataoecd/21/30/1857291.pdf>.

⁹⁰ The proportional representation may be by a single transferable vote or by a system of cumulative voting. As Professor Gordon describes:

Cumulative voting operates in two distinct settings. First, a single shareholder (or cohesive group) owning a significant minority block can automatically elect a director to the board. But second, cumulative voting lowers the cost of mobilizing diffuse shareholders because electoral success—in the sense of placing a nominee on the board—requires much less than 50% of the votes. For example, for a ten-person board elected annually, a dissident need to rally only a 10% shareholder vote to put a director on the board. So cumulative voting offers significant potential for shareholder selection of at least some directors who would be independent in this genealogical sense.

Gordon, *supra* note 5, at 1498.

the current system of board appointments confers paramount powers on the controlling shareholders to determine the composition of the board to the substantial exclusion of minority shareholders.⁹² *Second*, the controlling shareholders may be foisted with duties, such as fiduciary duties, owed to the company or to the minority shareholders, such that they are compelled to take into account the interests of that constituency.⁹³ However, under Indian law, shareholders do not owe fiduciary duties either to the company or to the minority shareholders as a matter of general principle.⁹⁴ *Third*, there are minority protection rights and remedies such as for oppression and mismanagement available in several Commonwealth countries.⁹⁵ In India, minority shareholders may approach the Company Law Board pursuant to sections 397 and 398, Companies Act, 1956 to seek appropriate relief against oppression and mismanagement by the controlling shareholders. However, minority

⁹¹ Section 265, Companies Act, 1956. It is hardly surprising then that very few companies, if any at all, have adopted the system of proportional representation to elect their directors.

⁹² For a detailed discussion on the matter, including the mechanics of director appointment, see, *supra* note 84 and accompanying text. As one observer notes: “In a cumulative voting system, minority shareholders may gain proportional representation on the board of directors if they accumulate votes, whereas in a majority voting system, even a minority with 49.9% of the stock may be completely shut out of board representation”. D. J. Hartnett, *Greenmail: Can the Abuses Be Stopped?* 80 Nw. U.L. Rev. 1271, 1285 (1986).

⁹³ Even outsider systems, the U.S. (under Delaware law) being the prime example, impose fiduciary duties on controlling shareholders. See, KRAAKMAN ET AL., *supra* note 61, 126-27 (noting that “U.S. courts attempt to control the abuse of minority shareholders by submitting controlling shareholders ... to a particularly high level of fiduciary duty – a duty of ‘utmost good faith and loyalty’ – toward the company and its minority shareholders”). See also, Kahn v. Lynch Communication Systems Inc., 638 A. 2d 1110 (Del. 1994), Kahn v. Tremont, 694 A. 2d 422 (Del. 1997). This fiduciary duty is applied specifically in cases involving self-dealing transactions by the controlling shareholders.

⁹⁴ See, *Rolta India Ltd. v. Venire Industries Ltd.*, [2000] 100 Comp. Cas. 19 (Bom) [Bombay High Court]. However, fiduciary duties do operate at the board level as they attach to directors. Hence, where controlling shareholders nominate directors on boards of companies, such directors are bound by fiduciary duties in their capacity as directors. *Id.* To that extent, the fiduciary duties that apply to controlling shareholders’ nominees as directors may likely act as an indirect constraint against certain actions such as self-dealing, although in the absence of any direct duties on controlling shareholders, the efficacy of these indirect checks and balances on controlling shareholder excesses is in grave doubt.

⁹⁵ These rights and remedies enable minority shareholders to approach a court of law or other appropriate authority to seek protection against acts of oppression and mismanagement by controlling shareholders. The court or authority usually possesses wide-ranging powers to grant reliefs to the minority shareholders, and these include requiring the controlling shareholder to purchase the shares of the minority shareholders at fair value, superseding the board of the company and even forcing a restructuring of the company.

shareholders are required to satisfy certain prerequisites from a substantive point of view before they can espouse their cause.⁹⁶ Furthermore, there are procedural hurdles as well: the remedies before the Company Law Board can be sought only by shareholders satisfying a minimum threshold.⁹⁷ Based on this analysis, we find that the existing system of minority shareholder protection (particularly under Indian law) is inadequate,⁹⁸ and hence corporate governance reforms in insider models generally, and India in particular, need to place greater emphasis on this issue.

However, as we have seen in Part II, the current focus of the law has been on various requirements of corporate governance such as independent directors, audit committee and CEO/CFO certification that originated in the context of the outsider model and have been replicated in the insider model in the case of India. Adequate attention has not been paid in existing literature to the efficacy of this approach when the concepts that were devised for one model are sought to be fit into another model from a corporate governance standpoint. This represents a perceptible gap in the theoretical underpinnings of Indian corporate governance, and hence requires careful reconsideration, as I detail in the next Part.

⁹⁶ The high bar imposed on minority shareholders in initiating such action is evident from the law laid down by the Supreme Court of India:

It is not enough to show that there is just and equitable cause for winding up the company though that must be shown as a preliminary to the application of section 397. It must further be shown that the conduct of the majority shareholders was oppressive to the minority as members and this requires that events have to be considered not in isolation but as part of a consecutive story. There must be continuous acts on the part of the majority shareholders, continuing up to the date of petition, showing that the affairs of the company were being conducted in a manner oppressive to some part of the members. The conduct must be burdensome, harsh and wrongful, and mere lack of confidence between the majority shareholders and the minority shareholders would not be enough unless the lack of confidence springs from oppression of a minority by a majority in the management of the company’s affairs and such oppression must involve at least an element of lack of probity or fair dealing to a member in the matter of his proprietary rights as a shareholder.

Shanti Prasad Jain v. Kalinga Tubes Ltd., [1965] 35 Comp. Cas. 351, 366 [S.C.].

⁹⁷ The support required for filing a petition against oppression and mismanagement is 100 shareholders or shareholders holding 10% of shares, whichever is less. Section 399, Companies Act, 1956.

⁹⁸ Apart from the inadequacy of minority protection under law, or presumably for that reason itself, there is a lack of a vibrant culture or practice of investor activism that could propel companies and their boards and controlling shareholders towards enhanced corporate governance. For a discussion on this point, see, Geis, *supra* note 45.

IV. ANALYSIS OF LEGAL TRANSPLANTS IN INDIAN CORPORATE GOVERNANCE

In this Part, I identify certain principles behind the phenomenon of legal transplants, and examine their impact in the context of the Indian corporate governance regime.

A. Legal Transplants: The Concept

A legal transplant involves the adoption by one country of laws or legal concepts from another country. This could “range from the wholesale adoption of entire systems of law to the copying of a single rule”.⁹⁹ Transplants have become common in the area of corporate governance, primarily due to globalization and the exportation of capital markets to various jurisdictions.¹⁰⁰

There are several benefits of legal transplants. They are not only useful in setting common standards for legal rights and obligations across jurisdictions, but are also less costly and quick to implement.¹⁰¹ On the other hand, transplants come with several disadvantages. Mere importation of a legal rule without proper adaptation to local conditions is likely to result in failure. This is on account of the fact that several social, political and economic factors that are present in the country of origin may not be present in the country of import, or may be present with substantial variations, all of which make the importation a fairly complex exercise.¹⁰² Unless these factors are taken into account, there will be a lack of

⁹⁹ H. Kanda & C. Milhaupt, *Re-examining Legal Transplants: The Director’s Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887, 887 (2003).

¹⁰⁰ Transplants have become a way of signaling to investors that a country intends to comply with the investors’ domestic legal standards. See, D. Berkowitz et al, *The Transplant Effect*, 51 AM. J. COMP. L. 163, 164 (2003).

¹⁰¹ Kanda & Milhaupt, *supra* note 99, at 889.

¹⁰² See, Berkowitz, *supra* note 100, at 167-68 observing as follows:

We develop a definition of the “transplant effect” as a proxy for the process of legal transplantation and reception. ... Our basic argument is that for law to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to the demand. If the transplant adapted the law to local conditions, or had a population that was already familiar with basic legal principles of the transplanted law, then we would expect that the law would be used. ... However, if the law was not adapted to local conditions, or if it was imposed via colonization and the population within the transplant was not familiar with the law, then we would expect that initial demand for using these laws to be weak. Legal intermediaries would have a more difficult time developing the law to match the demand. Countries that receive the law in this fashion are thus subject to the “transplant effect”; their legal order would function less effectively than origins or transplants that either adapted the law to local conditions and/or had a population that was familiar with the transplanted law.

motivation on the part of market players as well as regulators to implement the rule.¹⁰³ In other words, if the transplanted rule is unlikely to find a “fit” within the recipient legal system, the transplantation is bound to result in failure, as the rule may never be implemented.¹⁰⁴ Implementation failures may occur on two counts. First, the rule may never be implemented at all. Second, the rule may be implemented in a formal sense, but not substantively thereby defeating the purpose of the transplant.

The importation of several corporate governance concepts into an emerging economy like India from the developed economies like the U.S. and U.K. is a classic instance of legal transplant. However, the efficacy of the transplant is open for debate.¹⁰⁵ Any problems with regard to transplantation of these corporate governance concepts are exacerbated by the differing political, social and economic considerations that operate in these two sets of jurisdictions, namely the U.S. and U.K. (the outsider system) on the one hand, and India (an insider system) on the other.¹⁰⁶ It is the conceit of this Article that several of these corporate governance

¹⁰³ See, GORDON & ROE, *supra* note 41, at 6 (observing that “[t]ransplanting some of the formal elements without regard for the institutional complements may lead to serious problems later, and these problems may impede, or reverse, convergence”).

¹⁰⁴ Kanda and Milhaupt examine legal transplants through their study of the exportation of a single rule of corporate law, the director’s duty of loyalty from the U.S. to Japan, and find that the rule was dormant for nearly forty years after its importation into Japan. Kanda & Milhaupt, *supra* note 99, at 889. See also, T. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn’t the Answer*, 45 WM. & MARY L. REV. 1055, 1058 (2004) (arguing that a “danger of transplanting U.S. corporate law to developing economies is that it might not fit with the “importing” country’s economic structure, political system, social order, or cultural values”).

¹⁰⁵ Banaji and Mody study the Anglo-American approach to corporate governance in the context of the Cadbury Committee Report and observe:

[O]ne should note that Cadbury makes several assumptions. It assumes a corporate culture or system where there is already a widespread and well-established separation of ownership and control. Cadbury is not tailor-made to a context where dominant shareholders, e.g. promoters, control management where the corporate governance problem is chiefly one of the protection of minority shareholder rights. ... Cadbury’s assumption is dispersed ownership, and SEBI’s overdependence on Cadbury seems to have carried over some of the consequences of that assumption into a market where concentrated ownership is the chief source of the problem.

J. Banaji & G. Mody, *Corporate Governance and the Indian Private Sector*, (University of Oxford, Queen Elizabeth House, Working Paper Number 73, 2001) [emphasis in original], available at <http://www3.qeh.ox.ac.uk/pdf/qehwp/qehwps73.pdf>.

¹⁰⁶ See, Paredes, *supra* note 104, at 1059 dealing in general with the employability of U.S. corporate governance in other parts of the world. He observes:

The bottom line for most developing countries is that importing a corporate law regime along the line of the U.S. model, or otherwise depending on a market-based model of governance, is not a viable option. More to the point, importing U.S. corporate law falls far short of replicating the U.S. system of corporate governance in developing countries leaving many of the important parts behind.

concepts are not yet implemented effectively in India, and this implementation failure raises questions regarding the viability of the transplant itself.¹⁰⁷

At this stage, it may be useful to support this proposition by means of an illustration, one that deals with the concept of independent directors. As we have seen, controlling shareholders in Indian companies possess significant voting power, both *de jure* and *de facto*, and can determine the composition of the boards of most Indian public listed companies by exercising their voting power to appoint or remove directors.¹⁰⁸ This holds good for the appointment of independent directors as well. Hence, although independent directors (a seemingly critical component of the corporate governance norms) are required to act in the general interests of the company and the shareholder body as a whole, in practice they are generally likely to owe their *de facto* allegiance to the controlling shareholders, as such directors depend on the controlling shareholders for their board seats (as well as remuneration and other terms and conditions). In view of this, independent directors may have a tendency to passively approve actions taken by controlling shareholders and the managers (whose appointments again are subject to be influenced substantially by the controlling shareholders). Proceeding on the assumption that one of the fundamental purposes of corporate governance in India is to address the agency problem between two sets of shareholders by protecting the interests of the minority shareholders from actions of the controlling shareholders, this purpose is defeated at its very source because the instrumentality of independent directors that has been created to solve this agency problem is itself subject to potential dominance by the controlling shareholders.¹⁰⁹ The only argument that may nevertheless work in favour of independent directors is the fact that controlling shareholders would not risk the reputation of either themselves or the public listed company by hiring and firing independent directors at will since that would have its impact on market

reputation and in turn its ability to attract high quality investors and also command a good market value for its shares. However, reputational incentives alone may not be a fully reassuring solution to the problem if there is no legal support for enhancing the powers of the independent directors so as to keep them outside the influence of controlling shareholders.

In the U.S. this problem has been partially addressed by requiring each company to have a nomination committee consisting of independent directors who choose or recommend names of persons for appointment as independent directors.¹¹⁰ However, in India, Clause 49 does not make it mandatory for a company to have a nomination committee consisting of independent directors. The independent directors are appointed by the shareholders and hence the amount of control that a shareholder possesses would determine its influence in the decision-making process. Due to incongruence in the appointment process, the Indian system presents considerable obstacles to the appointment of truly independent directors. That would be the case unless the right to make the choice of independent directors is taken out of the hands of the controlling shareholders.¹¹¹

The incongruence in the position of independent directors does not end there. One specific fact demonstrates that the concept of independent directors has been transplanted from the outsider system to an insider system such as India without regard having been placed on the differences in corporate structures. In the U.S., both the New York Stock Exchange [hereinafter "NYSE"] as well as the

¹⁰⁷ It is, of course, arguable that ten years presents too short a timeframe to assess the viability of a new piece of legislation. See, Berkowitz, *supra* note 100, at 165 (noting that "[i]t obviously takes time for the law to gain more than a book-life and to influence household and firm-level decision making, for lawyers to be trained in the new rules and for cases to be brought to court for clarification and interpretation"). However, such a timeframe will likely provide preliminary evidence of the acceptability of the legislation, and any early assessment of its viability will help regulators mould their implementation strategy in a timely fashion.

¹⁰⁸ *Supra* notes 84 and 85 and accompanying text.

¹⁰⁹ As controlling shareholders have vast powers to determine the selection of the independent directors, it is likely that controlling shareholders would most likely appoint persons who would be passive to their decision-making. Further, even independent directors who may wish to act in the larger interests of the company may be precluded from doing so because of the wide-ranging powers that controlling shareholders exercise.

¹¹⁰ New York Stock Exchange, Listed Company Manual § 303A.04 (2003) [hereinafter "NYSE Listed Company Manual"], available at http://www.nyse.com/lcm/lcm_section.html; NASDAQ Stock Market Rules, Rule 4350(c)(4) (2003) [hereinafter the "NASDAQ Rules"], available at <http://nasdaq.cchwallstreet.com/nasdaqtools/platformviewer.asp?selectednode=chp%5f1%5f1%5f4%5f1&manual=%2fnasdaq%2fmain%2fnasdaq%2dequityrules%2f>. The requirement of a nomination committee consisting of independent directors ensures that the appointment of independent directors is kept outside the influence of the controlling shareholders or managers.

¹¹¹ There are some alternative possibilities for a more inclusive process of appointment of independent directors. First among them is voting through proportional representation, such that minority shareholders have a say in the appointment of some independent directors. For a discussion of proportional representation, see, *supra* note 90 and accompanying text. However, since proportional representation is not mandatory under Indian law, companies are not obligated to follow that method. The second method is the appointment of certain independent directors by a "majority of the minority" with such independent directors being elected by a vote of only the minority shareholders, where the controlling shareholders are required to abstain from participating in the voting process. Even this is not required under Indian law, although again there is a facility for appointment of a director by small shareholders (*i.e.*, those who hold shares of a nominal value of Rs. 20,000 or less), but even that is optional. See, section 252(1), Companies Act, 1956.

NASDAQ do not require a board to have a majority of independent directors when the company is a “controlled company”, i.e., one where a single person, group or company controls more than 50% of the voting power.¹¹² The rationale for the exception appears to be that where there is a controlling shareholder, the other shareholders may not be afforded sufficient protection by independent directors. Furthermore, this is explicit recognition of the fact that independent directors are a solution to the agency problem between managers and shareholders and, by inference, not to agency problem between controlling shareholders and minority shareholders.¹¹³

This illustration of the independent director concept is replete with problems that are likely to be encountered when concepts from outsider systems are transplanted to insider systems without adequate consideration of inherent differences in corporate structures or other relevant factors.

B. Impact of Transplants on Indian Corporate Governance Reforms

At a more general level, there exists some evidence, both empirical and anecdotal, about the impact of these corporate governance reforms on Indian businesses, which indicates mixed results.

1. Recent Empirical Evidence

There is an emerging body of empirical literature on Indian corporate governance,¹¹⁴ but for the present purposes it would suffice to review two recent empirical studies. In the first,¹¹⁵ an event study,¹¹⁶ Black and Khanna study the impact of corporate governance reforms reflected by the formation of the Kumar

¹¹² See, NYSE Listed Company Manual, *supra* note 110, § 303A.00; NASDAQ Rules, *supra* note 110, R. 4350(c)(5). This is a less-known detail in the context of Indian corporate governance. As a noted Indian industrialist bemoans: “I find the lack of mention of this fact in the outpouring of verbiage on this issue in our country quite amazing”. Rahul Bajaj, *How Independent Can a Director Be?*, REDIFF, Jul. 30, 2005.

¹¹³ There is some academic support for this argument:

[NYSE and NASDAQ] see independent directors as a protection for shareholders *specifically against management*, not against other shareholders. A shareholder who controls a company does not need an external rulemaker to protect him from a management team that he has the power to appoint. Minority shareholders may need protection from controlling shareholders, but the exchanges are apparently willing to leave this task to other bodies of law, such as federal securities law requiring disclosures, and state corporate law mandating certain fiduciary duties.

D. C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 94 (2007) [emphasis in original].

¹¹⁴ For a review of this empirical literature, see, Chakrabarti, Megginson & Yadav, *supra* note 17, at 70-71.

¹¹⁵ Black & Khanna, *supra* note 21.

¹¹⁶ An event study involves identifying the release of specific information about a company followed by an examination of the performance of the stock of the

Mangalam Birla Committee¹¹⁷ and find that over a 2-day event window around May 7, 1999,¹¹⁸ the share prices of large firms, to which the corporate governance reforms were then intended to apply, rose by roughly 4% relative to other small firms, thereby signaling the investors’ expectations that corporate governance reforms will increase market value of firms.¹¹⁹ The second study by Dharmapala and Khanna acknowledges the importance of enforcement in corporate governance reform.¹²⁰ The authors study the impact of the introduction of section 23E, Securities Contracts (Regulation) Act, 1956 in 2004 that imposed large penalties of Rs. 25 crores (Rs. 250 million) for non-compliance with the Listing Agreement (that also includes Clause 49 containing the corporate governance norms).¹²¹ Using a sample of over 4000 firms during the 1998-2006 period, the study reveals a “large and statistically significant positive effect (amounting to over 10% of firm value) of the Clause 49 reforms in combination with the 2004 sanctions”.¹²²

While these studies indicate a positive impact of corporate governance reforms in the market place, and are extremely useful in setting the agenda for further empirical debate in the Indian context, they are to be treated with some caution.¹²³ As for the first study by Black and Khanna, it is arguable that the date chosen for the event study, i.e., May 7, 1999, is premature, and that the information

company. If the information is important enough, the stock price will fluctuate upwards or downwards depending on the acceptability of that information to investors. See, R. J. GILSON & B. BLACK, *THE LAW & FINANCE OF CORPORATE ACQUISITIONS* 185 (West Publishing Company, 1995). This is a useful tool to determine whether the market accepts the information as positive (where the stock price can be expected to rise) or negative (when the stock price can be expected to drop).

¹¹⁷ See, Black & Khanna, *supra* note 21.

¹¹⁸ The authors selected May 7, 1999 as the core event date for the study as that is the date on which the Government announced the formation of the Kumar Mangalam Birla Committee to suggest corporate governance reforms. The authors also rely on the fact that “investors had reason to expect the [Kumar Mangalam Birla Committee] proposals to be similar to the CII Code”. See, Black & Khanna, *supra* note 21, at 6.

¹¹⁹ *Id.*

¹²⁰ Dharmapala & Khanna, *supra* note 41.

¹²¹ Dharmapala & Khanna, *supra* note 41, at 9.

¹²² Dharmapala & Khanna, *supra* note 41, at 3.

¹²³ It is a different matter, somewhat related though, that event studies generally are said to be accompanied by some innate limitations. For example, where there is gradual release of information, there could be some doubt as to *when* the information was in fact released to the market. There are also multiple explanations to events, and [a]n event study can tell us that something happened but it can’t tell us why. ... The event study technique does not eliminate the need to assess cause through deductive reasoning. Sometimes, there will be two or more plausible explanations for why a firm’s stock price changes in response to new information. See, GILSON & BLACK, *supra* note 116, at 215.

about the details of the corporate governance reforms cannot be said to have filtered through the corporate system so as to affect the stock price.¹²⁴ While the study can be said to confirm the desire and expectation of Indian firms to submit themselves to greater measures of corporate governance, the difficulty arises on account of the fact that the precise details of the reforms (including whether the measures will be imported to some extent from other jurisdictions) cannot have been factored in at such an early stage and hence this study does not affirm acceptability (or otherwise) of the specific concepts of corporate governance that were to be incorporated (which were subsequently introduced only after the Kumar Mangalam Birla Committee issued its recommendations). Acceptability of enhanced corporate governance measures is one thing; assimilation of the detailed norms is yet another.¹²⁵

The second study by Dharmapala and Khanna also poses some challenges. It shows a positive correlation between the introduction of stringent enforcement norms and companies' market value. But, in the Indian context, law (or even strong penalties) on the statute books do not result in effective enforcement. Regard is also to be had to the inadequate enforcement machinery and the overburdened court system that make enforcement cumbersome in practice. There is ample discussion in existing literature about these problems that plague law enforcement in India.¹²⁶ Hence, the evidence pertaining to the success of implementation of corporate governance reforms lies in whether violations have been successfully prosecuted in fact, and not whether there are stringent penal provisions in the law. An assessment based on the enforcement provisions on the statute books would be inadequate.¹²⁷

¹²⁴ All that was known to the market on that date is the formation of a committee under the chairmanship of Mr. Kumar Mangalam Birla to enhance corporate governance. There was no indication as to the possible outcome of the committee's deliberations, except perhaps some general expectation that it would further the reforms that began voluntarily by the CII Code. No details with any level of adequacy was available at that stage, thereby questioning whether the stock price movement that such an early stage is any indication at all about the acceptability of the reform measures in corporate governance.

¹²⁵ The event study answers the former, but does not entirely address the latter.

¹²⁶ As some academics note that "when it comes to enforcement ... the *de facto* protection of investor's rights in India lags significantly behind the *de jure* protection". Chakrabarti, Megginson & Yadav, *supra* note 17, at 67. This is essentially on account of an overburdened Indian judicial system. In the Doing Business Report 2009 published by the World Bank, India ranks 122 out of a total of 181 countries surveyed in relation to the ease of doing business. As regards enforcement of contracts, India is second from the bottom (after only Timor-Leste). See, World Bank Doing Business Report 2009, available at http://www.doingbusiness.org/documents/DB09_Overview.pdf.

¹²⁷ In a broad sense, the threat of enforcement may itself act as a deterrent against non-compliance. But, that may be the case in jurisdictions where the enforcement

2. Recent Anecdotal Evidence

The anecdotal evidence on the success of implementation of corporate governance reforms is not as optimistic as that of its empirical variety. While the general trend has been for companies to comply (at least in form) with the requirements of Clause 49, there have been significant obstacles to the implementation of these norms and to their acceptability within the Indian corporate ecosystem. To begin with, there was considerable resistance to the stringent corporate governance norms even prior to their enactment in a detailed form. For instance, although detailed revisions to Clause 49 (such as strengthening the definition of "independence" of directors) were introduced in 2004, it was met with cold reception from Indian industry, due to which the implementation of the revisions had to be postponed several times until they were finally mandated to take effect from January 1, 2006.¹²⁸

Even thereafter, the enforcement of Clause 49 by SEBI has been without tremendous success. Curiously enough, government companies are found to be the gravest violators of Clause 49. In a string of cases, SEBI initiated action in 2007¹²⁹ against several government companies for non-compliance with Clause 49.¹³⁰ However, these actions were subsequently dropped by SEBI.¹³¹ This episode

can be successfully taken to its logical end, and not in jurisdictions such as India where the success of enforcement actions is ridden with uncertainty due to the inadequacy of the enforcement machinery. More generally, it has been observed empirically that "in securities law, we find that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter ...". Rafael La Porta et al, *What Works in Securities Laws?* 22 (Tuck School of Business at Dartmouth, Working Paper No. 03-22, 2003).

¹²⁸ See, *supra* note 26. See also, R. Mishra & K.R. Srivats, *Revised Clause 49 of Listing Agreement—Murthy Panel may Redefine 'Independent Director' to Allay Fears*, THE HINDU BUSINESS LINE, Feb. 18, 2004; *SEBI Defers Implementation of Clause 49*, THE HINDU BUSINESS LINE, Mar. 24, 2005.

¹²⁹ *SEBI Cracks the Whip—Violation of Corporate Code Under Lens*, THE TELEGRAPH, Sept. 12, 2007; *SEBI Proceeds Against 20 Cos For Not Complying With Clause 49 Norms*, THE HINDU BUSINESS LINE, Sept. 12, 2007.

¹³⁰ SEBI repeatedly made public statements through its Chairman indicating its intention to ensure that government companies too strictly comply with Clause 49. See, *PSUs Must Meet Clause 49 Norms*, REDIFF MONEY, Jan. 3, 2008. These actions were initiated on the specific count that these government companies had failed to appoint the requisite number of independent directors as required by Clause 49.

¹³¹ During October and November 2008, SEBI passed a series of orders involving several government companies, viz. NTPC Limited (Oct. 8), GAIL (India) Limited (Oct. 27), Indian Oil Corporation Limited (Oct. 31) and Oil and Natural Gas Corporation Limited (Nov. 3), all available at www.sebi.gov.in. The principal ground for dropping the action is that in the case of the government companies involved the articles of association provides for the appointment of directors by the President of India (as the controlling shareholder), acting through the relevant

may likely have deleterious consequences on corporate governance reforms in India. Compliance or otherwise of corporate governance norms by government companies has an important signaling effect. Strict adherence to these norms by government companies may persuade others to follow as well. But, when government companies violate the norms with impunity, it is bound to trigger negative consequences in the market-place thereby making implementation of corporate governance norms a more arduous task.

Even among non-government companies, there have been inadequacies in strict compliance with the basic requirements of corporate governance set forth in Clause 49. For instance, over a thousand companies have yet to file their corporate governance compliance reports for the quarter ended September 30, 2008.¹³² Although this is a blatant violation of the listing agreement, there is no evidence of stringent action having been taken by SEBI or the stock exchanges against such companies. Such implementation failures raise important questions as to the acceptability of transplanted concepts of corporate governance in the Indian context.

3. Lessons from Satyam

The most recent, and significant, piece of anecdotal evidence regarding the lack of full-fledged implementation of Indian corporate governance norms presents itself in the form of accounting irregularities that emerged in Satyam Computer Services Limited, a leading information technology services company in India. On January 7, 2009, the Chairman of the company, Mr. Ramalinga Raju, who (along with his family) around that period owned about 5% shares in the company, confessed to having falsified the financial statements of the company, including by showing fictitious cash assets of over US\$ 1 billion on its books.¹³³ The stock

price of the company reacted adversely to this information and fell more than 70%,¹³⁴ thereby wiping out the wealth of its shareholders, some of whom are employees with stock options.¹³⁵ This episode invoked fervent reaction from the government. Several regulatory authorities such as the Ministry of Company Affairs, Government of India¹³⁶ and SEBI¹³⁷ initiated investigations into the matter. While several independent directors of the company resigned with the disclosure of the financial irregularities,¹³⁸ the remaining directors were substituted with persons nominated by the Government.¹³⁹ Certain key officers of Satyam, being the chairman, the managing director and the chief financial officer were arrested by the police within a few days following the confession,¹⁴⁰ while two partners of PriceWaterhouseCoopers, Satyam's auditor, were arrested thereafter.¹⁴¹ The investigations by the various authorities, which are likely to be time-consuming, are ongoing and it is expected that their outcome will be available only in due course. At a broader level, the Satyam episode has triggered renewed calls for

d. An over stated debtors position of [Rs. 4.90 billion] (as against [Rs. 26.51 billion] reflected in the books

2. For the September quarter (Q2) we reported a revenue of [Rs. 27 billion] and an operating margin of [Rs. 6.49 billion] (24% of revenues) as against the actual revenues of [Rs. 21.12 billion] and an actual operating margin of [Rs. 610 million] (3% of revenues). This has resulted in artificial cash and bank balances going up by [Rs. 5.88 billion] in Q2 alone.

The gap in the Balance Sheet has arisen purely on account of inflated profits over a period of last several years ... What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. It has attained unmanageable proportions as the size of the company operations grew significantly.

Letter dated Jan. 7, 2009 from B. Ramalinga Raju, Chairman, Satyam Computer Services Ltd. to the Board of Directors, Satyam Computer Services Ltd. [hereinafter the "Chairman's Confession"], available at http://blogs.livemint.com/blogs/initial_private_opinion/Satyam_Conf.pdf.

¹³⁴ *Satyam Chief Admits Huge Fraud*, THE NEW YORK TIMES, Jan. 8, 2009.

¹³⁵ S. Mishra & R. Shinde, *Satyam Esop-Holders in Deep Sea as Valuation Takes a Hit*, THE ECONOMIC TIMES, Jan. 8, 2009.

¹³⁶ S. Sanyal, *Government Refers Satyam Case to Serious Frauds Investigation Office*, THE ECONOMIC TIMES, Jan. 13, 2009.

¹³⁷ O. A. Ninan, *Satyam Episode: SEBI Enquiries Will Focus on Three Areas*, THE HINDU BUSINESS LINE, Jan. 16, 2009.

¹³⁸ *Two More Directors Resign from Satyam*, THE FINANCIAL EXPRESS, Dec. 29, 2008.

¹³⁹ M. Jagota & R. Guha, *India Names New Satyam Board*, THE WALL STREET JOURNAL ASIA, Jan. 12, 2009.

¹⁴⁰ *Satyam's Raju Brothers Arrested by AP Police*, THE ECONOMIC TIMES, Jan. 9, 2009; *Satyam Fraud: Raju Sent to Central Prison; CFO Vadlamani Arrested*, THE ECONOMIC TIMES, Jan. 10, 2009.

¹⁴¹ J. Range, *Pricewaterhouse Partners Arrested in Satyam Probe*, THE WALL STREET JOURNAL ASIA, Jan. 25, 2009.

administrative Ministry. SEBI found that despite continuous follow up by the government companies, the appointments did not take effect due to the need to follow the requisite process and hence the failure by those companies to comply with Clause 49 was not deliberate or intentional.

¹³² V. Dhoot *et al*, *Over 1,300 Firms Fail to File Corporate Governance Reports*, FINANCIAL EXPRESS, Jan. 31, 2009.

¹³³ In his confession addressed to Satyam's board, Raju wrote:

It is with deep regret, and tremendous burden that I am carrying on my conscience, that I would like to bring the following factors to your notice::

1. The Balance Sheet carries as of September 30, 2008
 - a. Inflated (non-existent) cash and bank balances of Rs. [50.40 billion] (as against [Rs. 53.61 billion] reflected in the books)
 - b. An accrued interest of [Rs. 3.76 billion] which is non-existent
 - c. An understated liability of [Rs. 12.30 billion] on account of funds arranged by me

corporate governance reforms in India, and it is likely that changes may be proposed to corporate governance norms in the light of lessons learnt from the Satyam episode.¹⁴²

In the meanwhile, it is necessary to examine how such misstatements were made possible despite the applicability not only of Clause 49 (as Satyam was listed on Indian stock exchanges), but also of SOX (as the company was also listed on the NYSE). Satyam had seemingly complied with all the onerous requirements imposed by Clause 49 and SOX, such as the appointment of an impressive array of independent directors, an audit committee, and the audit of its financial statements by a “Big Four” audit firm, but these corporate governance failures nevertheless occurred.¹⁴³ This episode raises serious questions about implementation of corporate governance norms in India, and points towards a failure of transplantation.

¹⁴² Some of the immediate developments towards change can be summarized as follows: (i) within days of the Satyam episode coming to light, the CII set up a special task force on corporate governance to examine issues arising out of the Satyam episode and to make suitable recommendations. *CII Sets Up Task Force on Corporate Governance*, Business Standard, Jan. 12, 2009; (ii) the National Association of Software and Services Companies [hereinafter “NASSCOM”], the premier trade body representing Indian IT – BPO industry announced that it will be forming a Corporate Governance and Ethics Committee to be chaired by Mr. N. R. Narayana Murthy, Chairman and Chief Mentor, Infosys Technologies Ltd. This signifies NASSCOM’s efforts to strengthen corporate governance practices in the Indian IT-BPO industry. *NASSCOM Announces Formation of Corporate Governance and Ethics Committee*, Business Standard, Feb. 11, 2009; and (iii) the Minister for Corporate Affairs, Government of India announced that the Ministry will consider changes to the Companies Bill, 2008 (that is pending in Parliament) in the light of events surrounding Satyam. *Satyam Scam: Provisions of New Companies Bill to be Reviewed*, THE HINDU BUSINESS LINE, Jan. 8, 2009.

¹⁴³ See, Pratip Kar, *Enron? Parmalat? Lehman? No, no, it’s Satyam*, THE BUSINESS STANDARD, Jan. 9, 2009; Salil Tripathi, *India Faces an ‘Enron Moment’*, THE WALL STREET JOURNAL, Jan. 9, 2009. It is ironical that Satyam was the recipient of the Golden Peacock Award for excellence in corporate governance in 2008 conferred upon it by the U.K.-based World Council for Corporate Governance. The award to Satyam was subsequently withdrawn when non-disclosure of material facts came to light. *Satyam Stripped Off Golden Peacock Award*, THE ECONOMIC TIMES, Jan. 7, 2009. An additional question that has baffled observers pertains to how Satyam was able to circumvent the onerous provisions of SOX that were applicable to it by virtue of its cross-listing on NYSE, and the consequent operation of the bonding thesis. For an introduction to the bonding thesis that arises out of cross-listings, see, Licht, *supra* note 44, at 142. However, at an academic level, there are some challenges to the bonding thesis. Licht argues that the role of the bonding thesis has been greatly overstated. He adds:

A large body of evidence, using various research methodologies, indicates that the bonding theory is unfounded. Indeed, the evidence supports an alternative theory, which may be called “the avoiding hypothesis”. To the extent that corporate governance issues play a role in the cross-listing decision, it is a negative role. The dominant factors in the choice of cross-listing destination

In this context, it would be relevant to discuss at least two of the failures that occurred at Satyam from a corporate governance perspective. First, there was a clear failure of the audit process as the genesis of the fraud can be pointed to the misstatement of financial information. The Indian corporate governance norms for audit provide for three basic sets of checks and balances in the audit process: they are internal audit, statutory audit and the audit committee.¹⁴⁴ However, despite the existence of such systems within Satyam (at least at a formal level), the falsification of accounts of such great magnitude continued unabatedly for several years prior to the Chairman’s confession.¹⁴⁵ Even the review by external reputational intermediaries such as a “Big 4” accounting firm was not capable of detecting the accounting malfeasance.¹⁴⁶

Second, the independent directors of Satyam were unable to prevent the falsification. Various reasons can be attributed to this failure. No doubt, the Satyam board was largely independent and also comprised distinguished and reputable individuals.¹⁴⁷ But, independent directors cannot generally be expected to uncover frauds in companies as the decisions they make are generally based on information provided to them by management.¹⁴⁸ Even in Satyam’s own case, independent

markets are access to cheaper finance and enhancing issuer visibility. Corporate governance is a second-order consideration whose effect is either to deter issuers from accessing better-regulated markets or to induce securities regulators to allow foreign issuers to avoid some of the more exacting domestic regulations. Overall, the global picture of cross-listing patterns is best described as a model of informational distance, which comprises elements of geographical and cultural distance.

¹⁴⁴ See, R. Sinha & N. Josphipura, *The Great Deception*, ASIALAW, Feb. 2009, at 24.

¹⁴⁵ One of the significant heads of falsification involves non-existent deposits of Satyam with its bankers. It is generally believed that cash or bank audits are most basic and that auditors generally rely on certification received from bankers as to the existence of cash deposits. Although the matter is under investigation, available reports indicate that there may have been forgery involved in the certification of bank deposits. G. Anand & R. Guha, *Satyam Bank Documents at Issue*, THE WALL STREET JOURNAL, Jan. 21, 2009.

¹⁴⁶ However, the question of complicity of the relevant partners of PriceWaterhouseCoopers is yet under investigation.

¹⁴⁷ As one report describes:

The independent directors on the board included Vinod K Dham (famously known as ‘father of Pentium’ and an ex-Intel employee), M Rammohan Rao (Dean of Indian School of Business), V S Raju (former director of IIT Delhi), TR Prasad (former union cabinet secretary), M Srinivasan (retired professor from many US universities) and Krishna Palepu (Professor at the Harvard Business School).

A. K. Bhattacharyya, *Satyam: How Guilty are the Independent Directors?*, BUSINESS STANDARD, Jan. 12, 2009.

¹⁴⁸ The management or controlling shareholders control the “amount, quality and structure” of information that is provided to the board, and this “kind of power over information flow is virtually equivalent to power over decision”. MELVIN ARON EISENBERG, THE

directors did raise several questions regarding the proposed acquisition by Satyam (only a few days prior to the Chairman's confession) of two related entities carrying on real estate business, namely Maytas Properties and Maytas Infra, but that did not prevent the board from unanimously resolving to proceed with the transaction.¹⁴⁹ It was in fact the strong adverse reaction from investors that stalled that proposed transaction.¹⁵⁰ At a structural level, independent directors are subject to nomination, appointment and removal, all at the hands of the controlling shareholders,¹⁵¹ and hence may be subject to influence by the controlling shareholders.¹⁵² Although Satyam was subject to the listing requirements of NYSE,¹⁵³ it did not have an independent nomination committee¹⁵⁴ that could have potentially brought the appointment of directors outside the purview of the controlling shareholders.¹⁵⁵ Furthermore, the Indian corporate governance norms do not specify the roles of independent directors. It is not

entirely clear whether independent directors ought to act as advisors to the management from a business strategy perspective or whether they ought to act as a guardian of shareholder interest.¹⁵⁶ The Indian corporate governance norms such as Clause 49 only provide a negative definition of independence,¹⁵⁷ but do not specify any positive qualities, a specific role or other attributes for independent directors. Such lack of clarity in their roles could result in less desirable outcomes from independent director action as we have witnessed in Satyam's case. Lastly, the Satyam episode is also symptomatic of a signaling problem with the role of independent directors. That is, the corporate governance norms bestow too much (and somewhat misplaced) importance on the role of independent directors than is justified. In epitomizing independent directors as a guardian of minority shareholders, the corporate governance norms create a false sense of security among corporate stakeholders. However, as the Satyam episode has demonstrated, the independent directors are constrained in the extent to which they can be effective in unearthing frauds, even by exercising a fair amount of diligence in their action.

Beyond the two specific failures of the audit process and board independence, there exists the larger issue of promoter control in Indian companies. Promoters (who are controlling shareholders) exercise significant influence on matters involving their companies, even though such companies are listed on stock exchanges and hence have public shareholders. Indian law confers some distinct roles for promoters.¹⁵⁸ This largely holds good even for companies that have controlling shareholders with small percentage holdings in companies. For instance, the Raju family who are the promoters of Satyam held only about

STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 144, 172 (Beard Books, 1976). Added to that is the complexity of the information based on which directors are required to decide. Often, directors' roles are "predicated on a detailed knowledge of a company and its business". JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 57 (Harvard Business School Press, 1989).

¹⁴⁹ N. Sheth & J. Range, *Satyam Minutes Show Directors Raised Questions*, WALL STREET JOURNAL, Jan. 19, 2009. The proposed transaction came under severe criticism as the board permitted Satyam not only to venture into an unrelated business by acquiring the Maytas companies, but also allowed Satyam to transact with shareholders of those companies that were predominantly the Raju family (and hence constituting related parties) in a manner not entirely transparent to investors.

¹⁵⁰ Within 24 hours of announcement of the Maytas deal, investors forced a reversal of the proposal through a significant decline (of about 50%) in the price of Satyam's American depository receipts (ADRs). A. Garg, *Lessons from the Satyam-Maytas Deal*, HINDU BUSINESS LINE, Dec. 22, 2008.

¹⁵¹ See, *supra* notes 84 to 86 and accompanying text.

¹⁵² To be sure, this is not to suggest any malfeasance on the part of Satyam's independent directors. The independent may act well-intentioned and bona fide, but due to the operation of several constraints on time, information, as well as on business, financial and legal expertise, they may not be in a position to challenge management or controlling shareholders when required. An observation made several years ago by a leading commentator on board behavior continues to be apt even today: "Professional courtesy" and "corporate manners" were phrases used to explain the lack of challenging questions". MYLES L. MACE, DIRECTORS: MYTH AND REALITY 54 (Division of Research, Graduate School of Business Administration, Harvard University, 1971).

¹⁵³ Satyam's ADRs are listed on the NYSE. Symbol: SAY. For further details, see, <http://www.nyse.com/about/listed/say.html>.

¹⁵⁴ Satyam did not constitute a nomination committee even though that is mandated by the corporate governance requirements of the NYSE. NYSE Listed Company Manual, *supra* note 110, § 303A.04 (2003). See, Form 20-F filed by Satyam with the U.S. Securities and Exchange Commission on Aug. 8, 2008, at 70.

¹⁵⁵ For a previous discussion on the importance of this feature, see, *supra* note 110 and accompanying text.

¹⁵⁶ Several independent directors I interviewed in the course of another study on board independence in India believe that their primary role on corporate boards is to provide strategic inputs to management and do not believe they have any significant role to play in acting as a constant check on management or controlling shareholders or in preventing frauds or similar corporate governance failures.

¹⁵⁷ Clause 49(I)(A)(iii) of the Listing Agreement lists out persons who do not qualify to become an independent director of a listed company.

¹⁵⁸ The importance of the position emanates in the context of public offerings of securities, where the role of key persons involved in control of the company is material information that is to be disclosed to investors to enable them to take an informed investment decision. Apart from that, promoters are required to hold minimum number of shares in the company at the time of listing (also known as minimum promoter contribution) and they are subject to lock-in on their shares. It has been argued that "[a]ny requirement that statutorily forces a promoter to bring in specific investment amounts or maintain specific shareholding would necessarily perpetrate the unfortunate reality of keeping our listed companies in the hands of the promoters". S. Sundaresan, *SEBI Should Phase Out 'Promoter' Concept*, BUSINESS STANDARD, Oct. 8, 2007. This would arguably inhibit any transition from controlling shareholding in companies (*i.e.*, the insider system) to diffused shareholding (*i.e.*, the outsider system) so as to engender board-driven-professionally-managed companies.

5% shares around the time when the Chairman's confession was made on January 7, 2009.¹⁵⁹ A company with 5% promoter shareholding will usually be considered as belonging to the outsider model in terms of diffused shareholding, and hence requiring the correction of agency problems between shareholders and managers.¹⁶⁰ However, the gradual decrease in controlling shareholders' percentage holdings coupled with the concept of "promoter" under Indian regulations makes the distinction between an insider-type company and outsider-type company somewhat hazy in the Indian context. The Raju family, as promoters, continued to wield significant powers in the management of the company despite a drastic drop in their shareholdings over the last few years. This was aided by the diffused nature of the remaining shareholding within the company.¹⁶¹ The Satyam episode illustrates that a company with minimal promoter shareholding could still be subject to considerable influence by the promoters, thereby requiring a resolution of the agency problems between controlling shareholders and minority shareholders even at those shareholding

levels.¹⁶² The transition of companies from the insider model to the outsider model through constant dilution of shareholding by controlling shareholders can be difficult, as Satyam demonstrates. Corporate governance regimes in emerging markets such as India which are likely to witness such transition from insider to outsider regimes through dilution of controlling shareholding need to provide mechanisms to tackle undue control by promoters with limited shareholding.¹⁶³

The Satyam case clearly demonstrates the inability of the existing corporate governance norms in India to deal with corporate governance failures in family-controlled companies, even where the level of promoter shareholding is relatively low. Any reforms that spring from this case ought to take into account the vulnerability of minority shareholders in such companies that lie at the cusp of insider and outsider systems.

¹⁵⁹ It has been reported that the promoters' percentage shareholding in Satyam declined over a period of time:

Though the precise numbers quoted vary, according to observers the stake of the promoters fell sharply after 2001 when they held 25.60 per cent of equity in the company. This fell to 22.26 per cent by the end of March, 2002, 20.74 per cent in 2003, 17.35 per cent in 2004, 15.67 per cent in 2005, 14.02 per cent in 2006, 8.79 in 2007, 8.65 at the end of September 2008, and 5.13 per cent in January 2009 (*Business Line*, January 3, 2009). The most recent decline is attributed to the decision of lenders from whom the family had borrowed to sell the shares that were pledged with them. But the earlier declines must have been the result either of sale of shares by promoters or of sale of new shares to investors.

C.P. Chandrasekhar, *The Satyam Scam: Separating Truth from Lies*, THE HINDU, Jan. 14, 2009. It would be cumbersome to obtain the exact amount of voting shares held by the promoters as large parts of those shares were pledged to lenders and those pledges were enforced by the lenders during the few months surrounding the revelation of misstatements in Satyam's financial information, thereby bringing the promoter holdings down to negligible levels.

¹⁶⁰ See, *supra* Part IIIA.

¹⁶¹ Although institutional shareholders (particularly foreign institutional investors) are beginning to hold significant number of shares in Indian listed companies, they have refrained from exercising significant influence over corporate decisionmaking. Collective action problems continue to operate and, over a period of time, "the culture of institutional shareholders always blindly voting with the promoter was established". A. Shah, *Getting the Right Architecture for Corporate Governance*, FINANCIAL EXPRESS, Jan. 13, 2009. In Satyam's case, institutional shareholders held a total of 60% shares as of Dec. 31, 2008; the highest individual shareholding of an institutional shareholders, however, was only 3.76%. This information has been extracted from Satyam's filing of shareholding pattern with the BSE for the quarter

ended Dec. 31, 2008, available at <http://www.bseindia.com/shareholding/shareholdingPattern.asp?scripcd=500376&qtrid=60>.

In the U.S., hedge funds and other institutional shareholders effectively monitor and sometimes agitate against inefficient boards and managements and also help shape general corporate governance norms. They are ably aided by proxy consultants such as RiskMetrics (previously known as ISS) to build coalitions of institutional investors to adopt an "activist" role in companies. The absence of these checks and balances in the Indian context confers unhindered powers to controlling shareholders or promoters (including those with limited shareholding percentages) to wield significant influence over corporate decisionmaking. The "transplantation" of investor activism from developed markets such as the U.S. and yet to find an entrenched position in the Indian corporate milieu, although signs of activist investors in India are slowly beginning to emerge. This tepid involvement of investors in corporate governance of Indian companies has also been a subject matter of empirical studies. See, Geis, *supra* note 45.

¹⁶² Observers believe that companies with controlling shareholders holding limited stakes can be particularly vulnerable to corporate governance failures. As Ajay Shah, a noted Indian economist states: "The incentive for theft [in such cases] is the greatest: there is a great temptation for a CEO who owns 8% of a company to make a grab for 100% of the cashflow". Further, promoters who are in the twilight zone of control, i.e., where they hold shares less than that required to comfortably exercise control over the company, have perverse incentives to keep the corporate performance and stock price of the company at high levels so as to thwart any attempted takeover of the company. The following statement by Ramalinga Raju is emblematic of how this incentive operates: "As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten". Chairman's Confession, *supra* note 133.

¹⁶³ There is an argument that if there is to be a smooth transition towards an outsider regime and "[i]f SEBI truly desires the Indian market to have board-driven-professionally-managed companies, it should begin by considering a roadmap to do away with the "promoter" concept over time". Sundaresan, *supra* note 158. See also, Cheffins, *supra* note 58.

V. HISTORY REPEATS ITSELF: WITHER GOVERNANCE?

In a provocatively titled book,¹⁶⁴ Francis Fukuyama argues that the advent of Western liberal democracy may signal the end point of mankind's ideological evolution and the final form of human government. But, of immediate interest to us is a debate in corporate governance that takes a leaf out of Fukuyama's book. In an article, *The End of History for Corporate Law*,¹⁶⁵ Professors Hansmann and Kraakman set the framework for the current global corporate governance debate, where their argument is twofold: (1) American corporate governance has reached an optimally efficient endpoint by adopting the shareholder primacy and dispersed shareholding corporate model, and (2) the rest of the world will inevitably follow, resulting in a convergence of corporate governance around the world on the lines of the U.S. model. Although these arguments have been subject to a fair amount of criticism,¹⁶⁶ events that have occurred in the recent months expose chinks in the U.S. model of corporate governance, and provide at least some anecdotal evidence that the success of such model is questionable.¹⁶⁷

The question that is being posed is: where was corporate governance when the CEOs and boards of directors of large and admired U.S. corporations such as Bear Stearns, Lehman Brothers, Freddie Mac, Fannie Mae, Merrill Lynch and AIG saw the performance of their companies plummet, which finally resulted in a massive erosion of value to their shareholders and other stakeholders?¹⁶⁸ Going back into (recent) history, this is indeed not the first time that such questions have been posed. Earlier at the turn of this century, we witnessed the very same

¹⁶⁴ FRANCIS FUKUYAMA, *THE END OF HISTORY AND THE LAST MAN* (The Free Press, 1992).

¹⁶⁵ H. Hansmann & R. Kraakman, *supra* note 47.

¹⁶⁶ See, Bebchuk & Roe, *supra* note 48 (arguing that divergence is likely to continue owing to path dependency); W. Bratton & J. A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRAN'L L. 213, 213 (1999) (noting that "neither global convergence that eliminates systemic differences nor the emergence of a hybrid best practice safely can be projected because each national governance system is a system to a significant extent"); T. Khanna et al, *Globalization and Similarities in Corporate Governance: A Cross-Country Analysis*, 88(1) REV. ECON. STAT. 69, 84 (2006) (concluding that "globalization may have induced the adoption of some common corporate governance standards but that there is little evidence that these standards have been implemented").

¹⁶⁷ The U.S. model of corporate governance has been subject to criticism at two distinct stages in the recent past. The first occurred when the Enron fraud came to light at the turn of the century, which was met with swift reaction by the regulators in terms of the enactment of SOX. The other occurred more recently with the onset of the global financial crisis and the collapse of financial giants such as Bear Stearns, Lehman Brothers and AIG which raises doubts regarding the efficacy strengthened regime under SOX.

¹⁶⁸ *Supra* note 13.

questions being asked when a governance crisis of a slightly different nature occurred with Enron, WorldCom, Tyco and other companies being mired in accounting scandals.¹⁶⁹ Following this, stern legislative measures were introduced in the U.S. in the form of SOX that required companies listed in the U.S. to put in place strong systems and practices to enhance corporate governance.¹⁷⁰ However, those measures have apparently been insufficient to deal with the current crisis.¹⁷¹

In this Part, I explore some of the factors involving U.S. corporate governance that may have triggered this situation,¹⁷² and also argue in favour of my second assertion that corporate governance norms followed in the U.S. and U.K. have themselves not been effective in preventing mass failures in corporate governance, and hence their efficacy may be in doubt in the Indian context.

A. Key Factors in U.S. Corporate Governance

It is useful here to explore some of the factors involving U.S. corporate governance that may have led to the current situation.

1. Dispersed Shareholding and Lack of Oversight

As we have seen, one of the key problems involving a dispersed shareholding model (that is prevalent largely in the U.S. and U.K.) is that the individual shareholders have relatively small stakes in companies and these do

¹⁶⁹ See, C. M. Elson & C. J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855 (2003); D. M. Branson, *Enron—When All Systems Fail: Creative Destruction of Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989 (2003).

¹⁷⁰ See also, NYSE Listed Company Manual, *supra* note 110; and NASDAQ Rules, *supra* note 110.

¹⁷¹ Nell Minow, an influential corporate governance activist and commentator, observes:

Despite the post-Enron adoption of the most extensive protections since the New Deal, a survey released this week by Kroll and the Economist Intelligence Unit found that corporate fraud rose 22 percent since last year.

The option back-dating and sub-prime messes show that even the post-Enron Sarbanes-Oxley reform law and expanded enforcement and oversight cannot eliminate the severest threats to our markets and our economy.

This proves that there are limits to structural solutions. Ultimately, markets are smarter and more efficient than regulation. What the government needs to do now is insist on removing obstacles to the efficient operation of market oversight.

Nell Minow, Commentary, *Blame Boards of Directors for Financial Mess*, CNN, Sep. 18, 2008, available at <http://edition.cnn.com/2008/POLITICS/09/18/minow.pay/index.html>.

¹⁷² Although the focus of this Part is on U.S. corporate governance, a large number of the general features of U.S. corporate governance can be found in U.K. as well. However, the current corporate governance failures have affected the U.S. more severely than they have the U.K.

not provide sufficient incentives for them to come together and form coalitions to effectively oversee the managers of companies.¹⁷³ While the shareholders are owners of the company, the control of the company is vested with the managers, as shareholders are unable to participate in decision-making due to collective action problems.¹⁷⁴ That bestows managers with a free hand in the way they manage companies without substantial oversight from shareholders. On the other hand, it is also necessary to acknowledge the strong trend of activist investors (such as hedge funds) to systematically engage in monitoring and oversight of company management.¹⁷⁵ Such investors are also aided by proxy consultants that put together voting guidelines based on corporate governance policy positions which have the effect of shaping corporate governance norms across U.S. corporations.¹⁷⁶

2. Director Primacy and Managerial Superiority

Due to the problems discussed above, managers are not only in a position to control the business policies of the company, but effectively also the composition of the board itself. Shareholders usually vote on a slate of directors provided by management, and they do not possess adequate powers to replace the board or management.¹⁷⁷ This situation is further aggravated due to defenses such as staggered boards and poison pills, which make it difficult for shareholders (or even hostile raiders) to unseat the incumbent boards and management.¹⁷⁸ All of these enable self-perpetuation of management with little fear of being overthrown

¹⁷³ For a detailed discussion of this issue in the context of outsider systems of corporate governance, see, *supra* Part IIIA.

¹⁷⁴ Collective action problems refer to the difficulties that arise in achieving consensus among a diffused set of shareholders who do not play an active role in the company. These problems are exacerbated by the heterogeneity of interests and differing levels of information available with these shareholders. See, S. M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 557 (2003).

¹⁷⁵ J. H. Biggs, *Shareholder Democracy: The Roots of Activism and the Selection of Directors*, 39 LOY. U. CHI. L.J. 493 (2008); Kuang-Wei Chueh, *Is Hedge Fund Activism New Hope for the Market?*, 2008 COLUM. BUS. L. REV. 724.

¹⁷⁶ See, e.g., RiskMetrics, details available at <http://www.riskmetrics.com>.

¹⁷⁷ See, L. A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 851-61 (2005).

¹⁷⁸ See, Lucian Arye Bebchuk et al, *The Powerful Antitakeover Force of Staggered Boards*, 54 STAN. L. REV. 887 (2002), J. Armour & D. A. Skeel Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1734-35 (2007) (observing that “[m]anagers of a target company are permitted to use a wide variety of defenses to keep takeover bids at bay. . . . The managers of a company that has both a poison pill and a staggered board of directors have almost complete discretion to resist an unwanted takeover bid”). Note, however, that takeover defenses such as the poison pill and staggered boards have been on the decline in recent years due to the increasing influence of activist investors. See, T. W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 697-98 (2007).

even in the wake of dismal performance. For these reasons, although the U.S. model of corporate governance is known as the “shareholder model”, in reality there is very little that shareholders can do to constrain managerial misdeeds.¹⁷⁹

3. Pay without Performance

Excessive managerial influence also extends to fixing managers’ own remuneration. Professors Lucian Bebchuk and Jesse Fried state that managerial influence can lead to inefficient arrangements and perverse incentives in fixing managerial remuneration that make the amount and performance-insensitivity of pay less transparent.¹⁸⁰ These have resulted in CEOs and other senior officers of large U.S. corporations being paid colossal sums of money that do not necessarily correlate with the performance of the company or the value created (or destroyed) for shareholders. Golden parachute arrangements ensure that CEOs obtain large payments even when their services are terminated for poor performance.¹⁸¹ With the onset of the financial crisis, however, certain restrictions have been placed on the ability of managements to award significant sums of money as compensation to its executives, more specifically in case of companies that are the beneficiaries of bailouts by the U.S. Government.¹⁸²

Unrestrained arrangements for pay, whether in the form of salary, bonus or even stock options encourage short-termism that incentivize managers to boost short-term profits of their companies and earn large sums of moneys, but at the cost of the interests of shareholders that tend to be relatively longer term.¹⁸³ This mismatch of expectations and incentives causes managers to take decisions that may in the end prove to be overly risky to shareholders as we have seen in the recent failures.

¹⁷⁹ Bebchuk, *supra* note 177. Again, this principle is subject to some dilution more recently in view of investor activism. See, Briggs, *supra* note 178.

¹⁸⁰ L. BEBCHUK & J. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (Harvard University Press, 2004).

¹⁸¹ J. W. Markham, *Regulating Excessive Executive Compensation—Why Bother?* 2 J. BUS. & TECH. L. 277, 291-93 (2007).

¹⁸² Under the Troubled Assets Relief Program (TARP) Capital Purchase Program, participating companies are required to “adopt the Treasury Department’s standards for executive compensation and corporate governance, for the period during which Treasury holds equity issued under this program”. U.S. Department of the Treasury, *Treasury Announces TARP Capital Purchase Program Description*, Press Release HP-1207, Oct. 14, 2008, available at <http://www.treas.gov/press/releases/hp1207.htm>. Furthermore, the U.S. President announced the setting up of “new rules for companies receiving “exceptional assistance” from the government [that] include a \$ 500,000 cap on salaries for senior executives (compensation beyond that must be in restricted stock), expanded bans on golden parachutes, and increases to “clawback” provisions”. The White House, *Remarks by the President on Executive Compensation*, Feb. 4, 2009, available at http://www.whitehouse.gov/blog_post/new_rules/.

¹⁸³ L. A. Bebchuk & J. M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 666 (2005).

Furthermore, the remuneration of directors and senior managers is fixed by the board (or compensation committee), with no approval required from shareholders for fixing such remuneration.¹⁸⁴ In other words, shareholders have no “*say on pay*” that is mandated by law, although there are proposals on the cards for requiring shareholder approval (at least on a non-binding basis).¹⁸⁵

4. Lack of Responsiveness on the Part of Boards

The recent events have questioned the effectiveness of boards of directors in curbing excessive risk-taking by managers, especially in the case of complex financial transactions that led to the current financial crisis.¹⁸⁶ The boards seemingly failed to oversee the actions of the company executives. That also leads to the issue of the types of individuals who served on the boards of these companies. Obviously, many of them were independent directors, but not perhaps eminently suited for the position and for the roles they were expected to discharge.¹⁸⁷ Surely, these were highly accomplished individuals, but whether they were suited for the job is a different question altogether. Board independence does not seem to have instilled a strong level of monitoring on such boards.

5. Combined Roles of Chairman and CEO

Even the apparently onerous provisions of SOX have failed to address one key issue: there is no mandatory separation of the Chairman and CEO on U.S. corporate boards.¹⁸⁸ Most companies still have the same individual occupying the post of the Chairman and CEO.¹⁸⁹ That places such individual in a powerful

¹⁸⁴ See, S. Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207 (2008).

¹⁸⁵ *Id.*

¹⁸⁶ See, C. Icahn, *We Pay So Much For So Little*, (The Icahn Report, Sep. 17, 2008), available at <http://www.icaahnreport.com/report/2008/09/we-pay-so-much.html>.

¹⁸⁷ A news-report discusses the composition of the Lehman board:

Lehman’s five-member finance and risk committee, which reviewed the bank’s financial policies and practices, is chaired by Henry Kaufman, the respected former Salomon Brothers economist. But Roger Berlind, a board member for 23 years, left the brokerage business decades ago to produce Broadway plays. Another director, Marsha Johnson Evans, is a former chief of the American Red Cross and the Girl Scouts. Jerry Grundhofer, the former US Bancorp chief executive, is the only Lehman external director who has recently run a bank. But he did not sit on any board committees.

“This was not the strongest board for a company this size – in terms of age and in terms of people who have a toe in the water,” said one senior Lehman employee”.

MacIntosh, *supra* note 13.

¹⁸⁸ PAUL W. MACAVOY & IRA M. MILLSTEIN, *THE RECURRENT CRISIS IN CORPORATE GOVERNANCE* 98 (Stanford Business Books, 2003).

¹⁸⁹ *Id.* See also, LORSCH & MACIVER, *supra* note 148, at 184-87.

position, which allows for little transparency into such individual’s acts, as they can go unmonitored until they reach irreversible proportions. On the other hand, separation of these roles and having two separate individuals serve as Chairman and CEO allows the chair to serve as a constraint on the CEO, thereby providing checks and balances that result in better shareholder value. Although other jurisdictions such as the U.K. have long been practising the separation of these roles,¹⁹⁰ this is not mandated in the U.S., and despite several calls from corporate activists for such separation, that has not received due attention yet.

These are some of the plausible reasons for governance failures in the U.S. in the recent financial crisis.¹⁹¹

B. Key Factors in Indian Corporate Law and Governance

As we have already seen, there are significant differences in corporate structures and governance between the U.S. and India.¹⁹² In India, companies predominantly display concentrated shareholding structures (as opposed to the diffused shareholding structures in the U.S.). Most Indian companies have a controlling shareholder (or group of shareholders). Most of them are business families. In fact, it has been stated that a “*glance at India’s 500 most valuable companies, that together account for over 90% of the market capitalization of the Bombay Stock Exchange, reveals that about two-thirds of them are part of conglomerates or “business groups”*”¹⁹³. On the other hand, there are hardly a few companies listed in India that do not have a shareholder or group exercising control over the company. This concept of a controlling shareholder is further reinforced by the Indian legal regime as well. For instance, the concept of a “*promoter*” that is prevalent in various Indian regulations does just that.¹⁹⁴

¹⁹⁰ U.K. Financial Reporting Council, *The Combined Code on Corporate Governance*, ¶ A.2 (Jun. 2008) (stating that “[t]here should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for running of the company’s business. No one individual should have unfettered powers of decision”).

¹⁹¹ An additional factor that has been attributed for the governance lapses relates to the failure of the risk management system within the companies and lapses in board oversight of risk functions. As one leading U.S. law firm notes:

Risk from the financial services sector has contributed to large-scale bankruptcies, bank failures, government intervention and rapid consolidation. ... In addition, the public and political perception that undue risk-taking has been central to the breakdown of the financial and credit markets is leading to an increased legislative and regulatory focus on risk management and risk prevention.

Wachtell, Lipton, Rosen & Katz, Memo, *Risk Management and the Board of Directors* 1 (Nov. 2008).

¹⁹² *Supra* Part III.

¹⁹³ R. Chakrabarti, *Group Therapy Advised*, FINANCIAL EXPRESS, Aug. 13, 2008.

¹⁹⁴ See, *supra* note 76.

What then is the relevance of concentrated shareholding in the context of governance of companies in India? I now turn to the corporate governance factors discussed earlier¹⁹⁵ in the background of the financial crisis that originated in the U.S.:

1. No Separation of Ownership and Control

In India, controlling shareholders do have a say in the management and control of the company. Often, controlling shareholders themselves are managers. Alternatively, and by virtue of their shareholding, they do possess the power to appoint their own representatives as managers. Due to their controlling stake, they take a greater role in assessing the performance of the company and are usually in control of the management in companies as active (as opposed to passive) investors. It is arguable that such direct oversight by controlling shareholders benefits all investors. The problems arising from the separation of ownership and control ought not to appear here.¹⁹⁶

2. Lack of Director Primacy or Managerial Superiority

Unlike in the U.S., Indian boards are amenable to the wishes of the shareholders. Directors can be appointed and even removed, all through a simple majority as these decisions are required to be taken merely by ordinary resolutions at a shareholders' meeting.¹⁹⁷ Where directors or senior management do not demonstrate performance, they are liable to be removed by the controlling shareholders. This ensures that there is absence of self-perpetuation on the part of the incumbent board and managers.

3. Managerial Pay

The remuneration of directors and senior managers in Indian companies are not comparable to the kind of proportions witnessed in the U.S., although Indian pay-scales at the top echelons have seen a steady increase over the years.¹⁹⁸ However, the key difference in India (at least in theory) is that senior management's pay is subject to shareholders' approval and also to certain maximum limits in view of sections 309¹⁹⁹ and 198²⁰⁰, Companies Act, 1956. To that extent, shareholders

¹⁹⁵ *Supra* Part VA.

¹⁹⁶ Concentrated ownership itself acts as a disciplining mechanism in countries where enforceable legal protection of investors is weak. This may help in monitoring managers, but may not entirely protect the interests of minority shareholders. See, Shleifer & Vishny, *supra* note 88, at 754-55, Sarkar & Sarkar, *supra* note 66.

¹⁹⁷ *Supra* notes 84 and 85 and accompanying text.

¹⁹⁸ See, *India Inc Must Heed PM's Call*, THE ECONOMIC TIMES, May 31, 2007, B.S. Raghavan, *Curbing Runaway Executive Pay*, THE HINDU BUSINESS LINE, Jun. 1, 2007.

¹⁹⁹ Section 198 stipulates the maximum amount of managerial remuneration payable by a company.

²⁰⁰ Section 309 stipulates the maximum amount payable to the directors of the company.

do have a "say on pay" that is mandated by law, unlike in other markets (such as the U.S.) where the decision is largely left in the hands of the boards of directors or their compensation committees.

4. Board Oversight

Unlike the U.S. boards which place a lot of emphasis on board independence, Indian boards consist of a mix of inside directors (such as representatives of the promoters) and outside directors (such as independent directors). This is likely to ensure greater discussion and participation on boards as compared to boards which are loaded with independent directors who tend not to have adequate information so as to participate effectively, and this is especially so during periods of crises as currently witnessed by several U.S. financial institutions.²⁰¹

5. Chairman and CEO

On this count, neither the U.S. nor India mandatorily requires a separation of the position of Chairman and CEO. However, in practice, it is found that more Indian companies follow the separation than do the U.S. companies.²⁰² Hence, in the Indian context, non-executive chairmen of several companies do play a significant role in stimulating more open discussions on boards and also acting as a check on the management of the company (such as the CEO/managing director and other senior managers).

In sum, this points to the fact that the current corporate governance norms in the U.S. have not been successful in preventing corporate governance failures, and further goes to show that it may not be entirely efficacious for other countries such as India to adopt concepts from the U.S. when their own economies may not only have different corporate governance structures but also other checks and balances that may possibly tackle at least some of the governance issues.

VI. CONCLUSION

Over the last decade, giant strides have been taken by the Indian industry as well as its securities regulator, SEBI, to enhance measures of corporate governance in India. These developments have closely followed efforts in other jurisdictions such as the U.K. (the Cadbury Committee Report) and the U.S. (SOX). Globalization and internationalisation of capital markets are said to be the driving

²⁰¹ For a criticism of the role of independent directors in the recent financial crisis, see, *supra* note 187.

²⁰² One study on Indian companies indicates that 59% of the surveyed companies had a separate chairman and CEO. Balasubramanian, *et al. supra* note 16, at 14.

forces behind this phenomenon. While enhanced measures of corporate governance will only augur well for the Indian industry and perhaps also be reflected in firm values,²⁰³ these measures do not recognize the differences between the outsider systems of corporate governance (such as the U.S. and U.K.) from which concepts such as independent directors, audit committee and CEO/CFO certification have emerged, and the insider systems of corporate governance (such as India) into which they have been transplanted. Unless these differences are factored in by the regulators, courts, industry and academia, there would likely be difficulties in implementation of the enhanced corporate governance measures (reflected in Clause 49) and their assimilation within the Indian corporate ethos. Furthermore, the recent corporate governance failures in the U.S. and U.K. are evidence of inadequacies in those regimes, and hence the efficacy of their concepts of corporate governance to Indian circumstances is in considerable doubt.

To be sure, this Article is not intended to make a case against enhanced corporate governance measures. We are far down the path from that. What it does is to question the fit of the current measures with the Indian corporate structure and governance system. Because this Article's main focus is to identify and deliberate on the differences between various systems of corporate governance and to undertake a comparative study with reference to the U.S. and U.K. on the one hand and India on the other, it does not attempt to resolve these differences or to deliberate upon normative ideas that are suitable to India. That will have to await another day. Greater research is required to identify the specific agency problems between controlling shareholders and minority shareholders that are prevalent in the Indian context and to develop academic literature as well as regulatory solutions to deal with this problem. In insider systems, the essential role of corporate governance norms should be to remove the governance systems from the purview of controlling shareholders and place them outside their influence. In other words, the corporate governance systems ought to be zealously guarded against "capture" by the controlling shareholders. This is because the purpose of such systems is to protect the interests of the minority shareholders against the actions of the controlling shareholders. Towards this end, several structural changes to India corporate governance norms may be considered during further research, and I endeavor to list only a few of them to provide some modest illumination of the path ahead:

- (i) Improve the external audit process by eliminating or mitigating the influence of the controlling shareholders. The appointment, remuneration and control of auditors should not be within the influence of the controlling shareholders;

- (ii) Reduce the reliance on independent directors in insider systems as a check on management failures, unless independent directors are appointed through a larger democratic process that involves close (and inclusive) participation by minority shareholders;
- (iii) Expound the role of the independent directors on boards in insider systems and clearly elucidate the constituencies they ought to protect, *i.e.*, including the minority shareholders;
- (iv) Dilute the concept of "promoter" under law so as to enable a transition of companies from the insider model to the outsider model involving professionally managed companies;
- (v) Consider the imposition of fiduciary duties on controlling shareholders in insider systems (such as India) where such duties do not exist under current law or are otherwise inadequate; and
- (vi) Encourage large investors (such as financial institutions) who are not controlling shareholders or promoters to take up a more activist role in corporate governance of Indian companies so as to protect the rights of minority shareholders; as a corollary, enhance the robustness of remedies available to minority shareholders, particularly against conduct involving oppression or mismanagement.

It would augur well if the Indian corporate governance debate were to transcend beyond conventional wisdom to take into account these distinctive factors that are characteristic to the agency problems between controlling shareholders and minority shareholders, rather than to continue to operate under concepts that relate to the agency problems between shareholders and managers that are inappropriate to Indian corporate law and governance.

²⁰³ See, Black & Khanna, *supra* note 21, Dharmapala & Khanna, *supra* note 41.