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Board of Directors versus Shareholders: The Battle for Effective Corporate Governance and Corporate Control

Dissertation submitted in partial fulfillment of the requirement for the degree of LL.M. (Business Laws)

Submitted by;

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Dissertation Guide

DR. N.L. Mitra

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Declaration

I declare that this dissertation entitled "*Board of Directors v. Shareholders: The Battle for Effective Corporate Governance and Corporate Control*" is the outcome of my own work conducted under the kind supervision of Dr. N.L. Mitra, Professor, Corporate Law at National Law School of India University, Bangalore.

I further declare that to the best of my knowledge that the dissertation does not contain any part of work, which has already been submitted for award of any degree either in this University or in any other University/ Deemed University without proper citation.

Dated: 30th May 2011.

Place: Bangalore

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Certificate of the Supervisor

This is to certify that this dissertation entitled "*Board of Directors v. Shareholders: The Battle for Effective Corporate Governance and Corporate Control*" is a piece of research work done by Miss. Sabaha Khan, I.D.No. 386, student of 2009-11 batch LL.M. (Business law Group), at National Law School of India University, Bangalore under my guidance and supervision for the partial fulfilment of the requirement of LL.M. Degree at National Law School of India University, Bangalore.

Dated: 26th May 2011.

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Cases Discussed

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- *Cook v. Deeks, (1916) 1 AC 554.*
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Abbreviations Used

- ABI: Association of British Insurers
- AGM: Annual General Meeting
- AIC: Association of Investment Companies
- AR: Annual Report
- BSE: Bombay Stock Exchange
- CA: Companies Act of 1956
- CC: Combined Code of 1998
- CEO: Chief Executive Officer
- CFO: Chief Financial Officer
- CR: Cadbury Report
- CII: Confederation of Indian Industries
- DC: Delaware Court
- DRC: Draft Combined Code
- ESV: Enlightened Shareholder Value
- FDI: Foreign Direct Investment
- FIIs: Foreign Institutional Investors
- FRC: Financial Reporting Council
- FSA: Financial Service Authority
- GR: Greenbury Report
- HR: Hampel Report
- ICI: Imperial Chemical Industry
- IFSA: Investment and Financial Services Association
- IMA: Investment Management Association

- ISC: Institutional Shareholders Committee
- LA: Clause 49 of Listing Agreement
- LSE: London Stock Exchange
- NAPF: National Association of Pension Funds
- NASDAQ: National Exchange of Securities Dealers Automated Quotation
- NED: Non Executive Directors
- NTF: National Task Force
- NYSE: New York Stock Exchange
- OECD: Organization for Economic Co-operation and Development
- OUP: Oxford University Press
- PFI: Private Finance Initiative
- QIB: Qualified Institutional Buyers
- QRBs: Quality Review Boards
- SEBI: Security Exchange Board of India
- UK: United Kingdom
- US: United States

This dissertation is dedicated to the source of my Inspiration, Support and my Love

My Beloved Parents

&

My Grandmother

They are the pillars of my strength and courage. I wish that their love and support be with me in every sphere of my life. For whatever I will achieve in my life, I know their blessings are always with me.

Chapter- 1

Introduction

Corporate governance has become widely recognised international concept. It is a dynamic process by which companies are controlled and managed. Although the concept is acknowledged in various jurisdictions, there is no accepted definition. The concept does however, have essential attributes and features. In the wake of corporate scandals in the early 1980s , the UK and other countries acknowledged the pressing need to address issues such as financial irregularities in companies, corporate fraud; abuse of power; mismanagement; negligence; excessive remuneration, depletion of corporate funds; neglect of interest of shareholders; disassociation from the interest of stakeholders in the corporation; dissipation of contribution made by employees towards their pension funds; insider dealing; money laundering; the role of chairman and the chief executive; the status, role, effectiveness of non executive directors on company boards; the scope of company investigations into corporate affairs; corporate killing; and the role of shareholders in corporate governance.

Large modern corporations still wield unassailable economic power capable of adversely affecting the interest of stakeholders and other affected by their activities. With their managerial powers vested in directors, being the main controller's of corporation, there is a risk of abuse of those powers, to the detriment of the corporation and stakeholders. The problem has exacerbated in countries like UK and India where shareholders have delegated their powers of control to the directors. As residual claimants, shareholders have only limited powers vested in them, preferring mainly to invest capital. The shareholder expectation is that director will maximize shareholder welfare and act in the best interests of the company, and the director will act ethically in the pursuit of profit. Board of directors; however, need to balance the interests of shareholders with other stakeholders taking into account of other external constraints such as environmental consequence, consumer and public opinion etc. this requires the Board to understand the requirement of society and other community in which their company is situated.

In the 1980s the corporate scandals in the UK such as BCCI, the collapse of Maxwell Empire, Polly Peck and excessive director's remuneration heightened concerns about the ailing and antiquated system of corporate governance and highlighted the need to develop a radical system that would ensure transparency, flexibility and accountability in relation to corporate affairs and interaction with stakeholders. For some time, the corporations had been the subject of growing unease from shareholders and other interest groups on issues such as abuse of power, the structure of the corporate system (including accountability of directors, chairman and chief executive) and the apparent concentration of power in one person who would be both chairman and chief executive. The 1980s exploded the myth in the UK that the tripartite relationship within the corporation system of directors, shareholders and creditors were the most effective mechanism of corporate accountability and prevented corporate abuse. The events of that decade demonstrated that the process of corporate governance left wide scope for abuse: there were no effective checks and balances to monitor and prevent the abuse of corporate power and hardly any effective sanction is available, other than from disqualification from acting as director and the possibility of enforcing contributions towards the company assets in the event of liquidation. A number of potential claimants could become exposed to abuse of corporate power- particularly shareholders, the very claimant who should have been able to monitor and ensure accountability towards them by the directors. It became therefore, clear that the corporate governance system in whatever shape and form was in the UK and India was not working and was inappropriately placed to deal with the series of scandals that were coming to the light at that time. Questions were raised about the real function of corporations in society and how trust and confidence should be restored to provide shareholders with some comfort about their investment and it sparked a lively debate among industrialist, academics, economists and practitioners about how to modernize the system.

The concept of corporate governance basically therefore, originated in UK on the basis of the report of the committee set up by London Stock Exchange and the Financial Reporting Council of Britain under the chairmanship of Sir Adrian Cadbury. The Committee was constituted to look into the reasons behind the corporate scandals and to come up with suggestions of reform. The Report of the Committee along with the Code of Best Practice was published in December 1991 and all the companies listed in the LSE were required to publish in their Annual Report, the extent of compliance with the code along with the reasons of non-compliance. Mr. Cadbury explains corporate governance as a method to hold the balance between individual and communal goals to align as nearly as possible the interest of individual, corporations and society. Apart from Cadbury Report, some other committees were also constituted to deal with specific abuses in corporate governance which is discussed later.

The concept of corporate Governance in India took root in the context of massive expansion of the capital market activities consequent dilution of foreign equity in Indian companies and issue of huge capital offering by enterprising Indian entrepreneurs. The first institutional initiative in India was taken by the Confederation of Indian Industries in 1996 to have a code of corporate governance to be developed for the Indian corporate sector. This was followed by various committees under the chairmanship of Shri Kumar Mangalam Birla[1], Shri Naresh Chandra[2] and Shri Narayan Murthy[3]. Public comments were invited by the SEBI on August 26, 2003 incorporating a clause on corporate governance to be followed by all listed companies. Keeping in view the growing importance of corporate governance in the expanding corporate sector and its ramification in the society as a whole, it would be better if a section is introduced in the Companies Act so that an overall view of the subject can be taken by the government and necessary legislation may be passed instead of peace-meal regulation by SEBI for listed companies alone.

The role of corporate governance is to ensure that directors comply with their duties, obligations and responsibilities to act in the best interests of the company. They have the duty of loyalty towards their company, to give directions and remain accountable to their shareholders and other stakeholders. The failure of Company Law to address these issues were principally attributable to a lack of clarity as to the role, responsibilities and duties of directors and shareholders and fragmented nature of the companies legislation- layer after layer of recommendations have been added on to the existing Companies Acts in terms of directions and regulations. A modern framework transforming the various duties, obligations and responsibilities into a practicable and workable governance system was well overdue. The role of shareholders is as important as that of directors in corporate governance and this

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[1] www.sebi.gov.in/commreport/corpgov.html, last accessed on 2nd May 2011.
[2] www.manupatra.com/.../Report%20of%20the%20Committee%20on%20Regulation%... -, last accessed on 2nd May 2011.
[3] www.nfcgindia.org/library/narayanamurthy2003.pdf, last accessed on 2nd May 2011.

work basically deals with the role and responsibilities of these two important constituencies in corporate governance. The role of shareholders continues to be an important aspect in corporate governance debate. Traditionally, the shareholders were perceived as passive investors in their companies leaving it to directors to manage the companies' affairs without any effective control and mechanisms vested in shareholder to hold directors accountable for their actions. Since 1992 there have been significant developments ensuring shareholders are able to participate in the effective governance in the corporation through accountability, transparency and participation at Annual General Meetings. Now here comes the controversial debate of board of directors v. shareholders; the controversy of who leads whom in the battle of effective corporate governance and control of modern corporations.

Research Methodology

The Methodology adopted in making this dissertation is doctrinal using quantitative as well as qualitative methods. The researcher has used historical, analytical and descriptive method of writing. Thus both primary data i.e., data collected directly from the subjects and secondary data is used. The study was undertaken in a planned manner to make the systematic studyof the research work.

The methodology involved in the study includes: structural analysis (foundationalism), identificatory approach, explanatory approach, case study method and interpretativism.

Raison D'être/ Purpose of Study

Large modern corporations still wield unassailable economic power capable of adversely affecting the interest of stakeholders and other affected by their activities. With their managerial powers vested in directors, being the main controller's of corporation, there is a risk of abuse of those powers, to the detriment of the corporation and stakeholders. The shareholder expectation is that director will maximize shareholder welfare and act in the best interests of the company, and the director will act ethically in the pursuit of profit. Board of directors; however, need to balance the interests of shareholders with other stakeholders taking into account of other external constraints, this requires the Board to understand the requirement of society and other community in which their company is situated.

The role of corporate governance is to ensure that directors comply with their duties, obligations and responsibilities to act in the best interests of the company. They have the duty of loyalty towards their company, to give directions and remain accountable to their shareholders and other stakeholders. The failure of Company Law to address these issues were principally attributable to a lack of clarity as to the role, responsibilities and duties of directors and shareholders and fragmented nature of the companies legislation- layer after layer of recommendations have been added on to the existing Companies Acts in terms of directions and regulations. A modern framework transforming the various duties, obligations and responsibilities into a practicable and workable governance system was well overdue. The role of shareholders is as important as that of directors in corporate governance and this work basically deals with the role and responsibilities of these two important constituencies in corporate governance. The role of shareholders continues to be an important aspect in corporate governance debate. Now here comes the controversial debate of board of directors v. shareholders; the controversy of who leads whom in the battle of effective corporate governance and control of modern corporations.

This problem, known today as the principal-agent conflict between shareholders and managers, has been a challenge for corporate law and legislators since the beginning of the modern corporation in the early nineteenth century. The purpose of this research work is to make the systematic investigation of this problem and come up with suggestive conclusion to the debate of who leads whom in corporate market.

Scope and Limitation

The Dissertation is an attempt to undertake a comprehensive analysis of the corporate governance regime at present. The study starts with the detailed analysis of the evolution of the concept of corporate governance with the help of soft laws in the form of codes and committee reports, special emphasis have been given on the combined code regulations on corporate governance followed by Indian Committee Reports. The role and responsibilities of the directors towards their companies and shareholders are also discussed along with the implications of non observance of such duties. Various Board committees have been formed to look into the different aspects of corporate governance and how Non Executive directors and independent directors can play their roles more efficiently and resourcefully; these are the matters which required consideration and henceforth are given consideration. How the shareholders can increase their participation in the decision making process and the growing facets of Institutional investors are also discussed. General meeting can serve as an effective tool for the shareholders and institutional investors for the corporate control. Lastly, this paper analyses what is more important from the corporate governance perspective? Is it the shareholders control or directors' primacy in the realm of corporate governance?

Research Questions:

1. How the concept of Corporate Governance evolved as an effective tool to curb corporate abuse?
2. Whether various Committee Reports and Combined Codes on Corporate Governance acting as soft laws are sufficient to curb corporate abuses?
3. What are the roles and responsibilities of Board of Directors in ensuring effective corporate governance?
4. Whether Non-Executive Directors and Independent Directors are playing their task effectively and resourcefully?
5. Whether General Meeting can serve as a platform for shareholders for better corporate control?
6. Whether Institutional Investors are discharging their role as *Watchdog of corporations* efficiently?
7. Who will lead the Corporation as a means for effective Market Control? Is it Board of Directors or shareholders?

Literature Survey and Sources

The researcher has collected the primary data in the form of information collected from different sources like Reports and Manuals etc. Secondary sources of data have also been consulted. Help has been taken from:

(a) Literature in the form of Books, Articles, Magazines, Seminar Papers and Workshops,

(b) Legal Provisions-their aim and objective as well as work,

(c) Judgments of the Supreme Court, various High Courts and foreign Judgments.

Mode of Citation

The Researcher has followed uniform mode of citation throughout the research work.

Organization of Chapters

The Research work is divided into six parts. First chapter introduces the topic and gives a brief outlook of the thesis. The second chapter deals with the various concepts and historical evolution of corporate governance, and various codes and regulations till date. Chapter three is dedicated to the role, responsibilities and powers of board of directors, non-executive directors and independent directors. It also highlights the role and responsibilities of the chairman of a corporation and the function of various Board Committees. Chapter four deals with the power and responsibilities of shareholders, how general meeting can be effectively used as a tool for effective corporate governance and the role of institutional investors as a watch dog of corporation. Chapter five is the crux of this paper which analyses the debate between shareholder pragmatists and directors primacy supporters as to who leads whom in corporate governance. Chapter six is the overall concluding remarks on the work followed by bibliography. It should be noted that each and every chapter is independent and has its own introduction and concluding remarks yet they are interlinked and can't be refined without one common conclusion about the topic.

Chapter-2

Concepts and Historical Evolution of Corporate Governance

2.1 Introduction

Corporate governance as a concept and as a problem area was first discussed in the United States; later, the European debate started in the United Kingdom. From there the issue of corporate governance began its pervasive course through all the modern industrial states, including Australia, China and India. Contributions and research projects on the topic abound all over the world[4]. During the last two decades in many of these countries, corporate and capital market law reforms have taken place or are underway with the express or implicit aim of improving corporate governance or particular elements of it[5].

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company[6].

This problem, known today as the principal-agent conflict between shareholders and managers, has been a challenge for corporate law and legislators since the beginning of the modern corporation in the early nineteenth century. Efforts to minimize this conflict have met with limited success, as the constant law reforms-sometimes exhaustive new codifications,

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[4] ECGI, see www.ecgi.org/ with comprehensive information and two working paper series "Law Series" and "Financial Series"; SSRN Corporate Governance Network (CGN), see www.ssrn.com/cgn; International Corporate Governance Network, see www.icgn.org., last accessed on 3rd May 2011.

[5] Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation, American Journal of Comparative Law,* 2011.

[6] Examples of codifications are the Australian Corporation Act 2001, the UK Companies Act 2006 and the plans of the "grosse Aktienrechtsreform" in Switzerland, 27CH 2. Germany stands as an example for piecemeal reforms with sixty-eight reforms of the Stock Corporation Act 1965. Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe, J. Econ. Persp.* Vol- 21, 2007. But see also Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standard, University of Pennsylvania Law Review,* Vol-157, 2009.

sometimes piecemeal acts amply illustrate. The history of corporate governance[7] is also a history of crises and scandals, as seen in cases like Enron, WorldCom, Parmalat and others in nearly every country[8]. The international financial crisis that began in 2008 has added additional problem cases, governance and systemic failures, and reform experiments, though one has to keep in mind that the extent to which corporate governance failures have contributed to the coming about of the financial crisis[9] is much debated. On a microlevel the same is true for the relevance of corporate governance for firm performance[10].

All countries have experienced and still experience crises and scandals of corporate governance[11]. However, the problems are not necessarily identical, and adequate answers and reforms are even less uniform. While legislators and regulators often tend simply to imitate responses emerging in other countries in the vague hope that they will also benefit their own system, it is rather the characteristic features of the corporate governance system of each country that help to understand its unique crises and scandals. Reform proposals in particular go astray if one does not understand how the unique combination of economic, legal and social determinants of corporate governance functions in each country.[12] A functional comparative analysis of existing methods will help to clarify the similarities and differences of corporate governance systems and therefore provide more useful general conclusions. Such an approach presupposes solid information on corporate governance features of not just a small handful of somewhat arbitrarily selected countries, but rather of a relatively large number of jurisdictions, and among them systems from different continents, legal families, cultures and traditions. Such broad and wide-ranging information will aid our understanding

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[7] Edward S. Adam, *Bridging the Gap between Ownership and Control, Journal of Corporation Law*, Vol- 34, 2009.

[10] For example Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance, Journal of Corporate Finance*, Vol- 14, 2008. As to the problems of corporate governance indices, Klaus J. Hopt, *Comparative Corporate Governance: the state of the Art and International Regulation, American Journal of Comparative Law*, Vol- 59, 2009.

[11] Naresh Kumar, *Concept of Good Corporate Governance, Tax and Corporate Referencer*, Vol- 26, 2006.

[12] See Surendra Arjun, *Corporate Governance- An Ethical Perspective, Journal of Business Ethics*. Vol- 61, 2005.

of the different systems and their path dependencies, assist us in developing best practices and bring about meaningful reform on the basis of comparative experience[13].

2.2 Corporate Governance: Concepts and General Problems

2.2.1 Concepts of Corporate Governance

The term "corporate governance" is relatively new; in most jurisdictions it is not a legal term, and its definition is ambiguous. For the purposes of this comparative study, the broad definition of the Cadbury Commission of 1992[14], written at the beginning of the modern corporate governance movement[15], is best suited: corporate governance is *"the system by which companies are directed and controlled."* Thus, direction and control are the two cornerstones of a corporate governance system.

More specifically, the use of either shareholder or stakeholder orientation characterizes the system. The classic shareholder-oriented approach prevails in the United States, and also in economic theory. Many European countries, such as Germany and the United Kingdom, have a stakeholder approach instead; in the former, this concept is further strengthened by labour codetermination on the board. In its weaker form, corporate law mandates that the board act in the interest of the enterprise as a whole, a requirement which is of course open to multiple interpretations[16].

The prevailing shareholder constituency of a country is also of considerable relevance[17]. Examples include the predominance of widely-held public companies with dispersed shareholdings, employing "separation of ownership and control" (Berle-Means

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[13] Klaus J. Hopt, *Comparative Corporate Governance- The state of the Art and International Regulation, American Journal of Comparative Law*, Vol- 59, 2011.
[14] http://www.noblecorp.com/Docs/Guidelines.pdf, last accessed on 13th May 2011.
[15] Adrian Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance, London, December 1992; Combined Code.
[16] See section 76 of the German Stock Corporation Act and an endless amount of doctrinal controversy on this question. As to economic and social science theories, see Thomas Clarke ed., *Theories of Corporate Governance: The philosophical Foundations of Corporate Governance*, 2004.
[17] As to the patterns of corporate ownership, Eric R. Godajlovic and Daniel M. Shapiro, *Management and Ownership Effect: Evidence from Five Countries, Strategic Management Journal*, Vol- 19, 1998.

corporations)[18], as traditionally found in the United States[19] and in Great Britain[20], or the existence of many blockholdings, family corporations and groups of companies, as found in many Continental European Countries. In addition, the presence of Institutional Shareholders, private equity and hedge funds is significant[21].

2.2.2 Internal and External Corporate Governance

Corporate governance is focused on the internal balance of powers within a corporation. The main questions of this internal balance in contrast to external corporate governance concern the relationships between the board, be it a unitary or two-tier board; shareholders, both controlling and minority; labour, especially if codetermination is a factor; and of course the audit system[22].

Forces from outside the corporation exercise a disciplining influence on management as well, in particular various markets such as takeovers[23], and to a lesser degree the product and services markets and the increasingly international market for corporate directors. Transparency of corporate affairs and disclosure to the shareholders, supervisors if any and the general public are also such external forces. External corporate governance by takeover regulation and more generally disclosure and transparency are huge research fields of their own and cannot be covered here[24].

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[18]Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property*, New York 1932 (Brunswick 1991).

[19]But see Ronald Anderson et al., *Founders, Heirs, and Corporate Opacity in the U.S., Journal of Financial Economics*, Vol- 92, 2009.

[20] Brian Cheffins, *Corporate Ownership and Control, British Business Transformed*, Oxford University Press, 2008.

[21] Klaus J. Hopt, *Comparative Corporate Governance- The state of the Art and International Regulation, American Journal of Comparative Law*, Vol- 59, 2011.

[22] The audit system consists of the audit committee of the board and the auditors of the company (see III D). In some countries, internal auditors work as organs of the corporation; however, in most countries today the auditors are external professionals. These external auditors are in a hybrid situation between internal and external corporate governance because they are involved in the company's financial reporting but must remain independent.

[23] The takeover market is usually referred to as market for corporate control, i.e., the market in which corporate control is bought, often by public takeover bids by the bidder to the shareholders of the so-called target company. In many countries, the codes as well as the discussions on corporate governance focus on internal corporate governance, takeovers being treated as a separate field.

[24]Klaus J. Hopt, *Comparative Corporate Governance- The state of the Art and International Regulation, American Journal of Comparative Law*, Vol- 59, 2011.

2.3 The Role of Scandals, Financial Crises, and Legal Transplants

2.3.1 The Impact of Corporate Governance Scandals on Corporate Governance Rules

Corporate, stock exchange and capital market reform has to a considerable degree been driven by corporate scandals; this is true also for corporate governance. Prominent examples are Enron and WorldCom in the United States, Parmalat in Italy, Vivendi Universal and France Telecom in France, the New Market in Germany, and HIH Insurance and One, Tel in Australia[25]. Yet all these cases involved more than just corporate governance failures; each included intentional non-observance of mandatory legal rules, and often even fraud and criminal behaviour. In the case of Enron, it has been said that its formal corporate governance was exemplary, with its requirements for independent directors and all the other modern corporate governance devices.[26] The reality, of course, was different: Enron's highly reputed directors learned of the existence of special purpose vehicles into which many of the risk papers were positioned only after the crisis had broken out. The positive by-product of scandals is that they show where regulation has lacunae or is not effective. Unfortunately, experience shows that legislators and rule-makers tend to overreact to these events, as scandal-driven legislation often goes a step too far. The Sarbanes-Oxley Act of 2002[27] is only one albeit prominent example that has been criticized by some as "quack" legislation.[28]

2.3.2 The Impact of the Financial Crisis

The current financial crisis provides further examples of the impact of crises on law-making. As hurried reforms of legislation on directors' remuneration in many countries show, crisis law-making may be carried out too quickly, and may reach too far. In Germany, instead of giving the Corporate Governance Code Commission time to stiffen its recommendations on directors' remuneration in a well-considered and flexible way, as the French legislators did, the German parliament reacted with a hastily prepared, mandatory law reform that resulted in

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[25] Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.

[26] Kshama kaushik and Kaushik Dutta, *Corporate Governance- Myth to Reality*, Lexis Nexis Buttersworth, 2005.

[27] Sarbanes-Oxley Act of 2002, PubLNo 107-204, 116 Stat. 745, codified in sections of Titles 11, 15, 28 and 29 of the U.S. Code; 32USAI 35 et s.

[28] Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008; also see Klaus J. Hopt et. Al (ed.), *Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and US*, Oxford University Press, 2005.

many new legal problems[29]. To be sure, remuneration in the financial sector is different from salary standards in other areas. There the perverse incentives, not only for board members, but for all categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking needed quick and stringent re-regulation such as set forth by the European Commission Recommendation of 30 April 2009.[30]

In the light of these failures and scandals which cropped up on the face of corporate governance, various committees were established in the west and in India to give suggestions on the following issues:

- Board composition and definition of director independence.
- Qualification and competencies of directors.
- Remuneration of directors
- Integrity of the financial reporting system
- Analysis and disclosure of business risks and company's risk management policies.
- Insider Information advantage
- Shareholder democracy[31].

2.4 Conceptual Analysis of the Various Codes on Corporate Governance

The 1990s seemed in "danger of becoming a decade of corporate governance"[32]. Although corporate governance in the form of check and balances by which directors are accountable to shareholders for the way they manage their company or setting standard of corporate governance for companies was nothing new , the subject had hardly attracted much debate in United Kingdom. Regulators were largely content to rely on the provisions of the Companies

[29] Sections 87(1), (2), 93(2) of the Stock Corporation Act as of 2009, 12Germ 3 et s. As to the compensation reforms in the United States, see 32 USAI 39.

[30] Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, OJEU L 120/22.

[31] Kshama V. Kaushik and Kaushik Dutta, *Corporate Governance: Myth to Reality*, Lexis Nexis Buttersworth, 2005.

[32] Chris Riley, *The Final Report of Hampel Committee on Corporate Governance, The Company Lawyer*, Vol-19,1998.

Act to regulate the statutory duties of directors, supplement by case laws to deal with director's duties, institutional investor's rights and duties.[33]

However, in the 1990s after series of corporate scandals, the debate on corporate governance has come to prominence as a specific and most controversial issue resulting from the work of three committees: *Cadbury, Greenbury and Hampel.*[34] The work of these committees led to the issuing of the *Combined Code 1998*[35] by the *London Stock Exchange (LSE)* on 25th June 1998. Thus corporate governance in the UK became prominent issue after the release of the *Cadbury Report* in 1992. *Cadbury Report* was followed by other Corporate Governance reports such as *Greenbury Report (1995), Hampel Report (1998)*.[36] While the Combined Code can now be thought of as the definitive guide to corporate governance in the UK, this does not mean that debate concerning the topic has ended. Instead, the work carried out by the Cadbury, Greenbury, and Hampel Committees has raised various issues that are likely to generate further discussion and analysis in corporate world. Moreover, the topic of corporate governance has preoccupied much debate in Britain over the past few years. There has been a great amount of commentary in the press over trilogy of committees: Cadbury, Greenbury, and Hampel[37]. The work which has been done in the United Kingdom has sparked reviews of corporate governance in markets around the world and has provided a yardstick against which investment frameworks in other countries are measured[38].

It should be noted that the Combined Code does not have any direct statutory backing. The only applicable enforcement mechanism of a legal character is a requirement that companies, as a continuing obligation of listing on the Stock Exchange, describe how they have applied the Combined Code's Principles and discuss the extent to which they follow the Code of Best Practice. The objective was to not to compel all companies, whether big or small to comply

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[33] Saleem Shiekh, *Introduction to the Corporate Governance Themed Issue, International Company and Commercial Law Review*, Vol- 9, 1998.

[34] Victoria Younghusband, *Corporate Governance in the United Kingdom, International Company and Commercial Law Review*, Vol- 9, 1990.

[35] Committee on Corporate Governance Combined Code, (Hereafter, Combined Code 1998).

[36] James Mc Convil et. al. *Principles of Contemporary Corporate Governance*, Cambridge University Press, 2007.

[37] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.

[38] Brain R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto, Duke Journal of Comparative and International Law*, 1999.

with this code but only to secure sufficient disclosure so that shareholders and others like creditors or employers can assess company compliance with corporate governance principles[39].

2.4.1 Analysis of Cadbury and Greenbury Report:

In 1991, after harsh economic realities had exposed existing methods of financial reporting to unusual close scrutiny in the 1980s/ early 1990s, the Cadbury Committee was set up by the *Financial Reporting Council (FRC),* the *London Stock Exchange (LSE),* and various members of the accounting profession[40]. It was chaired *Sir Adrian Cadbury,* Chairman of ICI. The Cadbury Committee grew out of the continuing concern about standards of financial reporting and accountability heightened by high profile crisis such as the collapse of the Bank of Credit and Commerce International[41], Polly Peck[42] and the Maxwell Group[43].

The stated objective was *"...to help to raise the standard of corporate governance and the level of confidence in financial reporting and auditing..."*[44] This resulted in *Cadbury Report,* which was issued in 1992, and which reviewed the structure and responsibilities of board of directors, the role of auditors and the rights and responsibilities of shareholders. The recommendations in relation to directors were summarized in a *"Code of Best Practice*[45]*."*This code requires all listed companies to include a statement in their annual report acknowledging compliance with the Code's terms or justifying instances of non compliance.[46] With their issue of 1st December 1993, the LSE added force to the recommendations of the report by amending the Listing Rules so as to require listed companies to make a statement about their level of compliance with the *Cadbury* "Code of

39 Saleem Sheikh, *A Practical Approach to Corporate Governance,* Lexis Nexis Buttersworth, 2003.
40 Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties,* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.
41 Financial Times, "Biggest Bank Fraud in History", 9th November 1991, taken from www.forexcare.net, last accessed on 4th May 2011.
42 Financial Times, "Polly Peck Affairs", 2nd October 1990.
43 Financial Times, "Collapse of the Maxwell Empire", 6th December 1991.
44 Committee on the Financial Aspects of Corporate Governance, Report of the Committee on the Financial Aspects of Corporate Governance, paras 2.1 and 2.8. (Hereafter: Cadbury Report).The full text can be downloaded from www.ecgi.org/codes/documents/cadbury.pdf.
45 The Report of the Committee on the Fiscal Aspects of Corporate Governance, The Code of Best practice, (Hereafter: Cadbury Code).
46 Stephen Griffin, *Company Law,* Essex, 3rd ed. 2000.

Best Practice" under section 12.43 and to give reasons for non compliance[47] the so called "comply and explain statement"[48].

In January 1995 the *Greenbury Committee*, chaired by *Sir Richard Greenbury,* Chief Executive Officer of Marks and Spencer, was set up to identify good practice in determining directors' remuneration and prepare a Code of such practice for use of UK companies[49]. The resultant *Greenbury Report*[50], is issued in July 1995, contained a "Code of Best Practice for Directors' Remuneration". The fundamental principle of this Report in relation to directors' remuneration is *"accountability, transparency and linkage to performance"*[51].

Both committees have been formed as a reaction against corporate sectors failings in: financial reporting and boardroom reporting. They did not attempt a reform of corporate governance in its entirety[52].

Thus, Cadbury emphasised on these following notions:

- The wider use of independent non executive directors.
- The introduction of an Audit Committee of the board with a minimum of three non executive directors with a majority of them independent.
- The division of responsibilities between the chairman of the board and chief executive, but if the roles were combined in single person, the board should have a strong independent element.
- The use of the remuneration committee of the board to oversee executive rewards.
- The introduction of the nomination committee with independent directors to propose new board members and
- Adherence to the detailed code of best practice.

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[47] Alice Belcher, *Regulation by the Market: The Case of the Cadbury Code and the Compliance Statement, Journal of Business Law,* 1995.

[48] Neil Harvey, *Corporate Governance: The British Experience, International Business Law Journal*, 1995.

[49] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.

[50] Study Group on Directors' Remuneration, Directors' Remuneration. (Hereinafter: Greenbury Report).

[51] Richard Smerdon, *A Practical Guide to Corporate Governance*, Thomson Sweet and Maxwell, 2004.

[52] Alan Dignam, *A Principle Approach to Self Regulation? The Report of the Hampel Committee on Corporate Governance, The Company Lawyer*, 1998.

It is interesting to note that being written more than seventeen years ago, this report contained many proposals that remain at the heart of today's corporate governance thinking and provides a shield for good corporate governance practice.

Similarly, *Greenbury Report,* addressed issues of directors' remuneration, then as now a matter of concern to directors, the media and society at large. The *Greenbury Report* recommended that:

- The remuneration committees of companies should consist solely of independent non executive directors.
- The chairman of the remuneration committee should respond to shareholders' questions at AGM.
- AR should include details of all directors' rewards- naming each director.
- Directors' contracts should run for no more than a year to avoid excessive golden handshakes.
- Share options schemes for directors' should be linked to long term corporate performance.[53]

2.4.2 Hampel and the Combined Code 1998

This changed with the set up of the *Hampel Committee* on the initiative of the Chairman of the *FRC* in November 1995, which was aired by *Sir Ronald Hampel,* Chairman of ICI. The *Cadbury* and *Greenbury Reports* had suggested that a new committee should review the extent to which their findings were being implemented[54]. The remit of the *Hampel Committee* was "...to review the Cadbury Code and its implementation to ensure that its original purpose is being achieved. We are also asked to pursue any relevant matter arising from the Greenbury Report. But we have an additional task, to look afresh at the role of directors, shareholders and auditors in corporate governance."[55] In contrast to the two former committees, the Hampel Committee was not appointed as a reaction to a particular scandal or public outcry and thus expected to be able to forward a non defensive, proactive approach to

[53] Bob Tricker, *Corporate Governance: Preamble, Policies and Practices*, Oxford University Press, 2009.

[54] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties*, published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.

[55] Committee on Corporate Governance, Final Report, para 1.6 (Hereafter: Hampel Report).

corporate governance.[56] Thus, the Hampel Committee was the first committee to deal with the whole spectrum of corporate governance in UK[57].

The Hampel committee produced a preliminary report in August 1997, a final report in January 1998, a draft document which was set of principles and a code which embraced *Cadbury. Greenbury* and their own work. This document then was passed on to the LSE which published a consultation document setting out the "*Draft Combined Code*" and the proposed related changes to the Listing Rules in March 1998. Following further consultation, the LSE made a number of changes to the draft, with the *Hampel Committee's* Agreement[58].

The *Combined Code 1998,* was then appended (it does not form part of, but has the status of appendix) to the LSE Listing Rules- which are now the Financial Service Authority (FSA) Listing Rules[59]- by inserting a new paragraph 12.43A that is effective for annual reports and accounts published by companies in respect of accounting periods ending on or after 31st December 1998. Under the heading of "Corporate Governance", the new paragraph 12.43A required the following items to be included in the annual reports and the accounts:

- Narrative statement of how it has applied the principles set out in Section 1 of the Combined Code 1998, providing explanation which enables a shareholders to evaluate how the principles have been applied.
- Statement has to whether or not it has complied throughout the accounting period with the code provision set out in Section 1 of the Combined Code 1998. A company that has not complied...or complied with only some...must specify the...and give reasons for any non compliance.

[56] Hampel Report, para 1.7.
[57] Alan Dignam, *A Principle Approach to Self Regulation? The Report of the Hampel Committee on Corporate Governance, The Company Lawyer,* Vol- 141, 1998.
[58] Ben Pettet, *The Combined Code 1998: A Firm Place for Self Regulation in Corporate Governance, Journal of International Banking Law,* Vol- 12, 1998.
[59] Under the Official Listing of Securities Regulation 2000 (SI 2000/968), the FSA became, with effect of 1st May 2000, the competent authority under the Financial Service Act 1986. Now, the FSA is acting as UK Listing Authority.

The technique of "comply and explain statement", which had been already used by the *Cadbury Committee,* was thus continued[60].

The basic feature of the Combined Code which distinguishes it from the *Cadbury* and *Greenbury Codes* is the emphasis on the desirability of complying with basic principles and, in addition, complying with more specific provisions contained in a *Code of Best Practice.*

It is crystal clear to anyone familiar with the Cadbury Code of Best Practice that most of its provisions finds its way in combined code; but it is worth observing that, less obviously, many of the principles and code provisions in the Combined Code are derived from recommendations or suggestions in the text of the Cadbury Report which did not find their way into the Cadbury Code[61]. In this latter regard, then, where the Hampel Committee agreed with the ideas in the recommendations of the Cadbury Committee, they had taken that ideas from it and after combining their own along with amendments added it to combined code[62]. The vagueness of the status of some of Cadbury's recommendations and suggestions had rightly been the subject of adverse comment and criticism. Many of the conclusions of the Hampel Committee had been to affirm the earlier work of Cadbury, which does indeed give the Hampel Report a vague and, in places, somewhat familiar feel, and at the time of the publication of the preliminary report, the Hampel Committee were criticised for creating confusion[63]. Of course, the Hampel Committee developed many valuable new ideas, but the reality is that the Hampel Report itself was very much unfinished business and it is in the

[60] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties,* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.

[61] Although some of them were code provisions in Cadbury which are elevated to the status of principles in the Combined Code; e.g. Cadbury Code para. 1.2 becomes part of Combined Code Principle A.2.

[62] For example, the basic idea in the Cadbury Report, para. 4.1, first sentence, does not find its way into the Cadbury Code but becomes Principle A.1 in the Combined Code. Other examples include Cadbury Report, para. 4.14 on the supply of information for non-executive directors which does not appear in the Cadbury Code, but in a broadened-out form appears as Principle A.4 in the Combined Code. Sometimes the Cadbury idea ends up as a code provision rather than a principle; for instance, the concept of nomination committee is mooted in Cadbury Report, para. 4.30, but does not make it into the Cadbury Code. Hampel adopts it and firms it up by making it a code provision (A.5.1) in the Combined Code.

[63] "Hampel has created a certain amount of confusion in the area of corporate governance because the Committee says that their objective is to draw together the conclusions of their own report and those of their predecessors, Cadbury and Greenbury, to form a single set of principles and code. At a press conference, Committee chairman Sir Ronald Hampel ... admitted that he did not yet know which parts of the three reports would be retained." Financial Times, August 10, 1997.

collation and production of the Combined Code that the true strength of the overall contribution of the Hampel Committee becomes apparent[64]

Overall, it can be concluded that combined code had lead the way to a sound system of corporate governance. Nevertheless, the combined code is not immune to changing commercial and market requirements and had to keep up to date to remain on its high level. That's why certain changes have been done in this Code and FRC came up with three new combined code setting standard of corporate governance in the year 2003, 2006, 2008 and 2010.[65]

2.5 Evolution of Corporate Governance in India

2.5.1 The CII Code

The development of corporate governance in India can be traced in particular from the establishment by the CII in 1996 of a NTF under the chairmanship of a leading business figure, Rahul Bajaj. The motivations behind this initiative included, at one level, public concern with fraudulent stock offers during the early 1990s and, at another, the expectations of international investors with regard to transparency and disclosure.[66] The Task Force was in due course responsible for the production in 1998 of a code of best practice entitled Desirable Corporate Governance[67]. In setting out its understanding of corporate governance, the CII Code expressed faith in what would shortly after be defined as the Enlightened Shareholder Value (ESV) model by the Modern Company Law Review in the United Kingdom.[68] Thus the CII Code is clear that corporate governance is concerned with managerial decision-making in the context of the company's relationships with a range of stakeholders, that shareholders are the residual claimants, that focusing on long-term shareholder value is the

[64] Ben Pettet, *The Combined Code 1998: A Firm Place for Self Regulation in Corporate Governance, Journal of International Banking Law,* Vol- 12, 1998.

[65] These Codes are available on www.ecgi.org last accessed on 5th May 2011.

[66] Confederation of Indian Industry, Desirable Corporate Governance: A Code (1998) (CII Code). See the foreword by N. Kumar, president of the CII. See also Solomon, *Corporate Governance and Accountability*, John Wiley and Sons Ltd, 2007; Bob Tricker, *Corporate Governance: Principles, Policies and Practices*, Oxford University Press, 2009.

[67] Varun Bhat, *Corporate Governance in India: Past, Present and Suggestions for the Future, Iowa Law Review,* Vol- 92, 2007.

[68] Company Law Review Steering Group, Modern Company Law for a Competitive Economy: the Strategic Framework, London: DTI, 1999, paras 5.1.12, 5.1.17 to 5.1.23.

best way to satisfy the claims of other stakeholders and that claims should be restricted to those that may be raised by shareholders and creditors[69]. The recommendations of this voluntary code indicated a clear awareness of developments in corporate governance in countries such as the United Kingdom insofar as they touched on the role of independent non-executive directors (NEDs)[70], focused on the appropriate scale and form of directors' remuneration[71], specified in detail the sort of information that should be reported to the board,[72] required audit committees for companies over a certain size[73], and called for compliance certification by CEOs and CFOs[74]. The CII Code also dealt with issues peculiar to the Indian context, in particular the fact that the financial institutions that were the largest shareholders were in the public sector (designated as public financial institutions or PFIs in a 1974 amendment to the Companies Act 1956[75]) with the consequence that their monitoring of corporate governance and placement of nominee directors did not appear to operate in the same way as with private sector institutions in developed markets. A number of factors were identified including: government involvement in decision making; lack of appropriate reward structures; and a tendency to favour stability over challenging the board[76]. As one commentator has put it, "In most instances these board members are believed to have supported existing management decisions.[77]"

2.5.2 The Birla Report and Clause 49

The next development was at the initiative of the Securities and Exchange Board of India (SEBI), the market regulator[78], which established a committee on corporate governance under the chairmanship of Shri Kumar Mangalam Birla, which committee duly reported in 1999. This is a particularly important document, as it represents the "first formal and

[69] CII Code, 1998, p.1.
[70] CII Code, 1998, recommendation 2. See also Cadbury Committee, 1999, paras 4.10 to 4.17.
[71] CII Code, 1998, recommendation 5. See also Cadbury Committee, 1999, para.4.40. See especially, Sir Richard Greenbury, Directors' Remuneration: Report of a Study Group, London: Gee, 1995.
[72] CII Code, 1998, recommendation 7. See also Cadbury Committee, 1999, paras 4.23 to 4.24.
[73] CII Code, 1998, recommendation 8. See also Cadbury Committee, 1999, paras 4.33 et seq.
[74] CII Code, recommendation 11.
[75] Companies Act 1956 s.4A.
[76] CII Code, 1998, recommendation 17.
[77] Kathryn C. Lavelle, *Politics of Equity Finance in Emerging Markets,* Oxford University Press, 2004.
[78] Note that the stock market regulator is a relatively recent phenomenon in India. SEBI was established by the Securities and Exchange Board of India Act 1992. See also the Securities and Exchange Board of India (Amendment) Act 2002.

comprehensive attempt to evolve a Code of Corporate Governance,[79] in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets"[80]. Influenced by the CII report, as well as by developments in the United Kingdom and the United States, the Birla Committee too adopted an essentially ESV approach, agreeing that the "fundamental objective of corporate governance is the 'enhancement of shareholder value, keeping in view the interests of other stakeholders"[81]'. While the impact of the CII was acknowledged, it was also noted that this impact was restricted to some "progressive"[82] or "forward looking companies"[83]. The Committee was accordingly clear that "under Indian conditions a statutory rather than a voluntary code would be far more purposeful and meaningful"[84]. While the Committee did then go on to note that some of its recommendations would require legislative change[85], by far the most important developments were to be achieved by modifications to the listing agreement[86]. The language of the report in this regard is, however, apt to mislead, for although the subsequent recommendations are identified as either mandatory or non-mandatory, this terminology is employed simply to differentiate those which the Committee felt could only be implemented via legislation (and over which it and the SEBI accordingly had no control) from those which could be implemented by amendments to the listing agreement. Thus, while a cursory reading of the report could lead the reader to assume that the approach here stands in stark contrast to the lighter touch "comply or explain" approach to be found in the United Kingdom's Combined Code[87], in fact it transpires that practically the same approach is envisaged. This becomes clear towards the end of the report where the Committee notes in relation to the separate section on corporate governance which it envisages as being part of the company's annual report that:

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[79] John Paterson, *Corporate Governance in India in the context of Companies Bill 2009, International Company and Commercial Law Review*, Vol 21(03), 2010.
[80] SEBI, Report of the Committee Appointed by SEBI on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla, 2000 (Birla Report), para.3.1.
[81] Birla Report, 2000, para.4.2.
[82] Birla Report, 2000, para.1.1.
[83] Birla Report, 2000, para.1.7.
[84] Birla Report, 2000, para.1.7.
[85] Birla Report, 2000, para.2.2.
[86] Birla Report, 2000, para.2.5.
[87] See Cadbury Committee, 1999, paras 3.7, 3.14 and 6.6. See now, Financial Reporting Council, The Combined Code on Corporate Governance, June 2008 (Combined Code).

one of the then Big Five auditing firms, and the passing into law of the Sarbanes-Oxley Act. The Committee reported on December 23, 2002 and opened by noting the advances that had been made as a consequence of the Birla Report and cl.49 of the listing agreement. Indeed, it went so far as to say that the guidelines to which Indian companies were now subject "rank among some of the best in the world[105]". It continued in a much more pessimistic tone, however, by suggesting that there was nevertheless "a wide gap between prescription and practice" and that the enforcement of corporate governance was hampered by "inefficiency, corruption and the intricate, dilatory legal system"[106]. The list of areas that the Committee was asked to examine and if necessary recommend changes to focuses extensively on auditors, with mention also of CEO/CFO certification and of the role of independent directors.[107]

The Committee's recommendations appear significantly influenced by the Sarbanes-Oxley Act[108] and include the following: disqualification of auditors where there is a question over independence[109]; prohibition of certain non-audit services and prior approval required for others[110]; rotation of audit partners[111]; disclosure by an auditor of contingent liabilities and of qualifications to the audit report[112]; certification of annual audited accounts by CEO and CFO with repayment of such part of any bonus or similar payment as the audit committee determines in the event of a serious misstatement[113]; the establishment of Independent Quality Review Boards (QRBs) in relation to audit, secretarial and cost accounting firms (although the Committee stopped short of recommending an equivalent to the US Public

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[105] Department of Company Affairs, Report of the Committee on Corporate Audit and Governance under the chairmanship of Naresh Chandra (2002) (Chandra Report), para.2.

[106] Chandra Report, 2002, para.2.

[107] Chandra Report, 2002, para.4. This more pessimistic view was backed by the Central Vigilance Commissioner, N. Vittal, delivering the Tata Memorial Lecture in the same year when he said: "I find the legal and administrative environment in India provides excellent scope for corrupt practices in business. As a result unless a management is committed to be honest and observe the principles of propriety, the atmosphere is too tempting to observe good corporate governance in practice.

[108] Note, however, that some were immediately keen to qualify the nature of the comparison with the US legislation. See Amit C. Kamath, Naresh Chandra Reports: A Pale Shadow of SOX, Hindu Business Line, August 18, 2003.

[109] Chandra Report, 2002, recommendation 2.1. See also Sarbanes-Oxley Act 2002 s.206.

[110] Chandra Report, 2002, recommendation 2.2. See also Sarbanes-Oxley Act 2002, ss.201 and 202.

[111] Chandra Report, 2002, recommendation 2.4. Though the Sarbanes-Oxley Act only calls for a study into the question of auditor rotation; see s.207.

[112] Chandra Report, 2002, recommendations 2.5 and 2.6.

[113] Chandra Report, 2002, recommendation 2.10. See also Sarbanes-Oxley Act 2002 s.304.

Companies Accounting Oversight Board and the new QRBs were to be funded by the respective professional institute)[114]; the establishment of a Prosecution Directorate within the Institute of Chartered Accountants of India as a means of trying to overcome the legal system's delays in dealing with disciplinary matters[115]; a definition of independence in the context of directors that is explicitly said to be more precise than that contained in cl.49[116] (this apparently salutary step must, however, be read in the context of the committee's observations at this point that the "directors are the fiduciaries of shareholders"[117], evidencing perhaps a degree of confusion about the position of the director in Indian Company Law, which is the same in this regard as in English Company Law[118]); a requirement that at least half of the board be independent directors (with nominee directors excluded from the calculation[119] representing an interesting and reassuring contrast with the amendment to cl.49 in this regard discussed above); ensuring that audit committees were entirely staffed by independent directors[120] and that the work of such committees be carried out in accordance with a published charter.[121] A variety of recommendations also sought to improve the position of independent directors in terms of ensuring that they received all relevant information, and were appropriately trained[122]. More controversially, the recommendation was also made that a legal distinction should be recognised between executive and non-executive directors such that the latter were exempt from a range of criminal and civil liabilities[123]. While this last recommendation was explicitly designed to encourage the appropriate quality of individual to take on the role of NED, there must be a question as to whether this approach does not raise significant risks that NEDs will lack the incentive to carry out the tasks envisaged for them insofar as there would appear to be no adverse consequences for inadequate performance. It is not clear that the Committee considered whether the existing test for the duty of care would not adequately protect NEDs from

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[114] Chandra Report, 2002, recommendation 3.1. Sarbanes-Oxley Act 2002 s.101.
[115] Chandra Report, 2002, recommendation 3.2.
[116] Chandra Report, 2002, recommendation 4.1.
[117] Chandra Report, 2002, Executive Summary, para.23 (emphasis in original).
[118] See Bikramaditya Ghosh and Karmedra Singh, *Directors' Duties in India: Strengthening the Laws on Trusteeship, International Company and Commercial Law Review*, Vol- 119, 2009.
[119] Chandra Report, 2002, recommendation 4.1.
[120] Chandra Report, 2002, recommendation 4.7. See Sarbanes-Oxley Act 2002 s.301.
[121] Chandra Report, 2002, recommendation 4.8.
[122] Chandra Report, 2002, recommendations 4.6 and 4.11.
[123] Chandra Report, 2002, recommendation 4.10.

draconian action[124]. A draft Companies (Amendment) Bill 2003 was prepared following this report, but, as will be seen below, it was held back pending a more extensive review of company law and has since been overtaken by a more comprehensive Bill[125].

2.5.4 The Murthy Report and the Revised Clause 49

Just as the Chandra Committee was on the point of publishing its report at the end of 2002, the SEBI established yet another committee on corporate governance under the chairmanship of NR Narayana Murthy[126]. The terms of reference for this committee called upon it "to review the performance of corporate governance" in India and "to determine the role of companies in responding to rumour and other price sensitive information circulating in the market, in order to enhance the transparency and integrity of the market[127]". The Committee's recommendations in some cases supported the Chandra Committee's ideas and in others went further. Thus, whereas the Murthy Report specifically adopts the Chandra Committee's proposals on disclosure of contingent liabilities[128], CEO/CFO certification[129], the definition of independence[130], the requirement that the audit committee be composed entirely of independent directors[131] and the call for legal exemption of independent directors from certain criminal and civil liabilities[132], it goes further in a number of respects, including: setting out the issues to be reviewed by audit committees[133], requiring all audit committee members to be financially literate[134], requiring justification for an explanation of non-standard accounting treatments[135], requiring management reporting to boards on risk

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[124] Sharmila Mahamuni, *The Potential Role of Non-Executive Directors in Indian Companies, International Company and Commercial Law Review,* Vol- 207, 2007.
[125] John Paterson, Corporate Governance in India in the context of Companies Bill 2009, International Company and Commercial Law Review, Vol 21(03), 2010.
[126] SEBI, Report of the Committee on Corporate Governance under the chairmanship of N.R. Narayana Murthy, February 8, 2003 (Murthy Report).
[127] Murthy Report, 2003, para.2.2.1.
[128] Murthy Report, 2003, para.4.2.1.
[129] Murthy Report, 2003, para.4.3.1.
[130] Murthy Report, 2003, paras 4.4.1 and 3.10.1.4.
[131] Murthy Report, 2003, para.4.5.1.
[132] Murthy Report, 2003, para.4.6.1.
[133] Murthy Report, 2003, para.3.2.1.4
[134] Murthy Report, 2003, para.3.2.2.3. This is a significantly tougher requirement than that imposed by the Sarbanes-Oxley Act 2002 s.407.
[135] Murthy Report, 2003, para.3.3.1.3.

management[136], the establishment of a published code of conduct for all board members together with a requirement for affirmation of compliance signed off by the CEO and COO[137], establishment of whistleblower access to the audit committee[138] and whistleblower protection[139]. In view of the second term of reference noted above, it is also not surprising to see the Committee recommend that the SEBI should make rules to avoid conflicts of interest in reports by analysts[140]. On the other hand, the committee was not minded to make recommendations regarding real time reporting of critical business events without further in-depth study of the matter[141]. It also went even further than Chandra in relation to nominee and institutional directors. It recommended that the former be prohibited and that in future if institutions wished to appoint a director, then they would have to be elected by the shareholders as a whole[142]. As regards implementation of its ideas, the committee proposed that this be done via amendment of cl.49 of the listing agreement[143]. In concluding, it noted that it did not in any sense think that it was issuing the last word on the matter, but that the corporate governance system it had further developed would continue to evolve. The proposed changes were eventually introduced in a revised cl.49 issued on October 29, 2004 with a deadline for implementation of April 1, 2005.[144] Intriguingly, the communication from the SEBI repeated the requirement that exchanges set up "monitoring cells" to monitor compliance[145], which would appear to be redundant had the same requirement in the initial version of cl.49 already been effectively and uniformly complied with.[146]

2.5.5 The Irani Report and the Companies Bill 2008

As was mentioned above, previous efforts towards the reform of company law as it affected corporate governance had resulted in draft legislation but had not produced actual legal

[136] Murthy Report, 2003, para.3.5.1.7.
[137] Murthy Report, 2003, para.3.7.1.3.
[138] Murthy Report, 2003, para.3.11.1.3.
[139] Murthy Report, 2003, para.3.11.2.4. See also Sarbanes-Oxley Act 2002 s.1107.
[140] Murthy Report, 2003, para.3.15.1.3. See also Sarbanes-Oxley Act 2002 s.501.
[141] Murthy Report, 2003, para.3.13.1; cf. Sarbanes-Oxley Act 2002, sec. 409.
[142] Murthy Report, 2003, para.3.8.1.5.
[143] Murthy Report, 2003, para.6.1.
[144] SEBI/CFD/DIL/CG/1/2004/12/10.
[145] SEBI/CFD/DIL/CG/1/2004/12/10, para.7.
[146] Varun Bhat, *Corporate Governance in India: Past, Present and Suggestions for the Future, Iowa Law Review,* Vol- 92, 2007.

change.[147] This was due to the fact that a more extensive review of company law was in due course envisaged. Finally, over a month after the SEBI issued the amended cl.49, an Expert Committee on Company Law was established by the Ministry of Company Affairs under the chairmanship of Dr Jamshed J. Irani, a director on the board of Tata, on December 2, 2004[148]. The scope of this review was obviously much broader than any of the other reports considered above, and what follows focuses only on the issues directly relevant to the consideration of corporate governance, in particular as they have been dealt with in the Companies Bill initially laid before the Indian Parliament in 2008 and reintroduced in August 2009.[149]

Concluding Remarks on the Evolution of Corporate Governance in India

At the end of this review of the evolution of corporate governance in India over the last decade, what stands out is that, on paper at least (and barring the issues identified where clarification appears to be required), the country has, at the level both of the rules applicable to listed companies and of the proposed legislation, arrangements that are surely as good as any in the world. Given the extent to which those involved in the various committees have been inspired by developments especially in the United Kingdom and the United States this is hardly surprising. Those committees have, however, also been at pains to stress the extent to which it has been necessary to take account of the particularities of the Indian context. In considering whether all of these developments have put India in a position where it has already taken steps sufficient to respond to the Satyam scandal[150], two questions next need to be addressed: first, it is necessary to consider whether the jurisdictions from which India has borrowed corporate governance concepts the UK and the US may still be regarded as adequate sources of inspiration given the problems that they themselves have encountered in corporate governance in recent years; and, secondly, it is necessary to examine the extent to

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[147] See section above on the Chandra Committee.
[148] John Paterson, *Corporate Governance in India in the context of Companies Bill 2009, International Company and Commercial Law Review*, Vol 21(03), 2010.
[149] For an overview of the report as a whole, see Aparna Viswanathan, *Reinventing the Company in India: The Expert Committee Report on Corporate Form and Governance, International Company and Commercial Law Review*, Part- I, 2006.
[150] Neil Baker, *Corporate Confidence in India shaken by Satyam Scandal: The Fraud at Satyam has highlighted Flaws in Indian Corporate Governance System, International Bar News*, Vol- 63(03), 2009.

which the Indian context has indeed been adequately taken into account when corporate governance concepts have been transplanted from other jurisdictions.

2.6 Clause 49 of Listing Agreement and Indian Corporate Governance

Clause 49 of the listing Agreement has become a buzz word in corporate sector in India and is viewed synonyms with good corporate governance norms and often dubbed as panacea for major corporate ills.

While the clause 49 related to Indian scenario, it is intrinsically connected with the global trend of improving corporate governance. It may be recalled after series of financial scandals in US and UK, corporate come under heavy criticism for their poor corporate governance which ultimately led to the passing of the Sarbanes Oxley Act. In India, SEBI's clause 49 is influenced by this act to great extent and addresses several corporate governance issues, including the number of independent directors on the board[151].

In India, the first concrete step taken by the Security Exchange Board of India (SEBI) in this direction was when it constituted a committee under Mr. Kumar Mangalam Birla to examine the issues of corporate governance in 2000. Again after this committee, a second committee was constituted under Mr. Narayana Murthy in 2003. SEBI implemented recommendations of Birla Committee report through clause 49 of the Listing Agreements of the stock exchanges for mandatory observance of corporate governance. Further, on the road, Narayana Murthy committee recommended enhancement in corporate governance norms to improve the quality of corporate governance among listed companies. Based on the recommendations of the committee and public comments received thereon, SEBI issued a circular on 26th August 2003 revising clause 49 of the Listing Agreement.

In the light of above, it is important to analyse clause 49 in the context of directors and shareholders role in the field of corporate governance.

Clause 49 also looked into the following matters:-

Composition of the Board of Directors

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[151] Atul Kumar, *Clause 49 and Corporate Governance, Company Law Journal*, Vol-2, 2006.

Composition and functioning of the audit committee

Governance and disclosure regarding subsidiary companies

Disclosure by the company

CEO/CFO certification of the financial results

Reporting on corporate governance as part of the AR.

Certification of compliance of a company with the provision of clause 49.

The issues regarding non executive directors, independent directors, board committees and shareholders participation are discussed in the coming chapters as envisaged under clause 49 and international regulations.

Chapter- 3

Corporate Governance and Board of Directors: Responsibilities, Risks and Remuneration

3.1 Introduction

At the core of corporate governance is the board of directors, which oversees how the management serves and protect the long term interest of all the stakeholders of the company. An active, well informed and independent board is necessary to ensure the highest standard of corporate governance[152].

As Adam Smith taught, managers are imperfect human beings who will inevitably wonder off the path now and again and choose self interest above the interest of the corporations and shareholders. Without monitoring the managers there is always the danger that managers will use corporate assets for their own self interest rather than shareholder generally or perform inefficiently or rather commit frauds[153]. The board of directors fulfil that role, that of overseeing management and holding it accountable for the performance of the corporate objective.[154]

There are possibly three broad dimensions that a board culture can encompass:

1. *Decision making role*
2. *Monitoring role*
3. *Advisory role*

Boards are ought to be decision makers for the corporate – at least in a strategic manner. When boards routinely take decisions about who the CEO is going to be, what business the company will engage in, major funding avenues and such, it is really playing a strategic role which will set pace for the company's functioning.[155]

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[152] Andrew J. Fellow, *Ethics Program, Board Involvement and Potential Conflict of Interest in Corporate Governance, Journal of Business Ethics,* Vol- 32(3), 2001.
[153] Mark R. Schwartz, *Tone at Top: An Ethics Code for Directors?, Journal of Business Ethics*, Vol- 58(1/3), 2005.
[154] Tolly's Corporate Governance Handbook, Andrew Chambers Management Audit Ltd.
[155] Kshama V. Kaushik and Kaushik Dutta, *Corporate Governance: Myth to Reality,* Lexis Nexis Buttersworth, 2005.

A bulk of corporate governance literature revolves round the Board of Directors and its functioning. Two recurring themes on Board of Directors[156] are- weak Boards being responsible for corporate excesses and failures in the 1980s and 1990s, there is a wide divergence between the theory about the Board's work and its actual functioning[157].

As regards the first theme, lack of balance due to paucity of appropriate skills, lack of commitment, inadequate information, inadequate system of financial control, over dominance of CEOs, their short term policies designed to increase profits rather than real earnings etc have been identified as important problems in the working of the board. In theory, shareholders of the company elect the board which nominate the managers to carry out the work[158]. In reality, top managers often select a Board of Directors which is approved by the shareholders and which often works at the pleasure of managers. Therefore, it came to be strongly believed that the highest internal mechanism of corporate monitoring was not working as it should, principally because there was little distance between managers and directors.[159] So, all the working group and committees on corporate governance had devoted maximum attention to the working of the boards and to making suggestions for improvements in them. Every aspect of the board- its election, composition, size, working style and functioning, access to information, effectiveness etc has been scrutinized to find out the ways for improvement[160].

3.2 Duties of Directors

3.2.1 Present Fiduciary and Common Law Duties

In order to restrict the potential for abuse of power within the corporation, directors in exercising their powers, are subject to a number of control and restrictions imposed by statute and by equity as well as common law. In law, directors are fiduciaries, and agree to undertake or act for or on behalf of, or in the best interests of the company where they have been

[156] D.N. Ghosh, *Corporate Governance and Boardroom Politics, Economic and Political Weekly,* Vol- 35(46), 2000.
[157] Varun Bhat, *Corporate Governance in India: Past, Present and Suggestions for the Future, Iowa Law Review,* Vol -92, 2007.
[158] D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from K- Mart, North Carolina Law Review,* Vol- 74(1037), 1996.
[159] Robert Gaddard, *Directors Duties, Edinburg Law Review,* Vol- 12(3), 2008.
[160] Vasudha Joshi, *Corporate Governance- The Indian Scenario,* Foundation Books Pvt. Ltd., 2004.

appointed[161]. Although the Company Law does not specify the company's main objective, it is implicit in the duties exercised by directors that they must maximize shareholders welfare[162]. The Company's interest is synonyms with the interest of the shareholders. Directors must therefore primarily exercise their duties towards profit maximization in an ethical manner, balanced against the need for corporate survival and to consider the wider stakeholder of the corporation[163].

Traditionally, however if one look at the English Company Law, it has reinforced the profit maximization principle within the corporate governance system. In *North West Transportation v. Beatty*[164] the claimant, Henry Beatty, sued the company's director and claimed an order to set aside the sale made to the company by James Hughes Beatty, who was one of the directors, of his steamer *The United Empire,* of which he was the owner before she was sold. Sir Richard Baggallay stated that the resolution of the majority of the shareholders[165], duly adopted, upon any question coming under the pinnacle of the Company's mandate was binding upon the majority, and consequently upon the company. Further, every shareholder had a right to vote upon any such questions, although he might have a personal interest in the subject matter opposed to, or different from, the general or particular interest of the company.[166]

In respect of the fiduciary duties, directors owe the following duties to the companies whose assets they are appointed to manage.

3.2.2 Duty to act in Good Faith

In exercising each of the power conferred upon them by company's constitution, directors act not on their own account but for the benefit of the company on whose behalf they are appointed to act. A fiduciaries, directors must act at all the times bonafide in what they

[161] http://www.corpgov.deloitte.com/site/in/board-of-directors/, last accessed on 17th May 2011.
[162] www.findsrticles.com, last accessed on 14th May 2011.
[163] D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from K- Mart, North Carolina Law Review,* Vol- 74(1037), 1996.
[164] (1877) 12 App Cas 589.
[165] Carol B. Swanson, *Corporate Governance: Sliding Seamlessly in the Twenty First Century, Journal of Corporation Law,* Vol- 21(417), 1996.
[166] R. Link Newcomb, *The Limitation of Directors' Liability: A Proposal for Legislative Reform, Texas Law Review,* Vol- 66(416), 1987.

consider (not what a court may consider) to be in the best interest of the company.[167] This is a subjective test that reflects the court of equity's reluctance to interfere with the second guess the commercial judgement of the directors. The company would clearly include shareholders collectively as a group. This is illustrated by *Percival v. Wright*[168], where Swinfen Eady J. contended that directors of the company did not normally stand in a fiduciary position towards their shareholders individually[169]. The *Percival Case* was concerned with shareholders who offered to sell their shares to the company's directors and chairman at a price of £12.50 per share. The directors and chairman however, negotiated a higher price with the third party for the sale of those shares. Swinfen Eady stated:

> *"...the true rule is that the shareholder is fixed with knowledge of all the directors' powers, and has no reason to assume that they are not negotiating the sale of the undertaking than to assume that they are not exercising any power."*

In this case, the directors were under no obligation to disclose the negotiations that had taken place between themselves and the third party. There was no question of unfair dealing. Further, the directors did not approach the shareholders with a view to purchasing their shares. Instead, the shareholders approached the directors and named the price at which they would be prepared to sell their shares. The directors did not take any initiatives to buy shares.

A number of basic obligations are in practice imposed upon the directors who seek to comply with their duty to act in good faith in the best interest of the company[170].

1. *When taking any decision concerning the management of the company, directors must positively apply their minds to the question of what are the interests of the company. If they fail to carry out the task, the courts may intervene and impugn the decision.*[171]

2. *The belief held by directors that a particular decision is in the best interest of the company must be a belief that is held honestly.*

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[167] *Re Smith & Fawcett*, (1942) Ch 304.
[168] (1902) 2 Ch 421.
[169] Robert Gaddard, *Directors Duties, Edinburg Law Review*, Vol- 12(3), 2008.
[170] Richard W. Holtz, *Interested Transactions by Corporate Directors: A Weakening of Fiduciary Duty of Loyalty, Suffolk University Law Review*, Vol- 28(93), 1994.
[171] *Inland Revenue Commissioner v. Richmond*, (2003) All ER (D) 123 (May).

3. *A director must decently apply his mind to the interests of the company and exercise his discretion in accordance with those interests.*

4. *A director must not fetter his discretion*[172].

It is fundamental that director act in the interest of the company as a legal entity rather than in the interest of the shareholders[173]. However, the general rule is that the interest of the company is synonyms with the interest of the shareholders, as a general body, both present and future: *Greenhalgh v. Ardene Cinemas Ltd.*[174] Further, directors are required to balance a long-term view against short-term interests of present members.[175]

The courts will inquire into director's decisions, and not into what a reasonable director would have done in the circumstances. In *Greenhalgh,* Evershed MR stated that the expression 'bonafide for the benefit of the company as a whole' does not mean the company as a commercial entity distinct from the corporators: it means the corporators as a general body. That is to say, a case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who vote in its favour, for that person's benefit'[176].

The concept of good faith has therefore, been treated in the abstract. It is based on the presumptions that directors, like parties to commercial contracts, will perform their commercial contracts in good faith, otherwise a breach will be established. In the context of Company Law and Corporate Governance, the concept of good faith has broader meaning that encompasses not only issues that concern protecting the interests of the company's financial position, but also those that protect community's interests[177].

[172] http://www.corpgov.deloitte.com/site/in/board-of-directors/, last accessed on 2nd May 2011.
[173] Paul H. Zalecki, *The Corporate Governance Role of Inside and Outside Directors, University of Toledo Law Review,* Vol- 24(831), 1993.
[174] (1951) Ch 286.
[175] *Giaman v. National Association of Personal Health*, (1971) Ch 317.
[176] S. Venkitaraman and Sharad Sharma, *Corporate Governance, Sebi and Corporate Laws*, Vol- 60, 2005.
[177] DD Prentice and PRJ Holland, *Contemporary Issues in Corporate Governance*, Clarendon Press Oxford Allen and Ivory, 2001.

The duty to act in the best interests of the company as a whole includes the interests of the creditors[178] and employees[179]. In some exceptional cases it is possible for the directors to act in the best interests of the particular individual shareholder[180].

3.2.3 Duty to act for Proper Purposes

Directors must ensure that they act for proper purpose: *Re Smith & Fawcett Ltd.*[181]. Where directors act for an improper purpose or 'collateral' purpose, the court will intervene and set aside the act in question. The duty not to act for improper purposes arises where the directors have acted in breach of their contracted purposes, or in breach of purposes inherent in their duties. This can include situations where directors are forestalling takeover in the belief that it would be contrary to the interest of the company, or issuing further shares to change the company's control structure[182].

In *Punt v. Symons& Co*[183]., in order to secure the passing of a special resolution, the directors had issued new shares to five additional shareholders. Byrne J. held this to be an abuse of director's powers. His Lordship stated that these shares are not issued bonafide for the general advantage of the company, but were issued with the immediate object of controlling the holders of the greater number of shares in the company and of obtaining the necessary statutory majority for passing the special resolution, while at the same time not conferring upon the minority the power to demand a poll. He stated:

> *"...a power of the kind exercised by the directors in this case is one that must be exercised for the benefit of the company; primarily it is given to them for the purpose of enabling them to raise capital when required for the purpose of the company"*[184].

[178] *West Mercia Safety Wear Ltd. V. Dodd*, (1988) BCLC 250.
[179] *Parke v. Daily News*, (1962) Ch 927.
[180] *Allen v. Hyatt*, (1914) 30 TLR 444.
[181] (1942) Ch 304.
[182] Naresh Kumar, *Concept of Good Corporate Governance, Tax and Corporate Referencer*, Vol- 26, 2006.
[183] (1903) 2 Ch 506.
[184] Saleem Shiekh, *A Practical Approach to Corporate Governance*, Lexis Nexis, UK, 2003.

In *Hogg v. Cramphorn*[185], the company's directors issued shares that carried special voting rights for the trustees of a scheme established for the benefit of the company's employees. The director's aim was to prevent a takeover bid. They had acted in good faith throughout the transaction. Buckley J. held this was an improper purpose, but that it could be ratified by the shareholders at a general meeting.

The decision in the above mentioned case evoke controversy in that it supported the view that an 'improper purpose' can be legitimised and ratified by means of ratification by shareholders in general meeting. This is a disturbing phenomenon in that shareholders might thus indulge in ratifying improper purposes which would otherwise have been regarded as factors that formed the basis for illegal acts. Furthermore, the process of legitimisation might be disregarding the interest of minority shareholders[186].

Judicial authorities in Australia and Canada disregarded the *Hoggs Case* approach and decided that the directors' decisions to use their powers to thwart a threatened takeover could be upheld by the courts. In *Harlowe's Nominees Pty Ltd v. Woodside (Lakes Entrance) Oil Co.*[187]and *Teck Corp. Ltd. V. Millar*[188] the High Court of Australia and the Canadian Court respectively upheld directors' decisions to prevent a takeover.

The various powers conferred upon the directors by the constitution of the company are capable of being exercised for a variety of purposes. The duty imposed upon the directors to exercise those powers solely for the purpose envisages that each and every power is conferred to permit the directors to achieve certain limited ends. A proper purpose is one for which, on a true construction of the articles of association of the company or statutory provision conferring it, the power can be said to have conferred. Any other purpose will be an improper purpose.[189]

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185 (1967) Ch 254.
186 Anupam Chander, *Minorities Shareholders and Otherwise, Yale Law Journal*, Vol- 113, 2003.
187 (1968) 121 CLR 483.
188 (1972) 33 DLR (3d) 288.
189 *Howard Smith Ltd. V. Ampol Petroleum Ltd.*, (1974) AC 821.

3.2.4 The no- conflict Rule

Directors must not place themselves in position where their personal interests may conflict with the duties they owe to the company of which they are directors[190]. In addition, a director is not permitted to put himself in a position in which his duty to the company may conflict with any duty owed to another, for example, a second company of which he is a director. Where a director finds himself in a position of conflict of interest, he is bound to disregard his personal interests[191].

In order to avoid the possibility of conflict of interests, the Companies Act 1985 requires the directors of both public and private companies to disclose to the Board of Directors of both the public and private companies any interest, direct or indirect, which they may have in a contract or purported contract or transaction or arrangement. The disclosure must be before the Board of Directors and not to a committee of the Board.[192]When a director does place himself in a position of conflict, any transaction with the director which is entered into by the company is voidable at the instance of the company[193]. The director is liable to account to the company for any profits he has made from his position.

The case of *In Plus Group Ltd. V. Pyke*[194], the Court of Appeal stated that although the fiduciary duty of a director to his company was uniform and universal, there was no completely rigid rule that the director could not be involved in the business of another company that was in competition with the company of which he was the director. Every decision whether a fiduciary relationship existed in relation to the matter complained of was fact-specific, and in exceptional circumstances, where the director have been effectively excluded from the company, it was not a breach of fiduciary duty for him to work for a competing company.[195]

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190 *Aberdeen Ryl Co. v. Blaikie Bros.* (1854) 1 Macq 461.
191 Amit K. Vyas, *Status of Corporate Governance in India: More Hype and Lesser Action!, Company Law Journal,* Vol- 01, 2002.
192 *Guinness v. Saunders* (1988) 1 WLR 863.
193 *Gardener v. Parker,* (2003) All ER 346.
194 (2002) 2 BCLC 201.
195 Saleem Shiekh, *Non executive Directors: Self Regulation Codification?, The Company Lawyer,* Vol 23, 2002.

3.2.5 The no-profit Rule

A director is not entitled, unless expressly provided, to benefit from his position within the company. This is known as the 'no profit rule': it prevents a director from making a secret profit for himself for the use of corporate assets, information or opportunities[196]. Where a director does make so profit, he is liable to account to the company for any profits made. In *Cook v. Deeks,* the company directors diverted a contract that belonged to the company for their own purposes. They were held liable to account to the company for the profit made from the contract. Lord Buckmaster stated that the directors had the duty to protect the company's interests because of their position of authority and the knowledge they have acquired as a result of the transaction. Similarly in *Regal Hastings case,* Lord Russell decided that even the directors had acted bonafide throughout the transaction, they may be liable to account to the company for the profit made: 'the liability arises from the mere fact of profit having, in the circumstances, been made. The profiteer, however honest and well intentioned, cannot escape the risk of being called upon to account[197].'

The liability to account is a personal liability and is dependent upon a profit being made by the director[198] where a director had intentionally transferred business and income from a company to new companies. The Court decided that the equitable remedy for a breach of fiduciary duty was restitution, which required the fiduciary to take account of the property that had been displaced[199].

The liability to pay damages for breach of duty will depend upon the company being able to show that it has suffered loss by reason of the breach of duty. In *CMS Dolphin Ltd. V. Simonet,*[200] the court stated that the underlying basis of the liability of the director who exploited after his resignation a maturing business opportunity of the company, of which he had knowledge as a result of being a director, was that the opportunity was to be treated as if it was the company's property in relation to which the director have fiduciary duty. By

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[196] *Regal Hastings Ltd. V. Gulliver,* (1942) 1 All ER 378; *Cook v. Deeks,* (1916) 1 AC 554; *IDC v. Cooley,* (1972) 1 WLR 443.

[197] Jayati Sarkar and Subrata Sarkar, *Board Independence and Corporate Governance, Sebi and Corporate Laws,* Vol- 52, 2004.

[198] *Gidman v. Barron,* (2003) All ER (D) 182 (Feb).

[199] Richard W. Holtz, *Interested Transactions by Corporate Directors: A Weakening of Fiduciary Duty of Loyalty, Suffolk University Law Review,* Vol- 28(93), 1994.

[200] (2001) 2 BCLC 704.

seeking to exploit the opportunity after his resignation[201], the director was appropriating to himself that property, and became a constructive trustee of the benefits of the abuse of the company's property[202]. The director was liable to account to the company for the profits attributable to the breach of fiduciary duty, taking into account the expenses connected with those profits and a reasonable allowance for overheads, together with the sum to take account of other benefits derived from those contracts[203]. There must however, be some reasonable connection between the breach of duty and the profit for which the fiduciary was accountable.[204]

3.2.6 A Duty not to Fetter Future Discretion

Directors must not anticipate in advance as to how they will vote in the future. They must seek the company's consent before they can seek to fetter their future discretion. However, provided directors act bonafide and enter into a contract as to how they vote at future board meetings, the court will uphold such a contract. In *Thorby v. Goldberg*[205], the Australian Court stated:

> *"There are many kinds of transaction in which the proper time for the exercise of directors' discretion is the time of the negotiation of a contract, and not the time at which the contract is to be performed... if at the former time, they are bonafide of the opinion that it is in the best interests of the company that the transaction should be entered into and should be carried into effect, I can see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board."*

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[201] Saleem Shiekh, *Non Executive Directors: Self Regulation Codification? The Company Lawyer*, Vol- 23, 2002.
[202] Kevin Keasey and Mike Wright, *Corporate Governance: Responsibilities, Risks and Remuneration*, John Wiley and Sons, 1997.
[203] M.H.Hirani, *The Company Law related to Social Responsibility of Company Directors*, APH Publishing Corporation, 1997.
[204] *Canadian Aero Services Ltd v. O'Malley,* (1974) SCR 592.
[205] (1964) 112 CLR 597.

The duty not to fetter future discretion is subject to the condition that it does not run counter to the fiduciaries duties that a director owes to the company, which includes a duty towards the majority as well as minority shareholders[206].

Directors have the duty to protect the interest of the company because of their position of authority and the knowledge they have acquired as a result of the transaction.[207] However, there are cases that have suggested that, provided the director has declared the contract and company rejected the opportunity to pursue the contract, the director may keep the profits made from the contract.[208]

3.3 Directors' Duty of Skill, Care and Diligence

At Common Law, directors owe the company a duty to act with reasonable skill, care and diligence. This is a lower standard of duty than the fiduciary duties imposed on the directors[209].

These general rules were analyzed in *Re City Equitable Free Insurance Co. Ltd*[210]. Following this case, a director need not exhibit a greater degree of skill than may 'reasonably be expected of a person of his knowledge and experience'. Accordingly, the standard of skill to be expected of a director is to be determined by the reference to his own personal qualities, and a director is not expected to exercise skill that he does not possess. In *Lagunas Nitrate Co. v. Lagunas Syndicate*[211], the Court of Appeal stated that:

> *"If the directors within their powers, if they act with such care as are reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty towards the company."*

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[206] Nagendra V. Chawdhary, *Corporate Governance in Emerging Markets,* ICFAI University Publications, Vol- I, 2002.
[207] *Regal Hastings Ltd. V. Gulliver,* (1942) 1 All ER 378.
[208] *Queensland Mines Ltd. V. Hudson,* (1978) 52 ALJR 399; *Island Export Finance Ltd. V. Umunna,* (1986) BCLC 460.
[209] Giles Proctor and Lilian Miles, *Corporate Governance,* Cavendish Publishing Limited, London, 2002.
[210] (1925) Ch 407.
[211] (1899) 2 Ch 392.

It is also clear that the directors of a specific company are not required to be experts in the type of business that the company promotes, unless they are appointed in view of their specialist qualification. A director is not bound to bring any special qualifications to his office[212]. The legal effect of this lower standard is that a director could undertake the management of the company, of which he has no knowledge of the industry, without incurring responsibility for the mistakes that may result from such ignorance.[213]

This approach continues the higher standard of expectation that a director has a particular knowledge, skill and experience of his own, while also applying to all directors[214] an objective standard determined by reference to the function that the particular director carries out in relation to the company.[215][216]

3.4 A New Regime for Directors Duties: The Need for Emphasis on the Principled Obligations of the Directors

This part addresses the status of Non Executive Directors (NED). Currently there is neither legal definition, nor any distinction made in the Companies Act between a director and NED[217] as to particular role and responsibilities ascribed to each specific type of directors, although the revised Combined Code does provide some guidance on the liability of NEDs on company boards. An assessment is made as to whether NEDs are truly independent, including what NEDs actually do in practice, by examining their role and responsibilities within the corporate governance system. The issues raised by Higgs Review of NEDs are addressed and recommendations that now form part of the revised combined code[218].

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[212] *Re Brazilian Rubber Plantations and Estate Ltd.*, (1911) 1 Ch 425.
[213] *Overend, Gurney & Co. v. Gibb and Gibb, (*1872) LR 5 HL 480.
[214] Paul L. Davies and Gower, *Principles of Modern Company Law,* Thomson, Sweet & Maxwell, 8th ed. 2008.
[215] *Re Produce Marketing Consortium Ltd* (No 2), (1989) BCLC 520; *Re Purpoint Ltd*, (1991) BCC 121; *Re DKG Contractors Ltd.,* (1990) BCC 903.
[216] Saleem Sheikh, *A Practical Approach to Corporate Governance,* Lexis Nexis UK, 2003, pp: 1-11.
[217] DD Prentice and PRJ Holland, *Contemporary Issues in Corporate Governance,* Clarendon Press Oxford Allen & Ivory, 2001.
[218] A.J. Boyle and John Bird, *Company Law,* Bristol, 4th ed. 2000, taken from www.amazon.co.uk last accessed on 13th May 2011.

3.4.1 Definition of NEDs

The concept of NEDs is problematic: there is no legal or statutory definition that is recognised in UK or India. Section 741 of the Companies Act 1985[219] only defines a director as including any person occupying the position of director by whatever name called. This is an unhelpful definition. The categories of directors under this definition would clearly include the NED. Company Law in the UK, however need to adapt to the modern reality of Boardroom practices: this include the appointment of NEDs who sit on the company boards. Company Law also needs to keep pace with the changing nature, role and responsibilities of NEDs. NED could be defined as 'those independent directors who, unlike executive directors, do not hold any executive management position in the company in addition to their role as a member of the Board but subject to all the duties applicable to directors that are established by law[220].'

The role, function and responsibilities of the NED have evolved gradually over a period of time. Initially, the role may have been equated to the honorary position to assist another company by bringing specialized knowledge, experience and skill that the company lacked-usually because the NED was in sympathy with the company's objective[221]. The appointment may have been on an informal basis, for the NEDs to assist the company and be there for guidance and support. Such informal arrangement does not require a formal letter of appointment or any terms of agreement. Various labels were attached to the concept of NED: they included 'part time directors', 'external directors', 'outside directors', 'special directors', or 'independent directors'. They have also from time to time referred to as 'business advisors' or 'watch dogs'. Whatever their label, NEDs traditionally possessed skills, experience and expertise owing to their directorships in other companies and their commercial know how and acumen of their particular business industry. Some companies usually appointed 'friendly band well acquainted' colleagues from other industries to sit as NEDs on their board to ensure 'cosy relationship' existed. Management could decide how much of the companies affairs it chose to disclose to the NEDs while company benefit from

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219 English Companies Act, 1985 can be accessed from britlaw.free.fr/company/companies_act_1985.htm, last accessed on 2nd May 2011.

220 Vasudha Joshi, Corporate *Governance in Indian Scenario,* Foundation Books, 2002.

221 Jaen Jaques Plessis, James Mc Convill, et al., *Principles of Contemporary Corporate Governance*, Cambridge University Press, 2005.

the skill and advice of the NEDs[222], who in turn receives remuneration from the company. Although the initial perception was that NEDs would bring independent judgment on to a company's board on which they sit, this perception has been gradually eroded by the seemingly 'comfortable relationships'[223] that existed between NEDs and the boards. In this type of environment, some NEDs would have been unlikely to display any sign of criticism to question board decision- preferring a quite life in agreeing with the companies' policies and future direction. Even the most well versed NEDs would struggle to know every aspect of information concerning the company. Management may have been content to select and choose only that information that a NED would need to know about the company to ensure that the corporate policy would be supported[224].

3.4.2 The Role and Responsibilities of NEDs

In 1987, PRO NED (then known as "Promotion of Non Executive Directors") issued a *Code of Recommended Practice on Non Executive Directors* (the code) that dealt with the role of NEDs, including their appointments to audit and remuneration committees. The code was not novel in anyway, but it represented statements of best practice, and at the time it had the support of major institutional investors. It raised awareness of the high level of responsibility expected of a NED[225], including the onerous responsibilities associated with such a position.

At the outset, the code specified that the NEDs must be independent of management. The code established certain conditions for determining 'independence'. It provided that a person who would be suitable for appointment would be one 'who has the integrity, independence, personality and experience to fulfil the role of NED effectively.' Independence was more likely to assured when the NED:

1. Had not been employed in an executive capacity by the company on whose board he or she sat, within the last 5 years.

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[222] http://www.heinz.com/our-company/corporate-governance/charters/corporate-governance-principles.aspx., last accessed on 2nd May 2011.
[223] Colin Boyd, *Ethics and Corporate Governance: The Issues Raised by Cadbury Report in United Kingdom, Journal of Business Ethics*, Vol- 15(02), 1996.
[224] Herman Siebens, *Concepts and Working Instrument for Corporate Governance, Journal of Business Ethics*, Vol- 39(1/2), 2002.
[225] Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation, American Journal of Comparative Law*, Vol- 59(01), 2011.

2. If a professional advisor or consultant, was not retained by the company (whether personally, or through his/her firm) on a continuing basis; and

3. Was not (whether personally, or through his/her employer) a significant customer of, or supplier to the company.

As will be seen, the Higgs Review and the Combined Code[226] now provide for a detailed guidance on the concept of 'independence'. The 1987 Code also required companies to provide NEDs with the necessary support and information to enable them to perform their functions.

> *"The non- executive directors will enjoy the full support of the chairman, and will need to be provided with the information which in their view they require in order to carry out their duties. They will also need to receive such information in sufficiently good time to enable them to give it to their proper consideration."*

The 1987 code also set out NEDs duties in general terms that included a supportive as well as supervisory role for management. The code did not propose that the duties of a NED be set out statutory form as they would vary but for there to be awareness of the actual functions of the NED. According to the code, these duties should be taken into account when preparing a letter of appointment or service agreement for the NED.

The nature of the duties and functions performed by NED are not set out in any legislation: they are contractual and problematic and in some cases vague and ambiguous.

3.4.3 Purpose of the NEDs

- *Role of Independent NED*

  An independent NED role is to supervise management, participate in the direction of the company's business and affairs and speak out firmly and objectively on these and other issues that may come before the board. NEDs must help ensure that the interest

[226] www.ecgi.org/codes/documents/combined_code.pdf, last accessed on 2nd May 2011.

of all shareholders and not only the interests of a particular faction or group are taken into account by the Board[227].

- *Devoting sufficient time*

Before accepting an appointment to the board, NEDs must acquire a realistic appreciation of the time that will be necessary to devote to board matters, and then decide whether they will have sufficient time to meet the new responsibilities; NEDs cannot give board matters the attention they require if they do not have the time:

- To learn about the company and the industry sector it is in;
- To attend regularly scheduled meetings; and
- To review and consider prior to board meetings all papers and materials that are relevant to matters to be considered at the meeting[228].

- *The Appointment Process*

On becoming a director, a NED accepts significant legal responsibilities that should not be taken on lightly. A potential NED should undertake due diligence by enquiring how the board on which he will sit operates and is organised. The NED should meet each member of the board[229]. The NED should also seek to identify the major challenges of the company faces and the strategic and commercial issues of the company will need to address in order to meet those challenges[230].

- *Independence*

The guidelines provide that independence is a state of mind, and only the NED will know upon reflection and good faith whether he or she can and will act independently. At a minimum, independent judgement is judgment formed after a fair

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[227] http://www.brefigroup.co.uk/directors/directors_roles_and_responsibilities.html, last accessed on 2nd May 2011.

[228] Vasudha Joshi, *Corporate Governance in Indian Scenario,* Foundation Books, 2002.

[229] Sharmila Mahamuni, *The Potential Role of Non-Executive Directors in Indian Companies, International Company and Commercial Law Review,* Vol- 207, 2007.

[230] Saleem Sheikh, *A Practical Approach to Corporate Governance*, Lexis Nexis UK, 2003.

consideration of all relevant information available, and mad free from the influence of NEDs personal interest whether direct or indirect[231].

- *Confidentiality and Disclosure of Interests*

  Matters of a confidential nature should not be divulged to a third party without the company's authority. All interests should be disclosed to the board, and the NED should refrain from voting on such matters in which he has declared an interest.

- *Know the Company and the Business*

  It is recognized that as a NED, his knowledge and business about the company will be less than those of executive directors. However, in order to make an informed judgement about the company, time must be spent learning about the company, its business, its competitors and the environment in which it operates.

- *Supervising Management*

  The board has a responsibility to supervise management, so that it is conforming to established policies, procedures and the plans. An independent NED should provide an objective view and to take on a more inquisitive role, questioning assumptions and challenging the board to see issues in a new or different way[232].

- *Contributing to the Company's Performance*

  The board is responsible for the company's commercial performance. A NED should contribute to the performance function of the board through active participation on the board by bringing general and/or specialist knowledge including experience to the board.[233]

- *Strategy*

[231] http://www.heinz.com/our-company/corporate-governance/charters/corporate-governance-principles.aspx, last accessed on 2nd May 2011.
[232] http://blogs.law.harvard.edu/corpgov/2011/03/31/the-directors%E2%80%99-duty-to-inform/, last accessed on 2nd May 2011.
[233] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Directors_responsibilities_August2006.pdf/$file/Directors_responsibilities_August2006.pdf, last accessed on 15th May 2011.

The responsibility for a long-term view of the company's outlook is normally carried out through a strategic thinking process leading to the formulation of strategic plans. A NED should be involved in this interactive process in determining the appropriate direction of the company.

- *Policy*

  A NED should be involved in policy making and providing guidance to the board.

- *Being Effective*

  A NED should be effective in his role, skills, training and knowledge. It will start with careful attention being paid to the appointment process and an honest reflection in the ability to the objective. NEDs must devote the time needed to learn the company's business, and to prepare and participate in meetings of the board.

- *Audit Committees*

  There should be clear written terms of reference that deal with the committee's authority and duties. A NED must have the time, skill, knowledge and expertise to carry out his duties on the committees[234].

3.5 Role of Independent Directors in Corporate Governance

An independent board of directors in public listed companies is seen as an integral element of a country's corporate governance norms[235]. Board independence has taken on such a pivotal status in corporate governance that it has become almost indispensable. Consequently, governance reform in recent years has increasingly pinned hope as well as responsibility on independent directors to enable higher standards of governance[236].

Although the institution of independent directors has been the subject of debate lately, the concept itself is hardly of recent vintage. Independent directors were introduced voluntarily

[234] Yuan Zhao, *Competing Mechanism in Corporate Governance: Independent Directors, Institutional Investors and Market Forces, International Company and Commercial Law Review,* Vol- 21(10), 2010.
[235] Sharmila Mahamuni, *The Potential Role of Non-Executive Directors in Indian Companies, International Company and Commercial Law Review,* Vol- 207, 2007.
[236] Thomas W. Joo, *Corporate Governance and the "D word", Washington and Lee Law Review,* Vol- 63, 2006.

as a measure of good governance in the United States in the 1950s before they were mandated by law[237]. Thereafter, owing to sustained efforts by the Delaware courts and stock exchanges in deferring to decisions of independent boards, independent directors took on greater prominence. Following the Enron cohort of scandals, independent directors were recognized by statute as well. A similar, but more recent, trend is ascertainable from the United Kingdom as well. The requirement for board independence there was triggered by the Cadbury Committee Report[238]in 1992. With these developments, board independence became well-entrenched in the U.S. and the U.K[239].

The turn of the century witnessed a proliferation of independent director requirements beyond the borders of the U.S. and the U.K. This is due to the profound impact that reforms have had on corporate governance norm making around the world, particularly in relation to the appointment of independent directors as an essential matter of good governance. The Cadbury Committee Report has led the development of corporate governance norms in various countries such as Canada, Hong Kong, South Africa, Australia, France, Japan, Malaysia, and India, to name just a few. Similarly, the U.S. requirement of independent directors has also resulted in readjustment of corporate governance norms in various countries. Since the 1990s, "at least 26 countries have witnessed publication of guidelines that stipulate minimum levels for the representation of outside directors on boards of publicly traded companies." This demonstrates the significant impact of Western-style corporate governance norms (particularly the independent director) on other countries[240].

3.5.1 Adoption of Independent Directors in Indian Corporate Practice

Although concepts in corporate governance originated in the outsider systems of the U.S. and the U.K., they have been transplanted to several other countries in the last decade. The transplantation has occurred even in insider systems that possess shareholding structures and other corporate governance norms and practices that are entirely different from those in the

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[237] Ananya Mukherjee Reed, *Corporate Governance Reforms in India, Journal of Business Ethics,* Vol- 37(03), 2002.

[238] www.ecgi.org/codes/documents/cadbury.pdf, last accessed on 3rd May 2011.

[239] Colin Boyd, *Ethics and Corporate Governance: The Issues raised by Cadbury Report in United Kingdom, Journal of Business Ethics,* Vol- 15(02), 1996.

[240] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Hastings Business Law Journal,* Vol- 6(281), 2010.

outsider systems. This phenomenon can be ascribed to a number of reasons. First, several developments in the outsider systems of corporate governance have had a profound impact around the world. These include legislation such as the Sarbanes-Oxley Act[241] in the U.S. and recommendations such as those of the Cadbury Committee in the U.K. Second, several emerging economies had opened their markets to foreign investment during the last decade of the 20th century. The process required development of their own corporate governance norms simultaneously with the explosion of corporate governance reforms in the outsider systems discussed above. Third, concurrent with the opening up of emerging economies to foreign investment, particularly from the leading investing countries of the U.S. and the U.K., there was a need to develop corporate governance systems that were familiar to investors from those countries. Transplantation was a convenient response to this need. Among all the transplanted concepts, the independent director presents some of the greatest challenges both from a theoretical and practical standpoint[242].

3.5.2 Clause 49 and Independent Directors

It is necessary at this stage to examine the specific provisions in Clause 49 relating to independent directors.

3.5.2.1 Basic Requirements

Boards of listed companies are required to have an optimum combination of executive and non-executive directors, with at least half of the board comprising of NEDs. As regards the minimum number of independent directors, that varies depending on the identity of the chairman of the board[243]. Where the chairman holds an executive position in the company, at least one half of the board should consist of independent directors, and where the chairman is in a non-executive capacity, at least one third of the board should consist of independent directors. Another condition was imposed in 2008 to determine the number of independent directors. Where the non-executive chairman is a promoter or a person "related to any promoter" of the company, at least one half of the board should consist of independent

[241] Accessed from www.soxlaw.com, last accessed on 3rd May 2011.
[242] Jayati Sarkar and Subrata Sarkar, *Board Independence and Corporate Governance, Economic and Political Weekly*, Vol- 39, 2004.
[243] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Hastings Business Law Journal*, Vol- 6(281), 2010.

directors[244]. The insertion of this condition was necessitated due to the then prevailing practice. Chairmen of companies retained themselves in a non-executive capacity, but were often relatives of the promoters or controllers of parent/holding companies (where promoters were other companies). For example, in family-owned companies, the patriarch or matriarch of the family would be the non-executive chairman, while the day-to-day management[245] (in executive capacity) would be carried out by persons from the subsequent generations such as children and grand-children[246]. Promoter-related chairmen were thus able to exert significant influence. With this amendment to Clause 49, chairmen are required to be truly independent to justify the composition of the board with one-third being independent rather than one half.

3.5.2.2 Independence

An independent director is defined as a non-executive director who: apart from receiving director's remuneration, 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. Apart from the general statement above, there are certain specific factors that help determine whether or not a director is independent. That all these factors dictate as to who cannot become independent directors. There is a complete absence of positive factors that would qualify a person for being an independent director (except perhaps for the age of the person). For example, there is no mention of the types of qualification or experience the person should possess prior to appointment to the position so as to be able to discharge board responsibilities effectively. This is a serious deficiency in the definition of independence. It encourages companies to appoint persons who satisfy the formal requirements of independence, but who may otherwise not be suited for the job. Directors are, however, required to ensure some minimum commitment towards boards on which they sit. Companies are required to have at least four board meetings a year. Apart from that, there may be meetings of various committees of the board that directors are required to attend if they are members of such committees. Towards that end, there are maximum limits as to the number of boards and committees on which

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[244] Saleem Shiekh, *Introduction to the Corporate Governance Themed Issue, International Company and Commercial Law Review*, Vol- 9, 1998.

[245] Victoria Younghusband, *Corporate Governance in the United Kingdom, International Company and Commercial Law Review, Vol-* 9, 1998.

[246] Taken from www.icai.org/resource_file/10980dec04p806-811.pdf last accessed on 17th May 2011.

independent directors can sit. An independent director cannot be a member of more than 10 committees or act as chairman of more than 5 committees across all companies. This is to ensure that the director is not so busy as to be unable to devote sufficient time and attention towards responsibilities in each company. The Listing Agreement, does not, however specify any positive commitment that each director has to make towards a company, for instance in terms of the minimum number hours or days to be spent each year on a company.

3.5.2.3 Nomination and Appointment

Clause 49 does not contain any specific procedure for nomination and appointment of independent directors. That process occurs in the same manner as it does for any other director. It therefore requires us to explore the provisions of the Indian Companies Act to examine how directors are appointed and the various factors that play out in that regard. 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 and thereby determine the constitution of the entire board. Similarly, controlling shareholders can influence the renewal (or otherwise) of the term of directorship[247]. More importantly, shareholders possess significant powers to effect the removal of a director: all that is required is a simple majority of shareholders present and voting at a shareholders' meeting. The removal can be for any reason, and there is no requirement to establish "cause," thereby making it a potential weapon in the hands of controlling shareholders to wield against directors (particularly those directors that the controlling shareholders see as delinquent to their own perceptions regarding the business and management of the company).[248]

The absence of a specific procedure for nomination and appointment of independent directors makes it vulnerable to capture by the controlling shareholders. Assuming that one of the

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[247] James Mc Convil et. al. *Principles of Contemporary Corporate Governance,* Cambridge University Press, 2007, p-301.

[248] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties,* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; last accessed on 3rd May 2011.

purposes of the independent directors is to protect the interest of the minority shareholders from the actions of the controlling shareholders, such a purpose can hardly be achieved given the current matrix of director appointment, renewal and removal. The absolute dominance of controlling shareholders in this process creates a level of allegiance that independent directors owe towards controlling shareholders[249]. If controlling shareholders cease to be pleased with the efforts of an independent director, such a director can be certain that his or her term will not be renewed, even if such director is spared the more disastrous consequence of being removed from the board. 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. This factor adds to the vast powers already available to controlling shareholders in determining the board composition of an Indian company.

There are possible alternative approaches that can considerably dilute the influence of the controlling shareholders in the appointment of independent directors. The first approach is to have an independent nomination committee of directors that will determine the persons who will be placed on the board as independent directors. Another alternative method of director election that provides some powers to minority shareholders is cumulative voting or proportionate voting rights. In such a system, the appointment of directors can be determined through proportional representation, such that minority shareholders are able to elect such directors on the board correlative to the percentage of their shareholding in the company. The Indian Companies Act does provide for cumulative voting in Section 265: the articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a public company or of a private company which is a subsidiary of a public company, according to the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise, the appointments being made once in every three years and interim casual vacancies being filled in accordance with

[249] Brain R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto, Duke Journal of Comparative and International Law*, 1999.

the provisions, mutatis mutandis, of section 262[250]. The key factor is that this provision is not mandatory and is only optional permitting companies to incorporate the system of proportional representation in their articles of association. It is hardly surprising then that very few companies, if any at all, have adopted the system of proportional representation to elect their directors because controlling shareholders do not have any incentive to incorporate these provisions by amending the articles association as their own influence in the voting process will be diluted.

3.5.2.4 Allegiance of the Independent Directors

Under Clause 49, there is no indication at all as to the constituencies that independent directors are to serve. It is not clear whether independent directors are to serve the interests of the shareholder body as a whole or whether they are required to pay greater attention to the interests of the minority shareholders. Considering that Indian companies predominantly display concentrated share ownership, it seems logical that independent directors should bear the interests of minority shareholders in mind, but there is no direct evidence of that intention in the express wording of Clause 49[251]. In the absence of any express signals, this leaves Indian independent directors in the unenviable position of having to determine for themselves the constituency they are to serve. Similarly, there is no indication as to whether independent directors are to bear in mind the interests of non-shareholder constituencies, and if so, in what situation. The inability of Clause 49 to pinpoint the interests independent directors are to serve arguably renders their position futile and this makes the institution somewhat ambiguous. In outsider economies, the absence of such clarity causes less ambiguity as board members generally, and independent directors more specifically, serve to preserve shareholder value, but in insider economies where divergent interests are involved in the shareholder body, the lack of clarity in the role is inexplicable.

[250]Alan Dignam, *A Principle Approach to Self Regulation? The Report of the Hampel Committee on Corporate Governance, The Company Lawyer*, 1998.
[251] Grant Hayden Mathew, *Shareholder Democracy and the Curious turn towards Board Primacy, William and Mary Law Review*, Vol- 51, 2010.

3.5.2.5 Role of Independent Directors

Much as Clause 49 does not specify to whom the independent directors owe their allegiance, it also does not contemplate any specific role for them. There is no separate task or function assigned to independent directors. The most prominent among such functions in the context of the majority-minority agency problem could have been for independent directors to consider and approve related party transactions that involve self-dealing by controlling shareholders[252]. But, there is nothing of the kind envisaged. Independent directors are treated like any other director for purposes of role and decision-making and there is neither a specific privilege conferred nor a specific duty or function imposed on independent directors, in either case specifically by law, on the board[253].

However, as regards board committees, there are some specific requirements pertaining to independent directors. All companies that satisfy a minimum size are mandated by the Indian Companies Act to constitute an audit committee. The audit committee must be comprised of at least two thirds NEDs, but no reference is made to independence. In case of listed companies, however, Clause 49 provides that an audit committee shall be constituted consisting of three directors, with at least two-thirds of them (including the chairman) being independent directors. In the case of audit committee members (unlike for independent directors on the board), there is a need for positive qualifications regarding competence: all members shall be "financially literate" and at least one of them must have "accounting or related financial management expertise[254]."

Finally, as we have seen earlier, the nomination committee generally plays an important role in corporate governance. But India does not impose a mandatory requirement to constitute nomination committees to nominate independent directors. For this reason, the controlling shareholders are able to significantly influence the process of nomination and appointment of independent directors. The absence of a nomination committee presents a significant obstacle to the protection of minority shareholder interest as controlling shareholders are able to

[252] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Hastings Business Law Journal*, Vol- 6(281), 2010.
[253] Calum Burnett, New *Threat to Company Directors, European Lawyer*, Vol- 54, 2005.
[254] Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, Hastings Business Law Journal*, Vol- 6(281), 2010.

determine the identity of individuals who occupy the position of independent directors and they are likely to ensure the appointment of such individuals who will be sympathetic to the perspectives of the controlling shareholders with complete allegiance in fact towards them. Moreover, at a broad level, the absence of any specific role for directors creates difficulties at a practical level. Neither independent directors themselves nor the corporate community in general are able to comprehend what is expected of independent directors. For instance, at least a majority of the independent directors in India believed their role to be one of advising management from a business or strategic standpoint rather than to act as monitors of management or the controlling shareholders. In the absence of any such clarity in regulatory intentions in the Indian context, one cannot expect any meaningful level of monitoring from independent directors[255].

3.6 Role of Chairman

The role and responsibility of chairman has become significant, attaining prominence over since the Cadbury Report in 1992. A chairman has a demanding role to play within the corporation, in providing leadership and direction towards achieving the company's objectives.[256] In the past, there had developed a practice in some companies of combining the role of chairman and chief executive in one person. There was perception that this could lead to a concentration of power being vested in one person, who could usurp the powers of corporation for his own benefit and to the company's detriment, by neglecting the collective interest of shareholders and other stakeholders of the corporation[257].

A chairman must command the respect of the board and the company's shareholders by providing effective leadership and direction within the corporate governance. As long ago as 1958, *Re Harmer (HR) Ltd*[258] demonstrated the demoralising effect of chairman had on the board, with deterioration in the relationships leading to a potential collapse of the corporation.

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[255] S. Venugopalan, *Corporate Governance and Independent Directors, Sebi and Corporate Laws,* Vol- 52, 2004.
[256] *Adrain Cadbury, The Company Chairman*, Padstow, 2nd ed., 1995.
[257] Von Mathias Hornberg, *Corporate Governance: The Combined Code 1998 as a standard for Directors' Duties,* published online on www.bibliothek.uni-hale.de/servlets/.../HALCoRe.../Heft25.pdf; as on 5th May 2011.
[258] (1958) 3 All ER 689.

In 1992, the Cadbury Report considered the significant role that a chairman occupied within the corporate governance system. Cadbury emphasised that the chairman's role in securing good corporate governance is crucial. A chairman was primarily responsible for the working of the Board, for its balance of membership subject to board and shareholders' approval, and for ensuring that all directors, executive and non executive alike, were enabled and encouraged to play their full part in the company's activities[259]. Cadbury advocated that the chairman should also be able to stand sufficiently back from the day to day running of business to ensure that the board was in full control of the company's affairs and continuously aware of the responsibilities towards its shareholders[260].

A chairman occupies a pivotal role within the corporation in maintaining and operating an effective board, and providing leadership and future direction in respect of the company's affairs. This entails a challenging and demanding role that requires chairman to be proactive.

The Hampel Committee reporting in 1998 also considered the chairman's role in corporate governance process. It agreed with the Cadbury Report that a chairman, as well as chief executive, had significant roles to play within the corporation. Hampel recommended that the two roles of chairman and chief executive should be separated, as a combination of the roles would lead to significant concentration of power in one person. Hampel's recommendations were incorporated in the combined code at that time[261].

3.6.1 Independent Directors

As part of the recruitment process of appointing non-executive directors on to company boards, a chairman must ensure that non-executive directors are truly independent of the company. The concept of 'independence' has been considered by various UK Committees on corporate governance, including recently by Higgs in his review of non executive director. The principle of independence ensures that the NEDs are free from any business relationships that could materially interfere their obligations and responsibilities towards the company on

[259] Colin Boyd, *Ethics and Corporate Governance: The Issues Raised by the Cadbury Report in the United Kingdom, Journal of Business Ethics,* Vol- 15(02), 1996.

[260] http://www.adbi.org/book/2005/02/02/884.corporate.governance.asia/evaluation.of.shareholders.rights.and.effectiveness.of.boards.of.directors/, last accessed on 2nd May 2011.

[261] www.fide.org.my/publications/**reports**/0007_rep_20081211.pdf, last accessed on 3rd May 2011.

whose board they sit. Independence becomes vital to key corporate issues that include directors' pay, issues on takeover and mergers and major policy issues that need to be decided by the company[262].

3.6.2 Appointment of Board

The significant role played by the board in effective functioning of the company will in part be due to the chairman's role in selection of a board that is credible, forward looking, possess a range of skills and is innovative in its approach towards various issues faced by the companies. The revised combined code requires the chairman to establish a formal process of recruitment of board. Main Principle A4 requires that there be formal, rigorous and transparent procedure for the appointment of new directors on the board. Further, care should be taken to ensure that appointees have enough time to devote to the job, particularly in the case of chairmanships.[263]

In structuring and developing a board, a chairman is likely to take a critical evolution of the present composition of the board. This is done by considering the background, skills and experience possessed by those on the board, and identifying deficiencies on the current board for which the chairman may need to look outside the company to rectify. Once the formal process of appointment has been fully completed, the terms and conditions of the appointment will need to be addressed.

3.6.3 Setting the Board Agenda

According to the various UK committees reporting on corporate governance, the chairman's role is essential in setting the board agenda. The chairman assisted by the Company Secretary has the task of putting forward key matters relevant for board consideration. The strategy is to ensure that only the most important issues affecting the company merit get full attention by the board, and that effective decisions are taken to deal matters set out in the agenda that deserve the board full concentration and practical input.[264]

3.6.4 Timely Information

[262] Ben Pettet, *Company Law,* Essex, 2001, taken from www.amazon.co.uk. Last accessed on 2nd May 2011.
[263] Vanessa Finch, *Board Performance and Cadbury on Corporate Governance, Journal of Business Laws,* 1992.
[264] http://www.austlii.edu.au/au/journals/MULR/2001/14.html, last accessed on 5th May 2011.

Another significant aspect of the chairman's role is to ensure that both executive and non executive directors are provided with timely information on matters they need to consider assisting their decision making. There is a balance to achieve so as to amount of information executive and non executive directors need to know, taking account of the fact that non executive directors may not be fully informed or appraised on a particular issue as compared to their executive directors[265].

The chairman skill and experience will be essential in providing timely information to board members. According to the Cadbury Report, it was for the chairman to make certain that their NEDs received timely relevant information that was tailored to their needs, and that they were properly briefed on the issue arising at board meetings.[266]

3.6.5 The Higgs Review and implementation of the Revised Combined Code[267]

The Higgs review published in January 2003 on the *Review of the Role and Effectiveness of the Non Executive Directors* also considered the significant role played by the company's chairman within the corporate governance system[268].

According to Higgs, the chairman should be responsible for:

- Leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda;
- Ensuring the provision of accurate, timely and clear information to directors;
- Ensuring effective communication with shareholders;
- Arranging the regular evaluation of the performance of the board, its committee and individual directors; and

[265] Adrain Cadbury, *The Company Chairman*, Padstow, 2nd ed., 1995.
[266] Ben Pettet, *The Combined Code 1998: A Firm Place for Self Regulation in Corporate Governance, Journal of International Banking Law,* Vol-12, 1998.
[267] www.ecgi.org/codes/code.php?code_id=121, last accessed on 2nd May 2011.
[268] Charlotte Villiers, *Self Regulatory Corporate Governance- Final Hope or Last Rite, Scottish Law and Practice Quarterly,* Vol- 3, 1998.

- Facilitating the effective contribution of NEDs, and ensuring constructive relations between executive and non executive directors.

3.7 Effectiveness of the Board committees in the context of Corporate Governance

Formulization of Board committees is an important development in recent years. The three basic board committees are the audit committee, the remuneration committee and the nomination committee. Delegating specific board responsibilities to smaller board committees can be an effective way of managing the myriad responsibilities of the board. Board committees can improve decision-making of the Board. Having board committees may be especially useful if the board is large, given the difficulties of large-group decision-making as well as to enhance the monitoring function of the board and its accountability to shareholders and other stakeholders. Further, in most cases, these committees are expected to have at least a majority of independent directors[269].

3.7.1 Audit Committee:

An audit committee is 'a committee of Board of Directors, generally consisting of non-executive directors, of a company. The Executive Director attends the meetings of the committee as a special invitee. The committee generally acts as link between the auditors, both internal and external, and the board of directors[270]. The main aim of audit committee, which originated in the United States in the 1970's, was to avoid such control of the auditing by the executive directors and to provide a link between the external auditor and the board. The main goal of the audit committee is to assist the board of directors by providing oversight of the financial reporting process and related controls. The committee is not empowered to make any decisions; rather it recommends actions to the board, which may then vote on its recommendations.

[269] Yuen Teen Mak, OECD/World Bank/ADB third asian roundtable on the role of boards and stakeholders in corporate governance: A comparative review of board committees in Asia, http://www.oecd.org/dataoecd/6/39/1873262.pdf, last accessed on 3rd May 2011.

[270] Audit Committee, Reserve Bank of India, http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=52, Last accessed on 3rd May 2011.

3.7.2 Remuneration Committee:

A remuneration committee is the committee of board of directors generally consisting of wholly or mainly of independent non-executive directors. The chairman of the committee should also be the independent director[271]. The remuneration committee is established to ensure that remuneration arrangements support the strategic aims of the business and enable the recruitment, motivation and retention of senior executives while complying with the requirements of regulatory and governance bodies, satisfying the expectations of shareholders and remaining consistent with the expectations of the wider employee population.[272]

But the issue is that the remuneration committee comprising totally of non-executive directors may not be totally independent. If the members of the remuneration committee were appointed by the CEO or Chairman of the company, then those non-executive directors may feel a kind of faithfulness towards the CEO or Chairman in making recommendation. If the non-executive directors are themselves executive directors of some other company also then they may recommend high reward which will inflate market rates ultimately benefit them only. Schedule XIII to the Companies Act, 1956 makes it necessary for the Board of directors to include in the board's report details of all elements of remuneration packages offered to the directors[273].

3.7.3 Nomination Committee:

A nomination committee is focused on evaluating the board of directors of its respective firm and on examining the skills and characteristics that are needed in board candidates. Nomination committees may also have other duties, which vary from company from company[274]. The nomination committee mainly consists of non-executive directors. The main function of the committee is to identify suitable candidates for various director positions. Also, changing and reviewing corporate governance policies.

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[271] Report of the Kumar Mangalam Birla Committee on Corporate Governance, http://www.sebi.gov.in/commreport/corpgov.html, last accessed on 3rd May 2011.
[272] Kumar Mangalam Birla Committee on Corporate Governance, 1999.
[273] Bob Tricker, *Corporate Governance: Principles, Policy and Practice,* Oxford University Press, 2009.
[274] http://www.investopedia.com/terms/n/nominationcommittee.asp, last accessed on 3rd May 2011.

The nomination committee has been more resisted by the board of directors around the world. The main reason advocated for the same has been the members, who the nomination committee has been imposed on the chairman of the board, could be incompatible with him. It's important for the chairman of the board to know and be able to work with the member of the board in order to meet the objectives of the company. Also the members of nomination committee who has been appointed by the chairman or the CEO may themselves feel loyalty towards the persons who nominated them[275].

3.8 Executive Remuneration: Nature, Component and Structure

The salary of an average rank-and-file employee in the Indian corporate sector is usually determined annually or monthly. A predominant portion of it being a fixed amount is the unmistakable character of the remuneration of such employees. By contrast, as one moves higher up the ladder of hierarchy of a corporation the compensation packages tend to have a substantial portion as a variable package. By default most compensation packages designed for the directors of a company today are multi-dimensional and complex. The ubiquitous trend that is hard to miss is that of massive grant of stock options as a form of compensation[276]. However, the popularity of granting stock options has waned in the past few years. The most recent trend is that of awarding restricted stock, which cannot be sold unless the recipient has spent a specified time with the company. Annual bonuses, retirement plans specially designed for top level executives and other incentive plans are some of the other components of a present day remuneration packages. However, every compensation package generally includes the following components: a base salary, annual bonus tied to accounting performance, stock options and long term incentive plans[277].

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[275] Bob Tricker, *Corporate Governance: Principles, Policy and Practice,* Oxford University Press, 2009.

[276] It is estimated that in the early 2000s one-third of the CEO compensation in US and UK was in the form of stock options, which is significantly higher as compared to the decade of 1990s. See Stephen Bryan, CEO Stock Based Compensation: An Empirical Analysis of Incentive Intensity, Relative Mix and Economic Determinant', Research Paper Presented at Babcock Graduate School of Management, 2005. Available online at ideas.repec.org/a/ucp/jnlbus/v73y2000i4p661-93.html. Last accessed on 3rd May 2011.

[277] These include restricted stock options and multi-year accounting based performance plans. In addition executives participate in broad based employee benefit plans and receive additional benefits like life insurance and supplemental executive retirement plans. The formal employment contracts negotiated by the executives also provide for severance arrangements in case of separation or change in corporate control. See Kevin J. Murphy, Executive Compensation, Marshall School of Business, 1998, Available online at www.ssrn.com. Last accessed 3rd May 2011.

The variable nature of compensation of a director has the law makers grappling with the right approach to put an effective cap on the maximum earnings of the director. The variable components in the salary are there for the avowed purpose of linking the performance of a director with that of his pay. Depending upon the efficiency level and satisfactory nature of his performance the variable component shall fluctuate. However, curbing the same has proven to be more than a handful. In the light of the increasing complexity and multitude variables in the compensation of a director, the provisions of the Act seem pedantic and inept to deal with the highly ingenious ways of compensating the directors and circumventing the provisions of the law in respect of remuneration[278].

Section 198 of Companies Act 1956 while laying down the general rule of a cap on the total remuneration of a director attempts to define 'remuneration' through an Explanation attached to the section. The inclusive definition includes within its ambit expenditure on rent free accommodation, expenditure on amenities, insurance and other amenities[279]. Such components have by and far become obsolete in the contemporary scenario. Employees and employers both tend to prefer compensation in monetary terms so that the employees have the choice to choose to whatever they want[280].

3.8.1 Fixing Executive Compensation: General Meeting and Remuneration Committees

3.8.1.1 Remuneration Committees

The requirement of appointing any remuneration committee is conspicuous by its absence in the entire scheme of the Act. There is no mandatory requirement of the remuneration of the directors to be decided by the remuneration committees. The practice of delegating the task

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[278] Saleem Shiekh, *A Practical Approach to Corporate Governance*, Lexis Nexis Buttersworth, 2003.

[279] Explanation attached to Section 198 states that for the purposes of this section, "remuneration" shall include,-

(a) Any expenditure incurred by the company in providing any rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to any of the persons specified in sub-section (1);

(b) Any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the persons aforesaid;

(c) Any expenditure incurred by the company in respect of any obligation of service, which, but for such expenditure by the company, would have been incurred by any of the persons aforesaid;

(d) Any expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity, or gratuity for any of the persons aforesaid, or his spouse or child.

[280] Stock options seem to be the only exception to this scenario. However, the directors are entitled to encash them after a few years of service and reap the benefits of the price difference.

of taking remuneration decisions of directors to a remuneration committee is commonplace in certain countries such as the UK and the US[281]. However, India is yet to adopt such a policy wholeheartedly[282].

Apart from the Act, the Listing Agreement also incorporates a provision regarding the remuneration. Annexure ID of the Clause 49 of the Listing Agreement makes a provision regarding the Remuneration Committee. It provides that the Board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors. However, the said requirement is non-mandatory. In other words, it is the discretion of a company whether to appoint and constitute a remuneration committee. Hence, there is no uniformity of practice in respect of deciding the remuneration. It is not surprising then that the practice of appointing remuneration committees has not gained widespread acceptance in India. The uniformity only seems to be in the aspect of remuneration is to be approved by the shareholders at the general meeting.

[281] The Cadbury Report stated that the board should appoint remuneration committees consisting wholly or mainly of non-executive directors and be chaired by a non-executive director to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice if necessary. Executive directors should play no part in the decisions on their own remuneration. See Report on the Financial Aspects of Corporate Governance, December 1992, Recommendation 4.42. The Greenbury Committee recommended that the Board should develop clear terms of reference for the remuneration committee. This should require the committee to determine on behalf of the Board and the shareholders the company's broad policy for executive remuneration and entire individual remuneration packages for each of the executive directors and as appropriate other senior executives. Report of a Study Group Chaired by Sir Richard Greenbury', July 17, 1995. Available online at www.ecgi.org/codes/documents/greenbury.pdf. Last accessed on 3rd May 2011. The Hampel Committee agreed with the earlier proposals of constituting a remuneration committee. It reiterated that it is clearly wrong for the executive directors to participate in the decisions of their own remuneration. However, the issue of broad remuneration policy and its cost is a matter for the entire board on the advice of the remuneration committee. It further was in agreement with Greenbury in respect of the matter that the remuneration of the non-executive directors should be a matter for the whole board and that the individuals concerned should abstain from discussion on their own remuneration. See Committee on Corporate Governance: Final Report (Ronnie Hampell), January 1998, Recommendation 4.11-4.13.

[282] Kumar Mangalam Birla Committee Report however did recommend that a company should have a credible and transparent policy in determining and accounting for the remuneration of the directors. The policy should avoid conflict of interest between the shareholders, the directors, and the management. For this purpose the Committee recommended that the Board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment. However, it was a non-mandatory recommendation. See Report of the Committee (Kumar Mangalam Birla) on Corporate Governance, May 07, 1999, Recommendation 10.1-10.3.

It is of prime importance that the remuneration committees should carefully examine the policy of granting fixed stocks fixed options to the employees/executives and should fully understand the cost and incentive implications of the fixed stocks and options and should communicate to the share recipients the value of the shares they receive measured by the opportunity cost as opposed to the number of the shares or options.

Additionally, as the experience of US and UK suggests, most of the companies have remuneration committees that perform the task of setting the compensation packages[283]. However, the proposal and the details regarding the packages emanate from the HR department and they recommendations are usually accepted by the remuneration committee and they are usually accepted. No survey is done of the comparative compensation packages in the other companies[284]. The fact that the initial recommendation is made by the HR department and not the remuneration committee suggests that the committee lacks both the time and the expertise to devise and design an effective pay structure[285].

Remuneration committees should develop a remuneration philosophy that is consistent with and faithful to the governing objective of the corporation. Remuneration committees need to take control of the remuneration process, policies and the practices. They are not there simply to ratify the management's practices and the initiatives taken by the management. However, it does not mean that committees should take decisions without taking into account the management's prudence but should not at the same time let management take the de facto control.

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[283] The Greenbury Committee recommended that the in order to prevent the Board members from deciding no their remuneration and to prevent a conflict of interest there should be setup a remuneration committee consisting exclusively of three non-executive directors who have no personal financial interests at stake.

[284] Brian R. Cheffins argues that one feature of remuneration committees which might account for their seemingly limited impact on the executive pay is their reliance on expert advisers. He states that the standard practice in listed UK companies is for a remuneration committee to have the executive pay details worked out by an outside firm of compensation consultants hired by the management but working to guidelines set out by the committee. However, their objectivity is open to question since they work for a business which might do more than executive compensation consulting. For instance, he states, they might be employed by an accountancy firm or an organization that implements pension schemes. Thus he might face subtle pressure not to offend management by recommending reductions in pay scale. See Brian R. Cheffins, *Company Law Theory, Structure and Operation,* Oxford University Press, 1997.

[285] Kevin Keasey and Mike Wright, *Corporate Governance: Responsibilities, Risks and Remuneration,* John Wiley and Sons, 1997.

3.8.1.2 Role of Shareholders

Generally, the board is empowered to appoint the executives and determine their pay. Clause 49 now also states that all compensation paid to non-executive directors, including independent directors shall be fixed by the Board and shall require prior approval of shareholders in the general meeting[286]. The approval of the general meeting is included as a safeguard to prevent excessive remuneration being paid to the Board[287]. The manner and whether it operates as a safeguard at all needs to be examined.

The problems associated with separation of ownership and control has been long ago highlighted by Berle and Means. They still stand true today, if not more true[288]. Companies in India have grown exponentially in size with the rapid expansion of the economy and new business opportunities presenting themselves almost every day. The large size of the companies and the multitude of shareholders however prove to be detrimental to the standards of corporate governance more often than not[289]. The law as it stands today in India provides for involvement of the shareholders in deciding the remuneration of the non-executive directors[290]. However, the effective exercise of this right is questionable. Firstly,

[286] All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate. See Clause 49 of the Listing Agreement, Annexure – I, I(B).

[287] N.R. Narayan Murthy Committee on Corporate Governance made a mandatory recommendation that all compensation paid to the non-executive directors may be fixed by the Board of Directors and should be approved by the shareholders in the general meeting. See Report of the SEBI Committee (N.R. Narayan Murthy) On Corporate Governance, February 8, 2003, Recommendation 3.9.

[288] Cheffins states that most large companies in UK are publicly quoted and most listed companies have a dispersed shareholding. He states that since the ownership of the shares is dispersed in a large number of individual and institutional shareholders they are rarely poised to intervene and take a hand in running the business. Hence, this gives the management a free hand to run the business. This leads to those in charge of the company to exploit the latitude to run the company in a self-serving manner and this leads to deterioration of the corporate governance standards. See Brian R. Cheffins, *Minority Shareholders and Corporate Governance, Company Law Journal,* Vol- 21(02), 2000.

[289] The sheer volume of the investors makes it difficult to have a structured body of shareholders in a forum. Moreover, the shareholders' passive approach arises from several factors: shareholder reverence of the management as experts and best judges of how to run a company, inactivity of the pension funds, etc. see Tim Pryce-Brown, *Shareholder Protection – A Cultural Quagmire, Company Lawyer,* Vol- 16(4), 1994.

[290] The Act provides that all Non-Executive Directors including Independent Directors have to subject themselves for re-election at the Annual General Meeting of the Company in accordance with the provisions of Section 255 and 256 of the Companies Act, 1956 (the Act) or any amendments thereto from time to time. All Non- Executive Directors will be paid sitting fees for every Board / Committee Meeting attended by them as may be applicable under section 310 of the Companies Act, 1956 read with Rule 10 B of the Companies

the shareholders even if they have all the information about the company, do not have the requisite expertise to analyze the wealth of information so available. In fact their lack of expertise in such matters is why managers are appointed to run the company. Secondly, presuming that the shareholders so dissect the available information, it is far fetched that they shall be able to overcome the compensation policy put forth by the management in the meeting. The management will always tend to have an upper hand from the analysis of the agents it shall appoint to suggest desirable levels of compensation. The shareholders as the law stands today shall not have access to the information about the link of the present pay structure with the performance. This aspect shall be known only to the management and thus they shall be in a better position to defend their stance.

In addition to this, the disclosure requirements presume that the shareholders are interested in taking an active part in the company matters. The shareholders of the modern day corporations predominantly prefer a 'hands-off' approach[291]. An average shareholder tends to hold only a miniscule part of the entire share capital of a company. Hence, the cost of being a vigilant shareholder is generally more than the gains. The shareholders thus choose to exercise the exit option and invest in a different company[292].

The case with institutional investors is not encouraging either. From the standpoint of corporate governance institutional investors can play a vital role in encouraging and ensuring the implementation of healthy corporate governance practices. However, in terms of exercising their voting options in favour of a more modest remuneration package they are a

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(Central Government's) General Rules & forms, 1956 and any amendments thereto from time to time. The sitting fees payable are subject to the approval of the shareholders in the Annual General Meeting. All Non-Executive Directors will be paid commission calculated in terms of Section 349 and 350 read with Section 198 of the Act. The maximum commission payable will be subject to the approval by the shareholders at the Annual General Meeting. The said approval will be for a period not exceeding five years at a time.

[291] The Irani Committee has recommended that the amount collected under Investor Education and Protection Fund established by the Government under Section 205C of the Companies Act, 1956 should not be expropriated by the government but be used to pay unpaid dividends to the shareholders and redressing investor grievances. Additionally these funds could also be used to make the shareholders aware of their rights and how their active participation could improve corporate governance standards in their companies. See The Irani Committee on Company Law, chaired by Dr. Jamshed Irani. Report submitted on May 2005 to the Ministry of Company Affairs. Cited in Aparna Vishwanathan, *Reinventing the Company in India: Expert Committee Report on Corporate Form and Governance, International Company and Commercial Law Review,* Vol 17(3), 2006.

[292] DD prentice and PRJ Holland, *Contemporary Issues in Corporate Governance,* Clarendon Press Oxford Allen and Ivory Publications, 2001.

bit circumspect. The reason being that institutional investors are themselves listed companies in almost all cases[293]. They do not want themselves to be so vocal of lower compensation as it may reflect badly on their board. Hence, the ineffectiveness of general meeting in controlling the managerial remuneration is evident. The inept control mechanism of the general meeting is evident from the thin attendance at the shareholder meetings. The meetings usually end up being attended by the directors and their cronies.

3.8.2 Executive Compensation and Ceiling Limits: Examining the Pitfalls

Sections 198 and 309, 310 and 311 read with Schedule XIII of the Indian Companies Act, 1956 deal with the managerial remuneration in India. The said Schedule has been amended with a view to give greater freedom to the companies for the purpose of appointing and fixing the remuneration[294]. This in turn was hoped would enable the companies to attract greater managerial talent[295]. However, these provisions are applicable only to: (a) public companies and (b) private companies which are subsidiaries of public companies. The provisions are not applicable to government companies.

The legal framework in relation to managerial remuneration in India gives the companies an almost free reign to determine their policy on executive compensation. The reasons are hard to trace but not difficult to guess. The public uproar on the hefty pay packets of the top executives of successful Indian companies has not yet reached a crescendo. The occasional bursts of austerity sermons from the political class apart there has hardly been a systematic

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[293] Institutional investors could be negatively affected by a number of factors. For instance, when some institutional investors simultaneously provide financial services or solicit pension plans from their portfolio companies, there is an evident conflict of interest which at times forces them to shut their mouth and succumb to the practices of the management. Further, among institutional investors, conflicts may arise between different groups and some investors' may not use their power to pursue the sole goal of maximizing shareholders' wealth. Moreover, most institutional investors tend to suffer form a myopia problem in that they tend to focus too much on the performance of the share price than on the long term development of the company. This is because the institutional holders are not too much concerned about how a company is running its business as they hold several companies at a time in their equity portfolio. See Yuan Zhao, *Competing Mechanisms in Corporate Governance: Institutional Investors, Independent Directors and Market Forces, International Company and Commercial Law Review*, Vol- 21(10), 2010.

[294] The Schedule was inserted by the Companies (Amendment) Act, 1974 and was thereafter omitted by the Companies (Amendment) Act, 1984. It was then inserted by the Companies (Amendment) Act, 1988 and subsequently is has been substituted by the Notification No. 510(E).

[295] Schedule XIII, Part II, Section II provides an elaborate table prescribing ceiling limits where in any financial year during the currency of the tenure of the managerial person, a company has no profits or its profits are inadequate, it may pay remuneration to a managerial person by way of salary, dearness allowance, perquisites and any other allowances as so laid down in the Table.

and relentless examination of the levels and nature of pay packages of the executives. In contemporary times where there is a continual call for inclusive growth in the country it is surprising that this subject has not received the scholarly attention it should. It is thus not surprising that the legal scaffold in this area is not comforting and satisfying. The Companies Act, 1956 even though prima facie appears to control the level of remuneration levels of the top level executives fails to put an effective and meaningful check on the same.

Section 198 valiantly states that the remuneration payable to the directors of a company shall not exceed eleven per cent of the net profits of the company for that financial year. As is the case for most of the legislations the general rule stated in sub-section (1) is followed by an exception in the following provision. Sub-section (2) putting a caveat on the above rule states that percentage mentioned in sub-section (1) shall be exclusive of the fees payable to directors under section 309(2)[296]. It is provided in turn in Section 309 that a director may receive remuneration by way of a fee for each meeting of the board or a committee thereof attended by him[297]. The rule provided for in Section 198 in respect of executive remuneration has inherent fallacies. Philosophical hesitancy, lack of clarity, feigned control and a lack of definite policy on the issue are some of the pitfalls of the above stated provision.

The Companies Act, 1956 does not reflect a consistent or crystal clear stand on the managerial remuneration of the companies. In attempting to strike a balance between putting a cap on the salaries and giving the companies a free hand in determining the remuneration, it seems to crash between the two opposing ends. It is indisputable, given the clamor for a cap on the executive compensation in the Europe and West that a legislative control on the same is necessary. The need when recognized needs to be fulfilled in a strong and decisive fashion rather than a hesitant fashion.

[296] Section 198(1) provides that the total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company, to its directors and its manager in respect of any financial year shall not exceed eleven per cent of the net profits of that company for that financial year computed in the manner laid down in section 349 and 350, except that of the remuneration of the directors shall not be deducted from the gross profits. Sub-section provides that the percentage aforesaid shall be exclusive of any fees payable to directors under sub-section (2) of section 309.

[297] Section 309(2) provides that a director may receive remuneration by way of a fee for each meeting of the Board, or a committee thereof, attended by him.

Concluding Remarks

To sum up, there is no doubt that corporate governance has been one of the key business topics of the first half of the 1990s and it will continue to be so in the foreseeable future. An active well informed board is necessary to ensure the highest standard of corporate governance. Satyam fraud unfolded the inherent weakness of corporate governance in India focusing mainly on the weaknesses of the Satyam Board. If the evidence demonstrates the board is failing, the logical next step is reform. The consensus is that the board structure has a viable role to play and substantial changes should be made to improve the institution.

In corporate governance equally important issues are the size of the board and the strength of independent directors to disagree with the dominant interest group when company's interest so demands. In reforming the board structure the proportion of independent non-executive directors is very essential for enhancing the quality of corporate governance. The ratio of the executive to non-executive should be raised to a minimum designated level. The non-executive directors should be fully independent from the company and should meet designated qualification criteria. The non executive directors should fully monitor the executive director's conduct rigorously. All important documents relating to company affairs should be made available to the non-executive directors.

Also, the independent non-executive directors should be allowed to consult with independent professional advisers for any help in order to fulfil the objective of the company. The SEBI should take an extra step and enhance the requirement of independent director's up to the level of the NYSE[298] and NASDAQ[299] which provides that the majority of the board be staffed with independent directors. In India, some directors like Vijay Mallya[300], hold directorship in as many as fifty one firms. Various other directors serve on more than ten boards.[301] Being a member of different boards is going to hamper the performance of the directors and is going to create conflict of interest between the different corporations they

[298] NYSE online Manual, www.nyse.com/pdfs/finalcorpgovrules.pdf, last accessed on 17th May 2011.
[299] NASDAQ Online Manual, www.nasdaq.com/about/listing information.stm. last accessed on 13th May 2011.
[300] Vijay Mallya is the CEO "of the £1.2 billion UB Group,... [India's] leading beer and spirits producer." Mark William, We're Rich and Proud, Say India's New Elite, Scotsman (Scotland), June 15, 2005, Available at http:thescotsman.scotsman.com/index.cfm?id=656072005.
[301] Ajay Jindal, Independent Director's Role Gets a Jolt, Economic Times (Bombay, India), Sept. 24, 2005.

serve. There should be a cap on number of directorship holdings of an individual. This will help the directors to monitor a firm's performance more effectively because they would have a focussed mandate and the time to familiarize themselves with their company.

In corporate governance board committees plays an important role specially in terms of improving the decision making of the board as well as in enhancing the monitoring of management and accountability to shareholders. But board committees are not a remedy and it is not advisable to push for the establishment of board committees if there is need of non-executive directors to serve in these committees. In India, the real issue is the lack of qualified non-executive directors due to which problem is faced by the companies to establish effective board committees and effective board of directors.

At last, the requirement of corporate governance is more than just effective board structures. The question whether the unitary structure is better than the two-tier board structure or vice versa is irrelevant. What is relevant for choosing a board structure rests upon the company ownership, culture, company law of that country etc. There should be an interaction between the different members of the company; modification in structure will automatically follow to meet the requirement of the companies.

The issue of regulating the compensation of top level executives of a company is not an easy one to navigate. Prescribing a legislative upper limit to the compensation payable to the directors can be a two edged sword. Mandating an upper limit can at times be tricky in order to prevent it from too high and thus avoid it being a hollow regulatory control. An upper limit that turns out to be too high would negate the very purpose of putting a ceiling limit on the remuneration of the directors. On the other hand, ceiling limit cannot be too low. An inexplicable low level of limit would stifle out the motivation of the directors. It would resemble a government pay structure, where performance is not adequately compensated. However, having stated that, it would be better to err on the latter side than on the former. Moreover, how far employees are motivated by high pay levels is still questionable. Though there should be no doubt about the fact that money is certainly not the only factor which instils a desire to work efficiently. The corporate culture, due recognition for one's work and a certain assurance that one's pay levels are comparable to contemporaries in similar organizations also play a significant role in improving efficiency levels.

There is however a certain need to overhaul the present legislative framework in India in so far as it relates to compensation of the directors. An industry specific approach to determine the adequate compensation for the directors of a company would indeed be appreciable and more effectual. The need for industry differentiated compensation caps arise from the vast difference in the sizes and profits of the companies in different sectors. This would ensure parity across various sectors. Moreover, having canvassed for a cap on the remuneration of the directors the regulation by the state should not come across as too forceful. It indeed should be a serious and effectual regulation but not a complete curb that leaves no room for any kind of flexibility in company policies. The companies should be left a considerable room to determine the compensation the directors should receive, without them having the free hand to set excessive remuneration.

Chapter -4

The Role of Shareholders in Corporate Decision Making

4.1 Introduction

The effective exercise by shareholders of their powers of intervention and control within the company framework is very important component of the governance system. The work of the Steering Group[302] to propose a law that will enable shareholders to exercise their control powers more effectively took place over several months. It has consulted widely, examines the nature of various rights shareholders are entitled to exercise and considered how the law relating to the exercise by minority shareholders may be enhanced. Many suggestions with regard to how the law could be improved to enable shareholders to be more proactive in ensuring proper corporate governance were received from large and small businesses, their representative's organisations and the legal and accounting profession, as well as academia.[303]

4.2 The Effective Exercise of Control Rights by Beneficial Owners of Shares and their Representatives

The Steering Group gave the rights of persons other than legal owners of shares some consideration. It is increasingly common today for legal and beneficial ownership of the shares to be split. Many private shareholders arrange for their shares to be held by their brokers. Institutional Shareholders may have their shares held by a custodian. Overseas investors may arrange for their shares to be held by specialist banks. Each of these depositors (broker, custodian and specialist bank) will manage the share portfolio on behalf of their client; it is invariably the latter who will receive dividends due on those shares. The legal owner may also under this contract, receive instructions from the beneficial owner as to how to vote those shares, or when to buy and sell[304]. These transactions work well and make good commercial sense. They provide certain sense of administrative convenience, ensure security

[302] See www.oecd.org/.../0,3343,fr_2649_34831_40669067_1_1_1_1,00.html – last accessed on 3rd May 2011.
[303] Edward S. Adams, *Bridging the Gap between Ownership and Control, Journal of Corporation Law*, Vol- 34, 2009.
[304] Eric R. Gedajlovic and Daniel M. Shapiro, *Management and Ownership Effect: Evidence from Five Countries, Strategic management Journal*, Vol- 19(06), 1998.

of transaction and may even attract tax advantages. The concern however, is that these arrangements also make it difficult for beneficial owner and their representatives to exercise corporate governance functions. Important control rights such as the right to receive reports, accounts and notices of general meetings, to table shareholder resolutions, requisition meetings and proxies, are exercisable only by legal owner. However, the legal owner may have very little concern about the above matters at all! He may technically be the owner of shares, but as we have seen, this ownership is on papers and largely for purpose of convenience only. This separation of legal and beneficial ownership of shares inhibits the potential of individual and Institutional shareholders to play an active part within the company. The beneficial owner who may be interested in intervening the affairs of the company cannot do so.

In order to enable beneficial shareholders and their representatives to exercise their control rights effectively., the Steering Group proposed an amendment to section 360 Companies Act 1985 so that companies can, at the request of the legal owner, recognise another person in his place as being entitled to exercise certain membership rights. One right which cannot be exercised by the beneficial owner, however, is the right to transfer title to shares. This will remain solely the right of legal owner. So, also the right to charge the shares as security or assent to a takeover offer. This is to prevent interference with rights which should be exercised only by legal owners. Companies should be permitted to note on the register of members that person other than the legal owner may exercise these rights. What rights may be passed to persons other than the legal owner of shares? It is envisaged that being the right to vote, propose and support resolutions, appoint a proxy, receive reports, accounts and notices of general meetings and attend company meetings[305].

An important question is whether there should be definitive list of rights which can be passed to persons other than the legal owner of shares, or whether these rights should be general in form, subject of course to the right of the legal owner to convey title. The Steering Group preferred the second option. It thought that, to a large extent, the nature of the rights, which can be passed to persons other than legal owner, could be resolved by contract between the

[305] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harvard Law Review,* Vol- 119(06), 2006.

company and legal owner, or even defined and provided for under the article of association[306].

These recommendations are welcome. Many beneficial shareholders and their representatives are keen and willing to monitor action of management but are prevented from doing so simply due to technicalities under the law[307]. Equally, legal owner of shares may not bother taking an active part in company governance; indeed they do not have an interest to do so. It is right that a means is devised to enable beneficial owner and their representatives to exercise control rights which they otherwise forfeit simply due to their not being legal owners.[308]

4.3 Enabling Responsible, Diligent and Active Exercise of their Powers by Shareholders in General Meeting

4.3.1 Introductory Remarks

General meeting of a company is essentially a meeting of its shareholders. The Companies Act specifically reserves certain issues important for running of a company to be discussed and decided at the general meetings.[309] In addition, general meetings provide an opportunity to the shareholders for asking questions to the board of directors about the company's past performance and its future plans, in effect, act as a mechanism for ensuring directors' accountability and guard against mismanagement.[310]

General meeting, its use, requirement and role has always been an important concern and topic for debate in the corporate world. It is seen by most people as an effective tool and fair

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[306] Anupam Chander, *Minorities Shareholders and Otherwise, Yale Law Journal*, Vol- 113, 2003.
[307] V. Manickavasagam and K. Mohan, *Shareholders' Activism- A Concomitant of Corporate Governance, Sebi and Corporate Laws*, Vol- 39, 2002.
[308] Giles Proctor and Lilian Miles, *Corporate Governance*, Cavendish Publishing Ltd. London, 2002, pp: 159-161.
[309] See, secs. 173 and 293 of the Companies Act, 1956.
[310] Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting. See, Report of the Committee on: The Financial Aspects of Corporate Governance, under the chairmanship of Mr. Adrian Cadbury, 1st December 1992, para 2.5.

process for keeping a control on the affairs of a company and ensure that things proceed in the right direction for welfare of the company and its shareholders. This is based on the fact that general meeting gives a chance to the shareholders of a company to meet personally, debate, communicate information, share opinion, and vote on matters affecting the company. It is because of these reasons that general meeting has always been an extremely important necessity for an effective corporate governance regime.[311]

The most important general meeting is the annual general meeting because it is a mandatory annual affair, unlike the extraordinary general meeting, and has to be held even if the board of directors is against it, which may happen if the company has been badly managed, making it an extremely potent and powerful tool for the shareholders of a company for imposing restrictions on powers of the board of directors.

It is important to note that the utility and welfare aspects of general meeting and effective corporate governance regime are beneficial not only to a company and its shareholders but also to its all other stakeholders. The reasons are manifold; firstly, it acts as a mechanism for ensuring that the resources of the society are not wasted, secondly, companies are an inseparable part of our society and their efficient regulation is important for well being of the social fabric, and thirdly, companies are centres of wealth creation and it is but essential to stop it from being misappropriated or being utilized for immoral or illegal activities. For the said reasons there is also a strong possibility that the shareholders would join hands with other stakeholders of a company in the interest of an efficient corporate governance system.[312]

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[311] The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance. See, Report of the Committee on: The Financial Aspects of Corporate Governance, under the chairmanship of Mr. Adrian Cadbury, 1st December 1992, para 1.1.

[312] An example is of labour unions. Unions have the capability and incentive to play a beneficial monitoring role for shareholders. This capability arises from their unique access to information, which comes from their day-to-day involvement with the corporation. Unions, in representing workers, regularly assemble and analyze information about the firm from a variety of internal and external sources. Unions routinely collect and evaluate general information regarding corporate performance, industry trends and forecasts, as well as information that is specific to contractual provisions. The informational expertise of unions may be most useful in scrutinizing executive-compensation decisions. Unions also have access to information regarding the day-to-day activities of firms. To the extent that day-to-day operations reflect corporate policies and strategies

In context of today's world, the separation between the ownership and management control of large public companies is an admitted fact. The capital of a company is owned by numerous, diversified, dispersed and passive shareholders who mostly are profit oriented and do not take much interest in affairs of the company despite being in a position to influence them. This enables the board of directors who have the management control of a company to enjoy unbridled power which is prone to easy misuse. Theoretically speaking the shareholders have quite a few methods[313] to control the powers of the board of directors and put restrictions on undesirable activities but over a period of time, because of the above said reason, the power of running the company's affairs has completely moved into the hands of the board of directors and the shareholders have been reduced to carry out a very minor role, sometimes just being an impotent rubber stamp on the wishes of the board of directors who due to this have great control over huge amount of public money. Thus, many public companies can be called as 'minority run' corporations as the promoter group which has comparatively lesser stake, and referred to as minority in this sense, is able to control the company by being able to take all major decisions as per its wishes despite comparatively larger public stake involved.[314]

Hence, there is an alarming need for making general meeting a more efficacious and potent instrument which is essential and beneficial for all the stakeholders of a company. The indispensable importance of general meetings needs to be highlighted and measures required

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defined by directors and officers, unions have information regarding the effect of those strategies "on the floor." Moreover, unions' presence in the firm gives them an opportunity not available to most shareholders to assess the extent to which compensation systems reward supervisors, managers, and officers for short-term, as opposed to long-term, improvements in productivity and decreases in operating costs. Unions often know when morale is good or whether a flashy new project is a boondoggle. Unions have a greater incentive than most shareholders to monitor management rather than free ride on monitoring by others. Workers are locked into the firm with firm-specific human-capital investments, while shareholders have diversified portfolios with relatively little fixed interest in a single firm. Workers thus have greater incentives to monitor management to ensure that the firm remains healthy. If unions could harness this incentive and ability to monitor and credibly relay their information to other shareholders or to the independent directors on the board, a major role for unions could develop. In short, if workers want to protect their residual claims on these firms, they have significant incentives to become activist shareholders and to reform inefficient corporate-governance systems. See, Stewart J. Schwab, Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labour Unions, Michigan Law Review*, 1998.

[313] See, secs. 291 and 293 of the Companies Act, 1956.

[314] Major Indian public companies in India like Infosys Technologies Ltd., Mahindra and Mahindra Ltd., Tata Motors Ltd. and Ashok Leyland Ltd. have total public shareholding to the extent of 80.28%, 72.25%, 58.02% and 55.40% respectively as on 30th June 2010. See, www.bseindia.com/shareholding, last accessed on 10th May 2011.

to reform the general meeting provisions are to be found and implemented so that it more effectively meets its primary objectives such as the following two;

- *Act as a forum where shareholders can properly exercise their rights.*
- *Act as a method of effective control on the board of directors.*

It is in the above context that effective utilization of general meeting and necessary reforms for the purpose of putting real power and effective control in the hands of the shareholders becomes significant and very essential for the well being of any company and all its stakeholders.[315]

4.3.2 Enhancing the Participation of Shareholders via General Meeting

It is in general meetings that important questions and aspects related to the functioning of a company can be collectively and rationally discussed bringing forth many ideas and suggestions to be exchanged, and such active participation and meaningful deliberations would purposefully help the shareholders of a company to decide and address issues on the basis of their informed consent. These issues *inter alia* could include financial status of the company, appointment and removal of directors, questioning[316] the directors on the performance of the company[317]. However, apart from the past affairs, what is most important for the shareholders here is that the future plans, targets and related issues of resources and deficiencies of the company be specifically discussed to the minutest details. For this purpose it is desirable that the board of directors makes an easy to understand presentation at the

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[315] Corporate governance has several claimants–shareholders and other stakeholders – which include suppliers, customers, creditors, the bankers, the employees of the company, the government and the society at large. This Report on Corporate Governance has been prepared by the Committee for SEBI, keeping in view primarily the interests of a particular class of stakeholders, namely, the shareholders, who together with the investors form the principal constituency of SEBI while not ignoring the needs of other stakeholders. The Committee therefore agreed that the fundamental objective of corporate governance is the "enhancement of shareholder value, keeping in view the interests of other stakeholder". This definition harmonises the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company. See, Report of the Committee Appointed by the SEBI on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla, 7th May 1999, para 4.1.-4.2.

[316] See generally, Stewart J. Schwab, Randall S. *Thomas, Realigning Corporate Governance: Shareholder Activism by Labour Unions, Michigan Law Review,* 1998.

[317] Stephen M. Bainbridge, *The Politics of Corporate Governance, Harvard Journal of Law and Public Policy,* Vol-18, 1995.

beginning of every general meeting showing a detailed roadmap for the future and take consent of the shareholders on all matters[318].

In addition to the above general suggestions, certain specific deficiencies and suggestions for their removal are discussed hereafter;

4.3.2.1 Appointment of Directors

An essential activity to be carried out in the general meeting is the appointment[319] of directors[320] for which in case of listed public companies it is necessary for the shareholders to be provided with a brief resume, nature of expertise in specific functional areas, details about other directorships and committee memberships and shareholding.[321] It is suggested that all candidates be made to give a point wise and easy to understand presentation about their objectives and plans for the growth of the company and the reasons as to why they should be elected, further they should be subjected to a question answer session with the shareholders so that doubts and queries related to them can be satisfactorily dealt with. Also, same provisions should be included in the companies act so that it can be made applicable to private companies and unlisted public companies as well. Further, the terms and conditions of appointment of directors should be discussed in a detailed manner and approved in the general meeting and shareholders should primarily take care of two things that the terms of appointment are beneficial for the company and that the costs to be incurred in case of removal[322] of directors is minimal.

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[318] Jeremy Charles Vanderloo, *Encouraging Corporate Governance for Closely Held Business, Mississippi College Law Review,* Vol- 24(39), 2004.

[319] Probably the single most important shareholder task is nominating and electing directors. Electing good directors is especially important for diversified institutions, who can't watch any one company closely and probably aren't competent to do so anyway. Yet legal obstacles are especially great for shareholder efforts to nominate and elect directors, even for a minority of board seats. See, Bernard S. Black, *Shareholder Passivity Re-examined, Michigan Law Review,* 1990.

[320] See, sec. 255 of the Companies Act, 1956.

[321] See, para IV(G) of Annexure I of Clause 49 of the Listing Agreement.

[322] See, sec. 284 of the Companies Act, 1956.

4.3.2.2 Disclosures

Same procedure as in the case of appointment of directors should be made applicable in respect of the disclosures mandated by the listing agreement[323] for listed public companies. Also, it should be made applicable to private and unlisted public companies by making necessary amendments to the Companies Act. Further, provision should be made for compulsorily displaying all disclosures on the company's website[324]; this would make it easier for the shareholders in preparing for meetings, for making requisitions and at the same time bring about more orderly procedure, reduction in cost, lesser effort and better utilization of time.[325]

4.3.2.3 Accounts and Budget

Regarding financial and accounts matters, it should be made compulsory that apart from the past accounts and reports[326], the whole future budget explaining all different sort of expenditures, including remuneration of the directors, of the company for the next financial year be declared and discussed at length in the meeting and should be adopted if only so approved by the shareholders with changes, if any made. This would greatly cut down the possibility of arbitrary and detrimental expenses. Further since it is difficult to study and understand financial documents, the same must be sent much in advance, the statutory

[323] Disclosures regarding and under the heads of basis of related party transactions, disclosure of accounting treatment, board disclosures - risk management, proceeds from public issues, rights issues, preferential issues etc., remuneration of directors, management and shareholders. See, para IV of Annexure I of Clause 49 of the Listing Agreement.

[324] In the area of shareholder participation in corporate governance, the problems with the proxy system as it is today and the utility of the Internet for wide distribution of information make a natural marriage. In preparation for an electronic meeting, the annual report may be published on the page ahead of time, allowing every shareholder to read it at her leisure. Proposals may be made electronically either through the messaging system or on the page itself; however, this may pose a potential problem. Larger corporate constituencies will likely have a greater number of proposals. See, George Ponds Kobler, *Shareholding Voting over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance, Alabama Law Review,* 1998.

[325] For example, the corporation may use a Web site to distribute information and allow shareholder communication prior to the annual meeting. This use would hopefully air out any significant issues so that the need for prolonged discussion during the meeting would be reduced. The meeting, conducted through teleconferencing, would potentially be more orderly and yet permit the shareholder to retain the benefits of attendance. In either case, shareholder activism is facilitated, which may result in overall social utility.

[326] See, sec. 210 of the Companies Act, 1956.

notice[327] period of 21 days[328] seems inadequate for this and should be increased. This would help the shareholders to come prepared for any sort of relevant issues and they will not be plagued by confusion and doubt.

4.3.2.4 Quorum

The number of quorum[329] has also been a topic of discussion and in today's world when the number of shareholders of a company runs into millions of people, the statutory prescribed number of five members, for public companies, seems grossly inadequate to be able to know, discuss and address the interests of all the members of a company. Hence, a practical suggestion would be to vary the quorum depending upon total number of shareholders i.e. the quorum should be a certain percentage of the total number of shareholders of the company. But there is also a negative possibility in this regard, understanding the lack of interest of the shareholders at large in attending general meetings due to a variety of reasons one may argue that it would be very difficult to hold general meetings if the quorum required is a very big number more so in case of large public companies where the number required maybe so high that the purpose sought be achieved may not be so attained. Thus, to remedy this problem an effective answer may not lie in increasing the quorum requirement to a specific number that is in general applicable to all companies, instead it would be more prudent to have a system of slab wise quorum[330] i.e. companies should be divided into different slabs on the basis of their total number of shareholders and a different quorum be prescribed for every slab.

4.3.2.5 Attendance of Retail Shareholders

The above made suggestion for institutional shareholders does not solve the problem of low attendance[331] of the retail shareholders at the general meetings, who do not find much

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[327] It is suggested that the notice along with the financial documents and other data should also be compulsorily sent by email and be prominently displayed on the company's website.
[328] See, sec. 171 of the Companies Act, 1956.
[329] See, sec. 174 of the Companies Act, 1956.
[330] For example, for companies having less than x number of shareholders the quorum should be 'a', for companies having x to y number of shareholders the quorum should be 'b', for companies having y to z number of shareholders the quorum should be 'c' and for companies having above z number of shareholders the quorum should be 'd'.
[331] Most modern corporate scholars, especially those with a law-and-economics bent, accept shareholder passivity as inevitable. They rely on market forces, especially takeovers, to limit managerial discretion. The critics' claim, stripped to its essentials, is that shareholders don't care much about voting except in extreme

incentive in attending because of the significant costs[332] they would have to incur to be able to attend. Useful methods for addressing this can include spreading awareness, educating about the benefits of attending meetings, creating a sense of responsibility, encouraging habits of regular contact, asking questions, raising doubts, seeking clarifications among such shareholders. These duties must be cast on the board of directors of the company. Further, financial incentives may also be given to retail shareholders holding a certain percentage or above of shares of the company for attending general meetings, however, this may not be a long term solution but would help in achieving the long term objectives of spreading awareness and creating a sense of responsibility among shareholders. Further, the use of webinars, as suggested here later under the head System of Postal Ballot, can also greatly help in increasing shareholder participation. In case, a company is not able to afford such webinar facility to each and every shareholder, it can instead provide for common facility[333] in major cities around the country.

4.3.2.6 Proxy System

The system of proxy[334] is meant for increasing shareholder participation[335] in general meetings but this objective is thwarted by not allowing proxies to speak in the meetings and

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cases and never will. Collective action problems, which arise because each shareholder owns a small fraction of a company's stock, explain why shareholders can't be expected to care. See, Bernard S. Black, *Shareholder Passivity Re-examined, Michigan Law Review,* 1990.

[332] The act of voting and becoming informed enough to vote intelligently, requires an investment of time, which is a scarce resource. Yet a shareholder's vote is unlikely to affect whether a proposal wins or loses. The cost and futility of becoming informed leads shareholders to choose rational apathy: They don't take the time to consider particular proposals, and instead adopt a crude rule of thumb like "vote with management." See, Bernard S. Black, *Shareholder Passivity Re-examined, Michigan Law Review* 1990.

[333] Video teleconferencing provides virtually face-to-face real time meeting capability expanded to include remote locations, which makes the meeting accessible to more people and eliminates the cost of traveling to a central meeting location. The problem with public corporations is that, depending on the number of shareholders entitled to vote, it may be impractical to assume or require that every member have video teleconference capability on their personal computer because of high cost. In addition, it could create problems with shareholder participation in that the central corporate location would have the capability to allow a myriad of shareholders with individual video-conferencing ability to have input. These problems are overcome if there are teleconferencing facilities at several locations where shareholders may come and attend the meeting. In fact, the best place may be the shareholders local brokerage firm which itself would realize certain advantages. First, brokerages are often located central to various groups of shareholders, making the meeting less inconvenient. Second, the brokerage is in a better position to afford the high cost of installation and maintenance of such a system. See, George Ponds Kobler, *Shareholding Voting over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance, Alabama Law Review,* Vol- 49, 1998.

[334] See, sec. 176 of the Companies Act, 1956.

also not counting their votes in the show of hands[336]. This is absurd as it defeats the very purpose of shareholder participation.[337] The proxies should be allowed to speak freely and participate in all discussions and deliberations in order to convey the ideas and opinions of the shareholder whom they are representing and also be counted in the show of hands as it is the first method adopted for passing a resolution.[338] In order to ensure that the proxy is conveying the shareholder's point of view the appointing shareholder should be asked to convey in writing their ideas, suggestions and also stands on all issues to be discussed along with the instrument appointing the proxy and the same should be duly checked before the meeting so as to avoid any malpractice.[339]

4.3.2.7 System of Postal Ballot

The system of postal ballot[340] including by electronic means aims to increase shareholder participation by saving them from the hassles and costs of attending general meeting and also benefit the company on the same counts. This system does away with the problems of organizing general meetings and it also becomes easier for the shareholders to participate in

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[335] When the corporation first developed, the shareholders, as residual owners of the corporation, typically were relatives or members of the local community. Shareholders' meetings were important because they provided a forum for discussion about the conduct of the business and a sharing of the collective wisdom. In that era, a shareholder's vote was considered a property right by the courts, so precious and personal that it could not be delegated. Then, as now, the corporation was a creature of state law. State common law and statutory law gave shareholders the right to make proposals and vote at corporation meetings. As corporate ownership became widely dispersed, with greater numbers of shareholders spread across a growing geographic area, it became more and more inconvenient for shareholders to attend meetings, and the absent shareholder was effectively disenfranchised. Thus, the delegation of one's voting right, or proxy, was developed out of state law to enable the shareholder to exercise her voting right in the corporation. See, George Ponds Kobler, *Shareholding Voting over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance, Alabama Law Review*, Vol 49, 1998.

[336] Carol Goforth, *Proxy Reforms as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little but not too late, American University Law Review*, Vol- 43, 1994.

[337] J. Harold Mulherin and Annette B. Poulsen, *Proxy Reform as a Single Norm? Evidence Related to Cross Sectional Variation in Corporate Governance, Journal of Corporation law,*, Vol- 17, 1991.

[338] See, secs. 177 and 179 of the Companies Act, 1956.

[339] A proxy is essentially a written contract in which the record owner of stock grants another person the authority to vote shares in his absence. The proxy holder then becomes the shareholder's agent for voting purposes. The shareholder may either grant the proxy holder unlimited voting discretion on any issue, or restrict voting authority only to certain issues. Because many shareholders cannot physically attend shareholder meetings, the majority of shareholders vote by proxy. Because so many shareholders vote by proxy, corporate governance decisions often hinge upon which of two opposing sides can garner enough shareholder proxies to win a vote at a shareholders' meeting—hence the name "proxy contest." See, Jill A. Hornstein, *Proxy Solicitation Redefined: The SEC takes an Incremental Step towards Effective Corporate Governance, Washington University Law Quarterly*, 1993.

[340] See, sec. 192A of the Companies Act, 1956.

the decision making process. However, there is a loss in the sense that there is no exchange of ideas, discussions, deliberations, question and answer sessions, and hence, it can be inferred that the shareholders voting on the issues by way of postal ballot do not have complete information and knowledge about the issues, decisions, reasons and consequences. Hence, the resolutions passed by this method cannot be said to be based on the informed consent of shareholders and in this regard the resolutions are deficient. An alternative to this method lies in the use of internet, with proper security measures[341] in place, by way of holding webinars i.e. web based seminars which allow for interactive and collaborative sessions, question and answer rounds and also voting. This would fill the deficiencies of postal ballot, keep in place the advantages offered by it and also offer additional advantages like reduction in costs[342].

4.3.2.8 Member's Requisitions for Resolution

The member's resolution[343] is a very important and effective power at the disposal of the shareholders but due to difficult to satisfy requirements it is rarely used[344]. It is troublesome task for small shareholders to generate the statutorily required support for their requisitions due to the numerous, dispersed and passive nature of shareholders and also the expenses[345]

[341] Considering all of the Internet users in the world, one potential problem is the maintenance of security. This problem can be overcome by keeping a record of all of the IP addresses allowed to access the host computer and correlating them with the permissible unique user identifications. Then, as a final measure, each user is assigned a password which, taken together with the foregoing information, allows a user to access the host. Implicit in this arrangement is that to maintain proper security, the host computer records the user and the IP address of the computer that has accessed the host. One pitfall of this arrangement is that the host cannot guarantee that the user will not inadvertently or otherwise divulge his password to an unintended accessor. See, George Ponds Kobler, *Shareholding Voting over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance, Alabama Law Review,* Vol- 49, 1998.

[342] Perhaps the most significant feature of Internet communication is low cost. Individual users generally either access the Internet through a "provider" such as America Online (AOL), Prodigy, or Compuserve. These providers give the user gateways to the various regions of the Internet, including e-mail and the Web, for a fee usually based upon time. Larger institutions such as corporations, schools, and the government generally provide services to their employees at no cost to the individual. The cost of doing this is feasible because of the huge corporate and organization presence on the Web. See, Ibid.

[343] See, sec. 188 of the Companies Act, 1956.

[344] Shareholder passivity is not inevitable even in large public companies. Instead, legal barriers, manager agenda control, and conflicts of interest may be important reasons why shareholders do as little as they do. Shareholders, who would purchase large stakes, join forces with others to present voting proposals, or nominate and elect their own directors, face a complex web of legal barriers and risks. Many also face strong conflicts of interest, which are only weakly controlled by legal rules. See, Bernard S. Black, *Shareholder Passivity Re-examined, Michigan Law Review,* 1990.

[345] Even when legal rules permit shareholder action, they raise costs. Those costs are important because a shareholder proponent bears most of the costs of her actions, receives a fraction of the benefits, and faces an opponent who has the enormous advantage of being able to spend other people's money. The obstacles to

involved in making such requisitions are very high which acts as barrier to the exercise of this power. Further, the requirement of depositing signed copy of the requisition at the registered office of the company at least six weeks prior to the date of the general meeting, in case of resolutions requiring notice, is a tough condition to satisfy considering the fact that the notice period for the meeting is much lesser i.e. 21 days. Thus, this right can only be exercised in a scenario when the shareholders know the date of general meeting much in advance i.e. the company gives a notice period of more than six weeks, which can happen when the company announces the date of its next general meeting at the earlier general meeting. Further, in case a shareholder wants to requisition a resolution with regard to any material circulated with the meeting notice it would be impossible for him to do so. Hence, it is suggested that the date of depositing a signed copy of the requisition at the company's registered office be changed from 6 weeks to 2 weeks prior to the date of the meeting and then a special notice be given regarding the member's requisition. This would give the shareholders proper opportunity and time to co-ordinate support for their requisition, for which purpose the shareholders should be allowed to use the company's web infrastructure over the internet. This change of procedure may result in increasing the expenses involved in the matter, though not much because of the use of internet, a possible solution to this barrier is that in case the member's requisitioned resolution is passed in the meeting, a second resolution seeking reimbursement of the expenses borne by the requisitioning shareholders be moved, the shareholders may be asked to use what may be called as an 'essential resolution' test wherein if the shareholders feel that the resolution was essential for benefit of the company as a whole then they should vote in favour of reimbursement of expenses of the requisitioning shareholders.

4.3.2.9 Chairman of Meeting

The chairman of the meeting plays a pivotal role in fair and efficient conduct of the proceedings of the meeting and it is imperative that he should be impartial and disinterested person.[346] The post has certain inherent responsibilities and powers to carry them out.[347] It is essential that the chairman should enjoy the support of the people attending the meeting

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forming groups magnify these cost barriers by discouraging cost-sharing among shareholders. See, Bernard S. Black, *Shareholder Passivity Re-examined, Michigan Law Review,* 1990.

[346] See generally, Hon'ble Mr. Justice Y.V. Chandrachud, S.M. Dugar (eds), A. Ramaiya,, *Guide to the Companies Act,* Wadhwa and Company, Nagpur, 2004.

[347] See, clauses 53, 54 and 55 of Table A in Schedule I of the Companies Act, 1956.

otherwise there is an easy possibility of disruptions and foul play. Hence, the power to elect the chairman is given to the shareholders.[348] However, this is subject to the Article of Association of a company and the problem lies in the fact that the articles can provide for rules wherein a member of board of directors would first have the right to become the chairman and only on their refusal can the shareholders exercise their right to choose the chairman.[349] This gives rise to a very evident possibility of bias in favour of the board of directors, who in such circumstances would be in a position to completely control the proceedings because of which they could hide all deficiencies, failures and instances of mismanagement causing serious detriment to the shareholders and thus defeating the very purpose of holding general meetings. Hence, it is suggested that these provisions be amended to make it compulsory that the chairman would be elected by the shareholders from among themselves and that the person so elected should not be a member of the board of directors[350].

4.3.2.10 Venue of Meeting

Apart from the annual general meetings, which need to be compulsorily held at the place[351] of the registered office or in the city where the registered office is located,[352] other general meetings i.e. extraordinary general meetings can be held at any place. This can result in inconvenience to the shareholders if the board of directors decide to hold the meeting at an obscure or far flung location, which can happen if the board of directors have been guilty of wrong activities, hence it should be made compulsory to hold all types of general meetings at the place of registered office or in the city where the registered office is located.

4.3.2.11 Day of Meeting

The provision[353] prohibiting holding annual general meetings on public holidays[354] seems to be misplaced. There have been arguments in the past requesting this prohibition to be lifted,

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[348] See, sec. 175 of the Companies Act, 1956.
[349] See, clauses 50, 51 and 52 of Table A in Schedule I of the Companies Act, 1956.
[350] Lucian A. Bebchuk and Assaf Hamdani, *The Elusive Quest for Global Governance Standard, University of Pennsylvania Law Review,* Vol- 157, 2009.
[351] See generally, Hon'ble Mr. Justice Y.V. Chandrachud, S.M. Dugar (eds), A. Ramaiya,, *Guide to the Companies Act,* Wadhwa and Company, Nagpur, 2004.
[352] See, sec. 166(2) of the Companies Act, 1956.
[353] Ibid.
[354] See generally, Hon'ble Mr. Justice Y.V. Chandrachud, S.M. Dugar (eds), A. Ramaiya, *Guide to the Companies Act,* Wadhwa and Company, 2004.

however, they did not meet their desired ends. The requirement compels people to miss out on their work day and lose their day's earnings if they wish to attend the general meeting; this seems contradictory to the very objective of holding general meetings. General meetings aim at maximum shareholder attendance and participation but with the requirement of losing out on a day's income not many would choose to do so. It may be argued that people should look at the bigger benefit of attending the annual general meeting only once a year to voice their opinions and problems but this seems to be frivolous in view of the fact that people may not understand this to be a bigger benefit and also that in today's world a single person is a shareholder in many companies and if he has to attend the annual general meetings of all the companies then he will lose out on a considerable amount of work days and also a substantial amount of his income, this definitely seems to be absurd and impractical. Thus, it is essential that annual general meetings be allowed to be held on weekends, and if possible, it should be made compulsory to do so in order to ensure convenience to the shareholders.

4.3.2.12 Quantum of Fines

Fines act as deterrents for people from not following the prescribed rules and procedures. Hence, it is important that their quantum should be such that it achieves its objective and is not a mere namesake value. It is for this purpose suggested that the fines prescribed in the Act[355], which seem to very less when compared to the loss that would be caused by the non compliance, be increased to such high amounts that would really act as a deterrent and today's companies and their officers would be more willing to comply with prescribed rules and procedures than to pay such fines. However, a right of hearing must be given before imposing fines in order to establish that the non compliance was due to reasons not beyond the control of the company and its officers.

4.4 The Rise of Institutional Shareholders

The institutional investor has existed since as long as the company limited by shares became popular. However, it rose to prominence only after the Second World War[356]. Several factors

[355] See, Secs. 165(9), 168, 176(2), 176(4), 188(8), 192(6), 192A(6), 193(6) and 196(3) of the Companies Act, 1956.

[356] For an historical analysis of the growth of institutional investment in the UK, see Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed*, Oxford: OUP, 2008.

have contributed to the rise of the institutional investor. In general, the rise of institutional investors in the United Kingdom from the mid-20th century onwards has been attributed to the fear of inflation for much of the post-war period[357], coupled with the existence of conditions favourable to retirement-driven long-term saving[358] and important legal changes [359]created a situation of dominance by insurance companies and pension funds which was[360] lacking earlier insofar as ownership in UK listed companies are concerned[361]. Internationally, in 1990s a group of corporate governance scholars led by Mark Roe[362] and Bernard Black[363] believed they had identified the "white knight" of corporate governance, i.e. the institutional investor, and that the only factor hindering their activism was legal barriers. However, institutional investors remained passive. Banks, insurance companies and private pension funds that were sponsored by corporate employees did not oppose the management of companies because of conflict of interest issues. Public equity funds like mutual funds and public pension funds, though free from these conflict issues, adopt the "Wall Street Walk" instead of investing in corporate governance. Private equity funds[364] like venture capital firms, LBO and certain hedge funds have been active.

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[357] It is this fear of inflation that made financial institutions gives up their fixation for fixed interest securities in favour of equity ownership which grew considerably during this period to the point where institutional investors came to dominate the buy side of the equity market. Paul L. Davies, *Institutional Investors in the United Kingdom* in D.D. Prentice and P.R.J. Holland (eds), *Contemporary Issues in Corporate Governance* Oxford: OUP, 1993.

[358] Long-term saving grew in the post-war years significantly. From £50 billion in 1976, long-term savings grew to a whopping £440 billion in 1989. In terms of personal sector wealth percentage, it grew from 11% to 18%. This contributed to the tripling of the share of pension funds between 1965 and 1988 where life insurance companies increased their share by half during the same period. Davies, *Institutional Investors in the United Kingdom in Contemporary Issues in Corporate Governance*, 1992.

[359] This included the relaxation of the trustee investment rules by the enactment of the Trustee Investment Act 1961 as a consequence of which, trustees were allowed to invest part of the trust fund in equities. Further, favourable tax treatment of insurance companies and unit and investment trusts also contributed to the growth of the institutional shareholdings in the United Kingdom. John H. Farrar, *Company Law*, Butterworths & Co, 1985.

[360] Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control, Washington University Law Quarterly*, Vol- 70, 1992.

[361] Davies, *Institutional Investors in the United Kingdom, Contemporary Issues in Corporate Governance*, 1992.

[362]Mark Roe, *Strong Managers, Weak Owners: Political Roots of American Corporate Finance*, Princeton University Press, 1994.

[363] Bernard Black, *Shareholder Passivity Re-examined, Michigan Law Review*, Vol- 89, 1980, where he argued that "institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes".

[364] Denoted the "kings of capitalism" by The Economist ("Kings of Capitalism: A Survey of Private Equity", The Economist, November 27, 2004, p.2), they generally seek to acquire control over a limited number of target companies in order to actively direct corporate policy. In other words, they compete based on their relative ability to squeeze agency costs out of inefficient companies.

When one looks at India, the data collected regarding the stake of institutional investors lacks the precision of the position of institutions in the United Kingdom, Australia, etc. However, there seems to be a consensus that institutional shareholders "have acquired large stakes of equity share capital of listed Indian companies"[365]. Financial institutions are also credited with "substantial" shareholdings. Such statements aren't unwarranted.[366] Further, in India the domestic financial institutions have always regarded themselves as "committed" shareholders[367]. However, their intervention has been uneven and has been criticised for its ineffectualness.[368]

4.4.1 The Debate of Institutional investors versus Regular Shareholders

Andrew Singler distinguishes the two, saying:

> *"The 'real' shareholder engages in fundamental analysis of particular companies and shares much the same concerns and time horizons that the traditional owners of a business might have."*[369]

By contrast, the frequent trader and the indexed investor "abstract from the company's real economic prospects to focus on its immediate performance or, even more narrowly, on its

[365] Final Report of the Kumarmangalam Birla Committee on Corporate Governance, para.14.14 (Kumarmangalam Report).

[366] The Life Insurance Corporation of India, the largest investor in the country, had investments in securities alone worth Rs 6,75,537.76 crores as of March 31, 2008. According to Lalita Som, "Corporate Governance Codes in India", Economic and Political Weekly, September 30 -- October 6, 2006, p.4152, the Unit Trust of India (UTI), the LIC and the General Insurance Company together own 15-20% of the listed sector. Foreign institutional investors (FII) investments in equity as of August 2009 was Rs 7,10,792 crores, a fivefold increase since December 2003 in nominal terms. Mutual funds have net assets under management worth as of August 2009 Rs 7,56,638.17 crores. Of this, 78.82% of the assets are concentrated in the hands of private sector mutual funds and the remainder is in the hands of public sector mutual funds. Of the latter, 9.73% of the assets are concentrated in the Unit Trust of India alone. A large chunk of these assets are a result of Income/Debt Oriented Schemes followed by Growth/Equity Schemes
See http://www.sebi.gov.in/mf/rmmf.html, last accessed on 3rd May 2011.
http://www.sebi.gov.in/mf/staaprmar2002.html; 51st Annual Report: 2007-2008 of the Life Insurance Corporation of India available at http://www.licindia.com/pages/Annualreport.pdf; http:// www.sebi.gov.in/odi/2009.html; http://www.sebi.gov.in/odi/2003.html, all accessed on 3rd May 2011.

[367] However, this is more of an assertion than a fact. See Jairus Banaji and Gautam Mody, *Corporate Governance and the Indian Private Sector,* QEH Working Paper Series, Working Paper No.73, 2001.

[369] Andrew Singler, Our Money's Worth: New York (State), Governor's Task Force on Pension Fund Investment 1990.

index weighting".[370] Kraakman et al. demonstrate that monitoring is a difficult task for institutional investors as compared with regular shareholders, owing to transaction costs involved and lack of incentive compared to the traditional shareholder. For corporate governance to be a plausible option to institutional investors they must enhance the aggregate value of the portfolio on the whole rather than merely transferring wealth from one firm to another[371]. Institutional investors have a higher obligation, for various reasons to take an active role in ensuring good governance as is discussed below.

4.4.2 Why institutional investors?

> *"It is the long term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks."* J.M. Keynes[372]

One may ask: why are institutional investors considered to be so important for achieving the objectives of corporate governance? There are several reasons for this: economic analysis suggests a positive relationship between active institutional investors and the enhancement of long-term value of the company[373]. This is advantageous in the long term not only for the firm but also the investors who have deposited money with the institution. In fact, in a market where institutional investors have a diversified portfolio and trading activity is restricted as a consequence, such an active involvement is perhaps the only way in which an institutional

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[370] Gilson and Kraakman, *Reinventing the Outside Directors, Stanford Law Review*, Vol- 43, 1991.

[371] As Kraakman observes: "Monitoring every company would mean sacrificing most of the transaction cost savings that motivated adopting an indexing strategy in the first place. Moreover, institutions should not take such an interest because they stand to gain much less from it than traditional owners might gain. Many improvements affecting the value of one company in an indexed portfolio come only at the expense of other companies in the portfolio. For example, the institutional investor does not gain when one of its portfolio companies acquires market share at the expense of another. From the portfolio holder's point of view, this improvement merely transfers money from one pocket to another in the same pair of pants. A corporate governance strategy for passive portfolio managers begins with the insight that efforts to increase investment values must be measured by their effect on the entire portfolio, not just on the individual companies." See Gilson and Kraakman, *Reinventing the Outside Director. Stanford Law Review*, Vol- 41, 1993.

[372] J.M. Keynes, *The General Theory of Employment, Interest and Money, 1936 as cited in Institutional Investment in the United Kingdom: A Review*, 2001 (Myners Committee Report).

[373] See Barry D. Baysinger, Rita D. Kosnik and Thomas A. Turk, *Effects of Board and Ownership Structure on Corporate R&D Strategy, Academy of Management Journal*, Vol- 34(1), 1991.; Rahul Kochhar and Parthiban David, *Institutional Investors and Firm Innovation: A Test of Competing Hypotheses, Strategic Management Journal*, Vol- 17(1) 1999.

investor can best service its investors in the long run. Short-termism is no longer an option, if it ever was[374].

Also, it is important to note that trading activity from institutional investors is important as it is an important tool to determine the right price of the stocks and add to the informational environment of the firm[375]. Such efficiency is a valuable public good as everybody in the market benefits from it. Therefore the increased presence of institutional investors adds to the market quality. Further, institutional activism in other jurisdictions has helped resurrect the voice of the shareholder in serving to make corporate management more accountable. Therefore it has been argued that institutional investors could take an active turn at effectively controlling corporate governance of the companies in which they are shareholders. By taking a closer interest in the firms they invest in, institutional investors would represent the stakeholder interest of their investors and this would result in better management, and firms strongly committed to long-term investment[376].

Lastly, an often unarticulated premise is also that institutional investors have an obligation to both, its investors and the company, to actively participate in the company's management. It is argued that the two principles, i.e. the obligations of the institution to its investors and to the company as a whole are competing. However, the researcher believes that the two are contemporaneous and converging but not necessarily competing owing to the aforementioned reasons. English courts have imposed a positive obligation on trustees with a substantial stake in a company to actively participate in the management of the company[377]. The same, it has been argued, could, but is unlikely to be applied to institutional investors. It is suggested that it certainly applies in cases of company where an institutional investor has a substantial stake

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[374] See Miles and Proctor, *Unresponsive Shareholders in Public Companies, Company Lawyer*, Vol 21, 2000; J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Oxford: OUP, 1993.

[375] Boehmer and Kelly have found that greater institutional holdings are associated with improved informational efficiency of prices, and this result is robust across different measures of efficiency, different econometric specifications, and a variety of controls. The presence of institutional investors has been found to add to the information environment of the firm. Ekkehert Boehmer and Eric Kelly, *Institutional Investors and the Informational Efficiency of Prices, American Finance Association 2007 Chicago Meetings Paper* (July 24, 2007), available at http://ssrn.com/abstract=791905 last accessed on 15th May 2011.

[376] Andrea Corfield, *The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis, Bond Law Review*, Vol- 10(02), 1998.

[377] See *Lucking's Will Trust*, Re [1967] 3 All E.R. 726 Ch D; *Barlett v Barclays Bank Trust Co Ltd* (No.1) [1980] 1 All E.R. 139 Ch D.

though not necessarily a controlling one[378]. The prime reason for singling out institutional investors over other investors for this is that institutional investors invest public wealth in companies and hence have a public duty to protect it as trustees[379]. Further, through their actions to use the voice route or exit route, they affect the market as well, as a result of which such power must be exercised for their benefit as well. The OECD Principles of Corporate Governance expressly recognise the fiduciary position of institutional investors[380].

4.4.2.1 Functions and Duties as an Influential Owner

Many of the authoritative Committee reports like the Cadbury Committee Report on the Financial Aspects of Corporate Governance and the Combined Code correctly emphasize on the role that institutional shareholders should play in facilitating good corporate governance and the manner in which they can discharge their responsibilities in this regard.[381] These reports mainly emphasize on three basic things that the institutional shareholders should do to execute their responsibilities and duties efficiently- voting effectively, having a constant dialogue with the companies and analyzing company disclosures[382].

Institutional Shareholders are expected to stick by the companies they invest in and not to bow out at the first opportunity when the companies start under-performing. 'Exit Route' is

[378] Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation, Vanderbilt Law Review*, Vol- 61, 2008.

[379] An individual investor may also be saddled with such responsibility only when his investment decisions are capable of affecting a large number of people or cause market distortions detrimental to other investors.

[380] Section II.F of the OECD Principles on Corporate Governance: "The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.
2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments."

[381] "...that there should be regular contact between companies and their major institutional shareholders at senior level and that such matters as board strategy and structure should be kept under review." Excerpt from: Cadbury Committee Report on The Financial Aspects of Corporate Governance, December 1992.

[382] "Principle E.1 of Section 2: Dialogue with Companies- Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives; Principle E. 2 of Section 2: Evaluation of Governance Disclosures- When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention; Principle E. 3 of Section 2: Shareholder Voting- Institutional shareholders have a responsibility to make considered use of their votes." Excerpt from: The Combined Code on Corporate Governance, July 2003.

much criticized and considered to be unhealthy for everyone be it the market and investors at large or be it the stakeholders, etc. However, it is debatable as to how many companies how frequently actually avail the exit option[383].

4.4.2 2 Tools of Control

Institutional investors use a variety of tools, instruments and approaches, direct and indirect to influence the investee companies such as meetings to communicate their opinions and even to advise them, pressure from professional bodies in the industry, demand to adhere to the standards set by esteemed committee reports on corporate governance like Cadbury Report, etc. It must be noted that Institutional Shareholders are well within their rights in intervening through dialogues, voting and other legitimate instruments or tools.

1) *Meetings*

Meetings are used by institutional investors to communicate to the investee companies their wishes on a particular issue, their dissatisfaction or discontent with the performance or even to threat the company of the dire consequences if their problems or issues go unlooked. Moreover, the term meeting also encompasses behind the scene discussions. Meeting is a very effective mode of communication and can be used successfully. For instance, Distillers Ltd in UK were engaged in a legal suit involving their drug Thalidomide, which caused birth defects when given to pregnant women. This resulted in a lot of bad publicity and consequently a fall in share prices. Finally, institutional investors intervened. They convened a meeting with the company and ensured generous compensation to rescue the company's reputation[384].

2) *Voting*

[383] "There has also been criticism in recent years of alleged "short-termism" amongst institutional shareholders, although the evidence for short-term holding appears to be somewhat anecdotal. The National Association of Pension Funds has estimated that the average holding period for any given share in a pension fund portfolio is over eight years". Excerpt from: Richard Smerdon, *A Practical Guide to Corporate Governance*, Sweet & Maxwell, London, 1998.

[384] More details available at: John H. Farrar, *Corporate Governance in Australia & New Zealand*, Oxford University Press, 2001.

Vote is a prerogative of the shareholders, it should be used efficaciously. An ideal institutional investor shall always vote and also if practicable take the clients' opinion on it[385]. Various reports prepared by several committees on corporate governance prescribe that the institutional investors must publish their voting policies[386]. Publishing the voting policies make things crystal clear both for the investee companies and clients of institutional shareholders and let them make informed decisions. After being inspired by the active participating institutional investor of U.S.A. the institutional investors of other countries like U.K., etc. are more and more getting into the habit of formulating their own voting policies[387] and participating in the voting process. This is helpful in further pushing the good corporate governance practices. Voting Policy of a particular institution indicates the policy and approach of that institution on various issues like election of directors, appointment of auditors, pre-emption rights etc.

3) Litigation

Litigation is not often resorted to by the institutional shareholders as it very apparently have certain undesired and unpleasant consequences in terms of spoiling the relationship of the two litigating parties. Moreover, it is an expensive method and therefore is avoided as far as there are effectual alternatives. Prudential Assurance Company Ltd., one of leading institutional investor of UK in 1982 brought an action against the directors of Newman Industries Ltd[388]. In this case Prudential succeeded but not after attracting criticism from the English Court of Appeal[389].

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[385] "The model institutional investor discusses its voting intentions with its clients and always exercise its vote, by proxy if not attending the AGM in person" – A report titled "Developing a Winning Partnership", 1996, which formulated the concept of "model company" and "model institution (as shareholder)." Excerpt from: Richard Smerdon, *A Practical Guide to Corporate Governance*, Sweet & Maxwell, London, 1998.

[386] "Institutional Investors should disclose their policies on the use of their voting rights". Paragraph 6.12, Cadbury Committee Report on The Financial Aspects of Corporate Governance, December 1992.

[387] "Mercury Asset Management (MAM) is one of the largest fund management companies in the United Kingdom...MAM have articulated five principles on which they have formulated policy. In particular, MAM takes the view that there are three areas "which are fundamental in protecting shareholders interests". These are: (i) the election of directors; (ii) the issuance of equity; and (iii) the appointment of auditors." Excerpt from: Richard Smerdon, *A Practical Guide to Corporate Governance*, Sweet & Maxwell, London, 1998.

[388] *Prudential Assurance Co. v. Newman Industries Ltd.* (No 2) [1982]Ch 204

[389] More details available at: John H. Farrar, *Corporate Governance in Australia & New Zealand*, Oxford University Press, 2001.

4) Nominee Directors

One more method of monitoring corporations is to appoint a nominee director on the Board. This further increases the possibility of monitoring them in a better way, as the director would is there inside the company keeping a watch on their activities. But there are problems to it, one the nominated director would be torn between his fiduciary duty towards the company and the 'watchdog job' entrusted upon him by the institutions. Secondly, the institution is also under the risk of being branded as an insider and can be accused of insider trading, which attracts adverse publicity and consequently may lead to loss of clients. Moreover, if it is branded as an insider it might lose the right to trade in the shares of the company. Thus all these things repeal the institutional shareholder from directly taking part in the affairs of the company. However, as suggested by the Cadbury Report, the institutions can appoint an independent or outsider as a director which has no association with them. However, there can still be doubts as to his independence and disassociation with the institutions.[390]

5) Ranking System and Focus List

Some of the big institutional investors like CalPERS have a practice of rating the companies who are underperforming. They rank them in the order of preference and worst ten or fifteen companies become their focus list on which they bestow special attention. This practice have shown to yield positive results.

4.5 *Impediments Confronting Institutional Shareholders*

The problem with the institutional shareholders is that they are a heterogeneous group consisting of mutual shareholders, fund managers[391], etc. who has to pay regular returns to their investors and there is much pressure on them to perform even in the short run. On the other side are insurance companies and pension funds who are not under a pressure to perform immediately and have ample time on their hands to lift their performances. The

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[390] Paul H. Zalecki, *The Corporate Governance role of Inside and Outside Directors, University of Toledo Law Review*, Vol- 24, 1993.

[391] http://www.austlii.edu.au/au/journals/MULR/2001/14.html, last accessed on 15th May 2011.

capital stays with them for a longer time and they are not under constant scrutiny. This means that institutional shareholders face a lot of difficulty[392].

4.5.1 Problems in Collective Action and Free-Ridership

There are different kinds of institutions with varied structures- some of them are very big and some are small, some are economically very strong and some not so capable. Thus, what works for one may not work for the others[393]. Therefore, due to all these variations they have different economic needs and plans and working together becomes difficult because of all these differences. Moreover, there are other hindrances too in collective action by institutions like, lack of coordination, lack of initiative, lack of participation, lack of communication or miscommunication, lack of time, etc. Further, if they come together and act there is another problem of 'free-ridership', where some not so active institutions also get the benefit of general result attained by the active shareholders. This discourages the active shareholders as they think it to be unfair that the others, who are their competitors avail the benefit of their hard work.[394]

There are bodies like 'Institutional Shareholders' Committee' (ISC) in UK and Investment and Financial Services Association (IFSA) in Australia, which provide the platform for collective action on the wider issues between the management and the institutional shareholders at large[395]. These bodies are quite active in the industry and always endeavour to make the collective action possible[396].

[392] O. Scott Stovall, John D. Neill, David Perkins, *Corporate Governance, Internal Decision making and Invisible Hands, Journal of Business Ethics,* Vol- 51(2) 2004.
[393] Edward S. Adams, *Bridging the Gap between Ownership and Control, Journal of Corporation Law,* Vol. 34, 2009.
[394] Lory Verstegen and Ann K. Buchholtz, *Trust, Risk and Shareholder Decision Making: An Investor Perspective on Corporate Governance, Business Ethics Quarterly,* Vol- 11(01), 2001.
[395] "The ISC is a forum which allows the UK's institutional shareholding community to exchange views and, on occasion, coordinate their activities in support of the interests of UK investors. Its constituent members are: The Association of British Insurers (ABI), the Association of Investment Companies (AIC), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF)." Quoted from: http://www.institutionalshareholderscommittee.org.uk/ last accessed on 3rd May 2011.
[396] "The IFSA (in its various forms) has been vocal on particular issues such as differential voting rights, continuous disclosure, disclosure of directors' share dealings, board composition and executive remuneration." Excerpt from: John H. Farrar, *Corporate Governance in Australia & New Zealand,* Oxford University Press, 2001.

4.5.2 Problems due to Conflict of Interest

The clients of institutional investors expect them to invest in securities judiciously and ensure fair and continued returns to them. As a rule, while depositing their money with the investors they aim to maximize their investments and do not care much about shareholder activism. Whereas, on the other hand, ideally speaking the institutional shareholders must also play their role as a shareholder properly and honestly, this would sometimes demand focusing on the larger issues. When there is a conflict of interest between the institutional shareholders and the investee company there is a big possibility that the institutions might vote for themselves ignoring their duty to vote for the company's larger interests. This is an unacceptable practice and the institutions should keep the company's interest on a higher pedestal than the interest of their clients[397]. This view was upheld *in Re Holders' Investment Trust Ltd*[398]. In this case the preference shareholders in a class meeting of preference shareholders voted for reduction of capital, which was actually not in the real interest of the company but they voted for it only to for their personal benefits. Hence, this proposal was rejected when challenged[399].

4.5.3 Short- Termism

There is much debate over 'short-termism'. They say that pressure that the institutional shareholders' exert on investee companies, especially those which are under performing, make them take decisions which reaps benefit for a short-term and doesn't contribute to the long term growth and indeed at times, have adverse effect on the long-term goals of the company[400]. This occurrence can especially be experienced in UK. The investors' watches the stock market as a hawk and principally base their decisions on the share prices which do not reflect the value system of an organization and thus their true potential[401]. This has given

[397] "Any duty which an institution owes to its investors ranks behind that owed to the company in which the institution holds shares, at least as far as company law is concerned." Excerpt from: John H. Farrar, Corporate Governance in Australia & New Zealand, Oxford University Press, 2001.
[398] (1971)2 All ER 289.
[399] Jayne W. Barnard, *Institutional Investor and the new Corporate Governance, North Carolina Law Review,* Vol- 69, 1991.
[400] Virginia Harper Ho., *Enlightened Shareholder Value: Corporate Governance beyond the Shareholder Stakeholder Divide, Journal of Corporation Law,* Vol- 36, 2010.
[401] Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control, Washington University Law Quarterly,* Vol- 70, 1992.

rise to the criticism and some even believe that to some extent managerial unaccountability is desirable then the 'hawk-eyed' monitoring by the institutional shareholders.

4.5.4 Cost of Supervision

Monitoring of corporations involves huge expenditures. Experts have to be employed for analyzing their financial reports, activities, proposed business plans etc; meetings have to be convened; time has to be spent. All this arrangement involves spending of money, which may not be desirable to all. Then, there are uneconomical costs too which may arise out of activism[402].

Concluding Remarks:

Considering the enormous importance of the issues to be discussed and decided at the general meetings and also keeping in view its potential of acting as a check and control on the activities of the board of directors and at the same time act as a platform for the shareholders to exercise their rights, it is certain that general meetings, no matter how expensive an affair, are absolutely essential for the well being of a company and all its stakeholders and hence, an integral part of an effective corporate governance regime. Some people have argued that the time and effort devoted to general meetings could be utilized for some fruitful activities but what needs to be realized is that general meetings are worthwhile occasions that foster growth, exchange of opinion and constructive ideas meant for welfare of the company. Hence, it cannot certainly be called as a useless and meaningless exercise or as a waste of time and ritualistic formality. In fact, it is the principal forum and major event which gives an opportunity to the company to showcase its achievements, its growth, its future plans and prospects, and at the same time all shareholders get a chance to voice their thinking and opinion. Hence, there is a grave need of encouragement and enthusiasm to put to use its potential of being the most influential internal regulator of a company.

In view of the extremely important supervisory and regulatory role of general meetings, the above identified problems, deficiencies, rectifications and solutions need to be seriously

[402] Jayne W. Barnard, *Institutional Investor and the New Corporate Governance, North Carolina Law Review,* Vol- 69, 1991.

considered. Some of the concerns may have been expressed in the past but the right steps have not been taken in their regard.

The biggest concern remains the numerous, diversified, dispersed and passive nature of the shareholders. It is assumed that the shareholders will use the tool of general meeting for effectively monitoring the affairs of the company but what is usually ignored is the fact that today's shareholder is profit oriented and will not burden himself with the task of monitoring for free[403]. Any shareholder would carefully study his relative cost and benefit and would only spend his time and money if the expected returns are more than his expenses. The modern shareholder typically sees his shares as a sheer investment and does not have much attachment with the company. Also, considering the fact that one person may hold shares of many companies[404], it would be rather impractical for him to keep a track of affairs of all the companies and actively participate in the process of monitoring them. This can be identified as the primary reason for the lackadaisical attitude of the shareholders and for the ineffective utilization of general meeting and its consequent failure in achieving its objectives.

The probable improvements in this regard, as discussed above, seem to be awareness, education, sense of responsibility and financial incentives. However, these would increase the financial burden on the company and so an additional step of imposing the above discussed necessary compulsions on the institutional shareholders also needs to be taken. It can be said

[403] Monitoring is one way to reduce agency costs. The active participation of shareholders in monitoring corporate management, according to traditional corporate theory, can improve the performance of the corporation. Corporate law is based on the premise that shareholder monitoring is valuable; it provides a number of mechanisms by which shareholders can review management decisions and correct improprieties. Monitoring, however, is not free. Every instance of shareholder monitoring requires the activist shareholder to spend money. It will be rational for an investor to spend funds to monitor only when the expected returns generated by monitoring exceed its costs. See, Jill E. Fisch, *Relationship Investing: Will it happen? Will it work?, Ohio State Law Journal*, 1994.

[404] The traditional explanation for the failure of shareholder monitoring to produce efficiently run corporations is a collective action problem. The growth of large public corporations and the development of a national securities market have led to an investment norm in which investors tend to diversify, that is, to own a small quantity of stock in a large number of companies. From the perspective of an individual investor, diversification can be justified by a variety of factors, including the reduction of risk. Diversified investors are less likely to encounter situations in which it is rational to expend funds to monitor their investments. This is because, while the return to an investor is a function of the quantity of stock owned, monitoring costs are largely unrelated to the size of the investment.

that the principle of shareholder's value is at the heart of the corporate well being and thus the concern regarding the role of institutional shareholders is justified.[405]

It may not be possible to have a single set of rules and provisions that can be applied universally as it is possible that in such an attempt some important issues may be left out. Hence, to ensure competence and integrity in the management, each company may need to be assessed individually and the central role to be played in such a scenario would be that of the shareholders. The main reasons for this are that shareholders expect returns on their investment and the board of directors is accountable to them for the use of their money[406] and that non existence of bias and doubt is necessary for the long term interest of all the stakeholders.

It can be summed up that for the overall welfare of the company, effective serving of needs of the shareholders and long term benefit of other stakeholders, it is essential to have a framework for regular, meaningful, participative, expressive and fair general meeting for an effective corporate governance regime.

Berle and Means explicated how in a corporation there is a division of ownership and management, but since the ownership is shared by many and is scattered, it is not able to control the management and as a result management can become corrupt and indulge in wrongful activities, however Institutional Shareholder has come out as a remedy to this fundamental problem arising out of this structural error. They can be the answer to check the immense power of the Board of Directors, however, for that they need to act in unification- "United We Stand and Divided We Fall". Ability to act together and reach a consensus is the reason behind the power that institutional investors wield. They may not have a uniform

[405] Advocates of institutional investor activism assert that institutions, because of their larger investment stake and better access to information, can monitor corporate decision making more easily than individual shareholders, and that the larger proportionate holdings of these investors make monitoring more profitable, overcoming collective action problems. Using models that portray money spent on monitoring as an investment, these scholars argue that, as the size of an investor's shareholdings in a company grows, the cost of monitoring is more easily justified. Hence the large investor, commonly the institutional investor, is more likely to monitor. See, Jill E. Fisch, *Relationship Investing: Will it happen? Will it work?, Ohio State Law Journal,* 1994.

[406] The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment. All boards have this responsibility and their policies, structure, composition and governing processes should reflect this. See, Committee on Corporate Governance: Final Report, under the chairmanship of Mr. Ronnie Hampel, January 1998, para 1.16.

approach towards voting yet if they rise above the individual issues and tackle the broader issues unitedly, they can change the way corporations function and force them to address the legitimate issues affecting the various stakeholders. This will restore the balance in the Corporation Matrix. However, they should also not get carried away because of the power they have and instead vote responsibly on all the matters of importance to the company without oppressing the minorities.

Institutional Shareholders have come up in importance since their aggregate holding has increased in the corporations. By and large, management is all ears to them if they make an effort to reach out and at times, they end up acting as partners discoursing on the important issues. Moreover, the concept of corporate governance has grappled the world and there has been increased activism on the international arena. Still, they cannot be very active in monitoring the corporations on each and every issue of day-to-day management as they have their own grave concerns and performances to look after, which at times leave them with no time and motivation to intervene in company affairs. So their role is also limited. Nevertheless, they have the potential and resourcefulness and therefore, they shall shed the passivity and look beyond short-termism to fulfil their primary role, which is to ensure that the esteemed benchmarks of corporate governance are met and rise further. They can act as the 'Acid Test' to check the compliance with the corporate governance principles.

There should be enough justification for the institutional shareholders in the form of ample incentives to take up the job of monitoring corporations.

Chapter- 5

Board of Director v. Shareholders: The Debate of who leads whom?

5.1 Introduction

Shareholder democracy is back from the dead. Dating back to Berle and Means' autopsy of corporate democracy[407], it had long been assumed that the shareholder franchise was relatively meaningless-a de jure power with little de facto effect[408]. Building on reforms from the 1970s, 1980s, and 1990s, however, scholars have taken an ever-more aggressive stance towards shareholder empowerment[409]. Institutional shareholders and the advocacy groups that represent them have become powerful players in corporate boardrooms and in the public markets.[410] With this new emphasis on the role of shareholders, it is only natural to focus on the power to vote which is, after all, the power to select those who control the company. Given the course of corporate law scholarship, strengthening the shareholder franchise is the logical next step.

Corporate law centers on the relationship between the corporation, the board, and shareholders. And the primary concern of corporate law scholarship has been to reduce the agency costs imposed upon shareholders by delegating those powers to the board and its appointed officers.[411] Successive waves of scholarship have carried in new suggestions for reform, such as the facilitation of the takeover market,[412] the expanded use of independent directors[413], and greater reliance on intermediaries[414]. It only makes sense for reformers to look to the franchise, as it is the direct structural power source for shareholders. Shareholders

[407] Adolf A. Berle and Gardiner C.Means, *The Modern Corporation and Private Property*, 1932.
[408] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review*, Vol- 97, 2003.
[409] Lucian A. Bebchuk, *The Case for Increasing Shareholder Power, Harvard Law Review*, Vol- 118, 2005.
[410] Paul Rose, *The Corporation Governance Industry, Journal of Corporation Law*, Vol- 887, 2007.
[411] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review*, Vol- 97, 2003.
[412] Lucian A. Bebchuk, *A New Approach to the Takeover Law and Regulatory Commission, Virginia Law Review*, Vol- 111, 2001.
[413] Victor Brudney, *The Independent Directors- Heavenly City or Potemkin Village?, Harvard Law Review*, Vol- 95, 1982.
[414] Stephen M. Bainbridge, *The Politics of Corporate Governance, Harvard Journal of Law and Public Policy*, Vol- 671, 1995.

can vote out directors and officers; strengthening the franchise is the most meaningful way to fulfil the norm of shareholder primacy[415].

Thus, much of corporate law scholarship of the past decade has focused on shareholder democracy. The most well-known shareholder democracy advocate in academia is Lucian Bebchuk[416]. In earlier work, Bebchuk advocated for pro-shareholder reforms such as eliminating staggered boards[417], monitoring managerial pay more carefully[418], and preventing boards from vetoing takeover bids that have been approved by shareholders[419]. Bebchuk's recent work has focused on fostering shareholder democracy as a way of effectuating shareholder primacy[420]. Other commentators in academia and the business press have also advocated for pro-democracy reforms. Institutional shareholders are taking their voting rights more seriously, and the proxy advisory sector continues to grow in size and importance[421].

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[415] Lawrence E. Mitchell, *Corporate Irresponsibility, America's Newest Export*, Vol- 101, 2001. ("The fact that the stockholders vote and have the power to oust the Board of Directors and corporate management is a very powerful incentive for directors and managers to focus their attention on stockholder happiness.")

[416] Lisa M. Fairfax, *Making the Corporation Safe for Shareholders Democracy, Ohio State Law Journal*, Vol- 53(55), 2008.

[417] Lucian Arye Bebchuk, John C. Coates IV and Guham Subramanian, *The Powerful Antitakeover Force of Staggered Board, Theory, Evidence and Policy, Stanford Law Review*, Vol- 887, 2002.

[418] See[418] Adolf A. Berle and Gardiner C.Means, *The Modern Corporation and Private Property*, 1932.

[418] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review*, Vol- 97, 2003.

[418] Lucian A. Bebchuk, *The Case for Increasing Shareholder Power, Harvard Law Review*, Vol- 118, 2005.

[418] Paul Rose, *The Corporation Governance Industry, Journal of Corporation Law*, Vol- 887, 2007.

[418] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review*, Vol- 97, 2003.

[418] Lucien Arye Bebchuk, *A New Approach to the Takeover Law and Regulatory Commission, Virginia Law Review*, Vol- 111, 2001.

[418] Victor Brudney, *The Independent Directors- Heavenly City or Potemkin Village?, Harvard Law Review*, Vol- 95, 1982.

[418] Stephen M. Bainbridge, *The Politics of Corporate Governance, Harvard Journal of Law and Public Policy*, Vol- 671, 1995.

[418] Lawrence E. Mitchell, *Corporate Irresponsibility, America's Newest Export*, Vol- 101, 2001. ("The fact that the stockholders vote and have the power to oust the Board of Directors and corporate management is a very powerful incentive for directors and managers to focus their attention on stockholder happiness.")

[418] Lisa M. Fairfax, *Making the Corporation safe for Shareholders Democracy, Ohio State Law Journal*, Vol- Grant Hayden Mathew T. Bodie, *Shareholder Democracy and the Curious turn towards Board Primacy, William and Mary Law Review*, Vol- 51, 2010.

[419] Lucian Bebchuk, *The Case Against Veto in Corporate Takeovers, The University of Chicago Law Review*, Vol- 69, 2002.

[420] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise, Valparaiso University Law Review*, Vol- 93, 2002; See also Lucian A. Bebchuk, *The Case for Increasing Shareholder Power, Harvard Law Review*, Vol- 118, 2005.

[421] Paul Rose, *The Corporation Governance Industry, Journal of Corporation Law*, Vol- 887, 2007.

It may seem hard, as a rhetorical matter, to be against shareholder democracy. However, there are a set of commentators and theorists who remain committed to the old ways[422]. Instead of advocating for greater shareholder involvement, they advocate for greater board independence. Rather than exposing the board to the will of the electorate, they believe the board should be insulated from such exposure[423]. Instead of shareholder primacy, they argue for some variant of board primacy namely, that the board, not the shareholders, should be the focus of the corporation.

Theories of board primacy have developed relatively recently, perhaps in part because shareholder democracy has languished so long. These theories and their policy prescriptions represent an important body of thought about the nature and purpose of corporate structure. Rather than following the fairly intuitive notion that voters should have more power to choose their representatives, board primacists argue for a more insulated board. They do so for a variety of reasons some common, some flecked. But they all believe that facilitating shareholder democracy, and thereby shareholder power, would create costs that would outweigh the purported benefits.

At this stage of our inquiry into the shareholder franchise, it is important to consider the counter-revolutionary turn toward board primacy[424]. This section seeks to disentangle the various justifications for board primacy and thereby illustrate the underlying value judgments and practical assumptions made by board primacists. As a result, we argue that board primacists may in fact be a rather unstable coalition one that might be best served by a re-examination of their underlying interests.

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[422] A well known advocate of board primacy is Martin Lipton, the inventor of the poison pill. See, e.g., Martin Lipton and Steven A. Rosenblum, *Elections in the Company's Proxy: An idea Whose Time has not Come, Business Law Review,* Vol- 67, 2003. Martin Lipton and William Savitt, *The Many Myths of Lucian Bebchuk, Valparaiso University of Law Review,* Vol- 93, 2007. Advocates for board primacy includes Lawrence Mitchell, Stepehen Bainbridge, Lynn Stout and Margaret Blair. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003. Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999. Lynn A. Stout, *The Mythical benefits of Shareholder Control, Valparaiso University of Law Review,* Vol- 93, 2007.

[423] See FN. 416.

[424] See Grant Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity, Cardozo Law Review,* Vol- 30, 2005; See also Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

5.2 The Traditional Story of Shareholder Primacy

Shareholder primacy is the core concept of U.S. corporate law[425]. Although there are various approaches to the concept, shareholder primacy generally means that corporations exist to serve the interests of shareholders[426]. The basic structural component of shareholder primacy is the right of shareholders to elect the board of directors[427]. Because the board is the locus of final authority within the corporation, the right to choose the board gives shareholders ultimate authority. In addition, shareholders are granted rights to vote on essential corporate decisions, such as mergers and the sale of substantially all of the corporation's assets. Shareholders are generally given the right to amend the corporation's charter[428], and in some jurisdictions may retain the power to amend corporate bylaws. In addition, company regulations permit shareholders to propose resolutions regarding governance issues that are placed on the corporation's proxy ballot and voted upon at the annual meeting.

However, the concept of shareholder primacy extends well beyond these structural mechanisms. Shareholder primacy is a theory, a belief system, if you will that maximizing shareholder wealth is in the best interests of society.[429] Scholars have referred to the notion that corporations should seek primarily, if not solely, to maximize returns to their shareholders as the shareholder primacy norm[430] or the shareholder wealth maximization norm. This norm is much more than a descriptive account of shareholders' rights; it is instead a normative judgment on the most socially efficient way of organizing the economy. Proponents of this norm argue that we will maximize our utility as a society only through a system of corporate law that recognizes and perpetuates shareholder primacy. One of the basic tenets of shareholder primacy is that, with few exceptions, shareholders

[425] Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, Washington and Lee Law Review*, Vol- 50, 1993.
[426] See D. Gordon Smith, *The Shareholder Primacy Norm, Journal of Corporate Law*, Vol- 23, 1998; "The Structure of corporate law ensures that corporation generally operate in the interests of shareholders."
[427] Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholders Democracy, Washington and Lee Law Review*, Vol- 63, 2006.
[428] See, e.g., Del. Code Ann. tit. 8, 211, 2009.
[429] See Grant Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity, Cardozo Law Review*, Vol- 30, 2005; See also Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review*, Vol- 1217, 2009.
[430] Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, Washington and Lee Law Review*, Vol- 50, 1993.

alone possess the right to vote in corporate board elections[431]. There have been many arguments advanced in support of this particular arrangement. One argument is that shareholders are the owners of the corporation and thus, ultimately, should be able to control corporate decisions[432]. But it is unclear why, among the many groups of corporate constituents, shareholders are deemed to be the owners[433]. They do not, for example, possess many of the traditional rights that come with property ownership including the right to exclude, or the right of possession. Moreover, this entire line of reasoning is circular. Shareholders purchase a set of rights from a corporation. That set of rights typically includes the right to vote for directors, but the stock ownership "bundle" could easily be constructed without that right[434]. In the end, *"labelling shareholders 'owners' is no more of a justification for the vote than is labelling them 'voters.'"*[435]

A second argument in favour of the exclusive shareholder franchise is that shareholders are the sole residual claimants and, as such, are in the best position to exercise control for the good of all corporate constituents.[436] This argument assumes that the interests of all other corporate participants that are employees, suppliers, customers, and creditors are captured by

[431] See D. Gordon Smith, *The Shareholder Primacy Norm, Journal of Corporate Law,* Vol- 23, 1998; (describing the development of the principle of shareholder primacy as deriving in part from the fact of "the exclusive right of shareholders to vote".)

[432] For a version of this argument see, for example, Milton Friedman, The Social Responsibility of Business is to Increase its Profits, New York Times, 13th September, 1970 (Magazine); (arguing that shareholders are the "owner of the business" and that therefore the only "social responsibility of the business is to increase profit".

[433] A well known advocate of board primacy is Martin Lipton, the inventor of the poison pill. See, e.g., Martin Lipton and Steven A. Rosenblum, *Elections in the Company's Proxy: An idea Whose Time has not Come, Business Law Review,* Vol- 67, 2003. Martin Lipton and William Savitt, *The Many Myths of Lucian Bebchuk, Valparaiso University of Law Review,* Vol- 93, 2007. Advocates for board primacy includes Lawrence Mitchell, Stepehen Bainbridge, Lynn Stout and Margaret Blair. See Stephen M. Bainbridge, Director Primacy: *The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003. Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999. Lynn A. Stout, *The Mythical benefits of Shareholder Control, Valparaiso University of Law Review,* Vol- 93, 2007.

[434] See Grant Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity, Cardozo Law Review,* Vol- 30, 2005; See also Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

[435] See Fn. 428.

[436] Most corporate law theorists have focused on the maximization of the particular set of constituents-namely, shareholders. See, e.g., Frank H. Easterbook and Daniel Fischel, *The Economic Structure of Corporate Law,* Harvard University Press, 1991; (discussing how the corporate voting structure maximizes utility). However, the concept of shareholder primacy is based on the theory that maximizing shareholder welfare also maximizes the overall welfare of all corporate constituents.

rigidly set contractual entitlements.[437] Shareholders benefit from maximization of the residual because they are not paid until all other claimants receive their entitlements. This gives shareholders, and shareholders alone, the appropriate incentives to exercise discretion in a way that maximizes value for the entire corporation[438].

The residual argument, while more substantive than the "shareholders are owners" argument, is not without shortcomings.[439] First, there is no doubt that constituents other than shareholders have interests in the corporate residual that are uncaptured by their contracts. Employees with firm specific skills, for example, have an interest in the residual because, by definition, there is no market that would allow them to capture the full value of their skills by contract.[440] Second, the argument also has circularity to it. While it may make sense to give the right to vote to those with a residual interest, this just changes the question to "who should have contractual rights to the corporate residual?" Without some additional argument that, for some additional reason, shareholders should have a right to the corporate residual, we really haven't progressed very far. The "argument" becomes a mere description of the current state of affairs, not an independent reason to assign the residual (and voting rights that come with it) to shareholders alone[441].

In order to get away from these potential circularities, many scholars have made further arguments as to why only one class of constituents should have the right to vote and why shareholders are best suited for the task. The residual argument, for example, ceases to be

[437] See Jena Martin Amerson, *The SEC and Shareholder Empowerment- Analyzing the new Proxy Regime and its Impact on Corporate Governance, Banking and Financial Services Policy Report*, Vol- 32(02), 2011.

[438] Lori Verstegen Ryan and Ann K. Buchholtz, *Trust, Risk and the Shareholder Decision Making: An Investor Perspective on Corporate Governance, Business Ethics Quarterly*, Vol- 11(01), 2001.

[439] For an extended critique of the argument based on shareholder as sole residual claimants: See Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty First Century*, Brookings Institution Press, 1995.

[440] See Fn. 433.

[441] There are additional shortcomings to the argument from the residual. For one, the "residual" is not the simply money left over, because that is the function of all of the other agreement that have come before it. Employees may have the claim to the residual if they have rights. This argument can be expanded further into the nature of the shareholders' claim to the residual etc. second, shareholder have the right to profit based on their right to control, as well as their position as the residual claimants. Their share prices reflected the possibility that someone will buy them out in order to take control of the company. This is not really part of the residual – it is the monetary value of the control itself. Third, even if the residual have some meaning (that is the right to firm profits), it is not a static concept- some shareholders will want to increase the short term residual, while others will want to plow more money into research and design for long term profits. There is n one "residual payments" that everyone can agree on maximizing.

circular when one gives a reason that shareholders alone should be contractually entitled to the residual (and thus, the vote). So what are these additional arguments?

Many of the arguments for the exclusive shareholder franchise have, at their core, an assumption of (at least relative) shareholder preference homogeneity. Shareholders, it is argued, have a single minded interest in profit maximization. This makes them the most homogeneous group of corporate constituents, and certainly more homogeneous than a combined electorate including, for example, shareholders and employees. This homogeneity is thought to bring many advantages when it comes to designing the structures of corporate governance.

Those who champion a more homogenous electorate typically pose their arguments in the negative: a more heterogeneous electorate causes all sorts of problems. For example, a more diverse electorate is believed to introduce various procedural inefficiencies to the corporate governance process. The argument here is that voters with special interests would be in a position to exploit other voters or other corporate constituents rather than pursue a common goal of maximizing corporate wealth. Corporate scholars from across the spectrum who argue in favour of the exclusive shareholder franchise rely on one or both of these sets of inefficiencies to advance their vision of corporate governance. Scholars typically point to three basic types of procedural inefficiencies that come with a more diverse board electorate: political breakdowns, voting pathologies, and difficulties in apportioning voting power.

In addition to these more procedural inefficiencies, there are said to be substantive inefficiencies that would accompany an expanded electorate. The most straightforward of these is that a more diverse set of voters just means more opportunities for groups to exploit each other[442]. This is viewed as especially problematic when a tyrannical majority imposes its will on other constituents, but may also occur when a minority, for some reason or another, comes to dominate the process[443]. Either way, expanding the electorate to include other constituents would allow factions to advance their own special interests over the good of the

[442] Lewis A. Kournhauser, *Constrained Optimization: Corporate Law and the Maximization of Social Welfare in the Jurisprudential Foundation of Corporate and Commercial Law,* Cambridge University Press, 2000; arguing that diverse constituencies may pursue their own special interests, or in some cases, allow its management to pursue its own self- interest by playing different constituencies off against each other.
[443] Imam Anabtawi, *Some Skepticism about Increasing Shareholder Power, UCLA Law Review*, 2006

corporate whole. For that reason, voting should be limited to a single group of constituents, and the most homogenous group at that[444]. Shareholders, once again, fit the bill. In sum, many of the arguments used to support shareholder primacy theory, and the exclusive shareholder vote in particular, are based on shareholder homogeneity. The like-minded views of shareholders make it easier to reach consensus and avoid the risk of damaging voting cycles. They also alleviate the concern that one group of voters will hijack the decision process to favour their own special interests over those of the firm. Shareholder homogeneity, then, provides some of the most important undergirding to shareholder primacy theory; without it, we would need to significantly revise our view of corporate governance.

5.3 The Counter-Narratives of Board Primacy

Throughout the reign of shareholder primacy as the dominant theoretical narrative of corporate law, there have been dissenting voices. At various points, some of these voices have coalesced into groups of like-minded theorists[445]. As it stands now, however, there is no one school of thought standing in opposition. Instead, a collection of academic commentators have individually rallied around various versions of what we call "board primacy." All of these commentators agree that the board of directors should be accorded more power and deference within the corporate structure.[446] They stand opposed to greater shareholder democracy and they believe that the corporation is best served by a board that can make decisions largely free of shareholder influence. However, they all stand in support of a version of "board primacy" in which the board can operate in a more independent manner than shareholder primacists currently advocate.

Below are brief descriptions of four prominent board primacy theories: Stephen Bainbridge's director primacy theory, Margaret Blair and Lynn Stout's team production theory, Lawrence Mitchell's self-perpetuating board, and Martin Lipton and Steven Rosenblum's quinquennial election model. Based on similarities in their approaches, we categorize Bainbridge as well as

[444] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.
[445] In the early 1990's, e.g., a group of scholars rallied around the progressive banner in their critiques.
[446] Luca Enriques and Matteo Gatti, *EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism, North Western Journal of International and Business*, Vol- 28(1), 2007.

Blair and Stout as "wise ruler" theorists, while we characterize Mitchell as well as Lipton and Rosenblum as "long-term interests" theorists.[447]

5.3.1 The "Wise Ruler" Theorists

Shareholder democracy advocates generally bemoan director independence. They view the disconnect between shareholders and directors as the primary source of intrafirm agency costs namely, the costs shareholders must bear for delegating control of the corporation to someone else. If shareholders can find ways to exert more power over the board, they posit, the corporation will focus more on shareholder interests and less on their own self-interest. This change will cut down on agency costs and lead to greater firm and societal efficiency. However, Bainbridge as well as Blair and Stout disagree with this analysis. They have argued instead that the board must be free to make its own decisions without undue pressure from shareholders. Freed to operate more independently, directors will make better choices about how the firm should proceed.

We call these commentators the "wise ruler" theorists because they invest the board with a great deal of acumen, as well as power. Bainbridge has described the board as the "Platonic guardian" of the firm[448]. He argues that the board sits at the centre of a nexus of contracts between various constituents of the firm and the fictional "firm" itself.[449] Similarly, Blair and Stout describe the board as "mediating hierarchs" who manage the relationships of various corporate constituencies[450]. Under both scenarios, the board is envisioned as a body that

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[447] These categorization are our own: we do not mean to imply that the members of each group have adopted these labels or are working in concert.

[448] Stepehen M. Bainbridge, *Directors Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003.

[449] Stepehen M. Bainbridge, *Directors Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003; Stepehen M. Bainbridge, *The Board of Directors as Nexus of Contracts, Iowa Law Review,* Vol- 88, 2002.

[450] A well known advocate of board primacy is Martin Lipton, the inventor of the poison pill. See, e.g., Martin Lipton and Steven A. Rosenblum, *Elections in the Company's Proxy: An Idea whose Time has not Come, Business Law Review,* Vol- 67, 2003. Martin Lipton and William Savitt, *The Many Myths of Lucian Bebchuk, Valparaiso University of Law Review,* Vol- 93, 2007. Advocates for board primacy includes Lawrence Mitchell, Stephen Bainbridge, Lynn Stout and Margaret Blair. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003. Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999. Lynn A. Stout, *The Mythical benefits of Shareholder Control, Valparaiso University of Law Review,* Vol- 93, 2007.

exists above all the other participants, with authority apart from them. Indeed, independence and insulation are critical to the performance of their roles.

Bainbridge's "director primacy" theory has a significant descriptive component in that he believes the theory offers the best account of why boards are structured to have the independence that they are generally afforded[451]. However, Bainbridge also defends the status quo, arguing that shareholder democracy reforms would be harmful to corporate welfare[452]. He largely relies on the work of Kenneth Arrow with regard to the tension between authority and accountability[453]. Although greater board accountability to shareholders might reduce agency costs, Bainbridge argues that such reforms would create much inefficiency within the corporation. As he describes:

> *Active investor involvement in corporate decision making seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially no reviewable decision making authority in the board of directors. The chief economic virtue of the public corporation is ... that it provides a hierarchical decision making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies*[454].

Bainbridge does not quarrel with shareholder primacy as the goal of the corporation; in fact, he believes that the board should direct itself toward shareholder wealth maximization[455]. However, he believes that the proper means to achieve this end is through director primacy. Blair and Stout see a comparable role for the board within their model of the corporation. Similar to Bainbridge and other contractarian theorists, Blair and Stout see the firm as a series

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[451] See Fn. 444.
[452] Stepehen M. Bainbridge, *Director Primacy and Shareholder Disempowerment, Harvard Law Review*, Vol-119, 2006.
[453] Stepehen M. Bainbridge, *Directors Primacy: The Means and Ends of Corporate Governance, New York University Law Review*, Vol- 97, 2000.
[454] Stepehen M. Bainbridge, *Director Primacy and Shareholder Disempowerment, Harvard Law Review*, Vol-119, 2006.
[455] Stepehen M. Bainbridge, *Director Primacy and Shareholder Disempowerment, Harvard Law Review*, Vol-119, 2006.

of relationships between the various constituencies that make up the business[456]. These relationships result in the joint production of goods or services that in turn create wealth. The directors serve as the ultimate authority when it comes to assigning responsibilities, mediating disputes, and divvying up the profits.[457] Board insulation and independence is therefore critical to their role. The board must be independent from all constituencies in order to be trusted with such a crucial and uncertain responsibility. If the board favoured one constituency over others, the unfavoured groups would be less willing to make the proper investments of capital and labour to make the firm function.

Unlike Bainbridge, Blair and Stout do not argue that shareholder wealth maximization should be the goal of the corporation[458]. Instead, they argue that directors owe a duty to the corporation and that the corporation consists of all of the stakeholders who are responsible for the business of the enterprise[459]. Blair and Stout focus on shareholders and employees, but they also cite to creditors and the local community as potential stakeholders as well[460]. According to the model, these stakeholders contribute their resources to the enterprise with the implicit bargain that the enterprise itself will fairly apportion the responsibilities and rewards. The board is hired by these stakeholders to serve as the apportioning body. Thus, although the board is in some sense an agent for the stakeholders, it must have authority

[456] A well known advocate of board primacy is Martin Lipton, the inventor of the poison pill. See, e.g., Martin Lipton and Steven A. Rosenblum, *Elections in the Company's Proxy: An Idea whose Time has not Come, Business Law Review,* Vol- 67, 2003. Martin Lipton and William Savitt, *The Many Myths of Lucian Bebchuk, Valparaiso University of Law Review,* Vol- 93, 2007. Advocates for board primacy includes Lawrence Mitchell, Stepehen Bainbridge, Lynn Stout and Margaret Blair. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003. Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999. Lynn A. Stout, *The Mythical benefits of Shareholder Control, Valparaiso University of Law Review,* Vol- 93, 2007; stating that the term production approach is consistent with the nexus of contracts approach.

[457] James Mc Convill, *Shareholder Participation and the Corporation: a fresh Inter Disciplinary Approaches in Happiness,* Cavendish Publishing Ltd, 2002.

[458] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harvard Law Review,* Vol- 119, 2006.

[459] James Mc Convill, *Shareholder Participation and the Corporation: A Fresh Inter Disciplinary Approaches in Happiness,* Cavendish Publishing Ltd, 2002.

[460] See Fn 550. (stating that along with shareholders, other corporate contributors include "executives, rank and file-employees, and even the creditors or the local community"); moreover describing participants in the corporation as "shareholders, employees, and perhaps other stakeholders such as creditor and local community").

above them in order to carry out its function. The role is thus less one of an agent and more that of a trustee.[461]

Neither Bainbridge nor Blair and Stout offer extensive policy reforms. Instead, both theories are best characterized as descriptions of the status quo that explain, as well as justify, the current regime. Bainbridge and Stout have both extensively criticized efforts to expand upon shareholder democracy[462]. However, they have not argued for efforts to further insulate or protect directors' discretion. Instead, they largely believe the status offers the proper balance.[463]

5.3.2 The "Long-Term Interests" Theorists

Another set of theorists also argues for board primacy: namely, board insulation and independence from shareholder pressure[464]. However, they base their analyses not on a model of corporate structure, but rather on concerns about the influence of short-term interests. In their view, shareholders have developed an extremely short time horizon by which they judge the success of the corporation and its leadership. As boards and officers have come under more pressure to follow the desires of shareholders, they have adopted the goal of short-term share price maximization. This focus, they argue, has skewed the perspectives of shareholders and, as a result, has hurt the long-term efficiency of corporations. Although a number of commentators share this concern about short-termism, we look at two sets of commentators who have long focused on it. Since the early 1990s, Lawrence Mitchell and Martin Lipton have criticized shareholder primacy on the grounds that it inexorably leads to short-term share price primacy. And both have proposed somewhat dramatic solutions to this problem.

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[461] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harvard Law Review*, Vol- 119, 2006.

[462] Stepehen M. Bainbridge, *Director Primacy and Shareholder Disempowerment, Harvard Law Review*, Vol-119, 2006.

[463] Lynn Stout has argued in later articles for greater constraints on shareholders. See Imam Anabtawi and Lunn Stout, *Fiduciary Duties for Activist Shareholders, Stanford Law Review*, Vol- 60, 2008; (arguing that corporate law should impose a duty of loyalty on shareholders). She has also echoed the concern about shareholders' short term time horizons that derive the proposals of Mitchell and Lipton.

[464] Lawrence E. Mitchell, *A Critical Look at Corporate Governance, Vanderbilt Law Review*, Vol- 45, 1992.

In an article and a subsequent book, Mitchell has argued that board's at large public companies should be self-perpetuating.[465] As Mitchell describes his proposal: *"Once the members of the board are put in place, either by a one-time stockholder vote or public appointment or something like it, the board itself is to fill the periodic vacancies resulting from death, resignation, and increases in board size by selecting the people to fill those vacancies.*[466]"

Mitchell acknowledges that this is a "pretty radical idea[467]," but he believes such a radical approach would best free managers to manage the firm. Because any control by shareholders would focus directors on share price, Mitchell believes that complete freedom from shareholder oversight would "enable them to manage responsibly and for the long term."[468]

The self-perpetuating board elected board are significantly more insulated from shareholders than current law provides. In the original description of Mitchell's self-perpetuating plan, the board would only become self-perpetuating once the corporation went public. Therefore, the board of the privately-held company elected by the private shareholders would essentially become the board ad infinitum. Mitchell recommends, however, that this board "replace itself with a group of directors who are neither managers nor stockholders;" instead, the board would be made up of independent directors[469]. Mitchell believes that this change would render the board "far less likely to feel allegiance to management." In his later discussion of the policy, Mitchell is more oblique about the composition, stating that "the members of the board would be put in place, either by a onetime stockholder vote or public appointment or something like it.[470]"

From these brief sketches, it is clear that all board primacists believe the board should not become more responsive to shareholder concerns. The "wise ruler" theorists largely believe the system is balanced properly, while the "long-term" theorists would reorient the board

[465] See Fn. 458.
[466] Lawrence E. Mitchell, *Corporate Irresponsibility: America's Newest Export*, Vol- 101, 2001.
[467] See Fn. 460.
[468] Settling on the quinquennial plans as "middle ground" proposal that it is a "good idea" and "a little less scary to contemplate" than the self perpetuating board).
[469] Lawrence E. Mitchell, *A Critical Look at Corporate Governance, Vanderbilt Law Review,* Vol- 45, 1992.
[470] See Fn. 463.

toward a longer-term outlook by extending the tenure of board members.[471] Only Mitchell suggests any changes to the electorate, and he does so in a somewhat offhanded way. Instead, these theorists largely believe that tinkering with the board itself, rather than those who choose the board, would be the best course of reform. We now turn to a deeper examination of the theories and, in particular, the issue of the electorate.

5.3.3 Board Primacy, Board Responsiveness, and the Composition of the Electorate

Over the last several years, it has become increasingly clear that shareholders are not, in fact, the homogeneous wealth maximizers they were once thought to be. Shareholders, it turns out, have interests that diverge along a number of dimensions[472]. Commentators have recently focused attention upon the problems caused by equity derivatives, which carve up various shareholder rights into discrete financial securities[473]. But there are many other ways in which shareholders fail to share common interests[474]. And even when shareholder interests line up and they agree on a definition of wealth maximization, they may differ as to the best way to achieve that goal[475]. Ultimately, the notion that shareholders have homogeneous preferences is a simplifying assumption that is increasingly under strain[476]. One possible response to shareholder heterogeneity is to move away from shareholder primacy toward a system of governance that is less responsive, in the direction of board primacy. The preferences of the shareholder electorate, it turns out, are as diverse as those of other constituents. Thus, many of the reasons for restricting the voting rights of those other constituents (the procedural and substantive inefficiencies) now apply to shareholders as well. For those reasons, then,

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[471] Hermen Siebens, *Concepts and Working Instruments for Corporate Governance, Journal of Business Ethics,* Vol- 39, 2002.

[472] Lewis A. Kornhouser, *Constrained Optimization: Corporate Law and the Maximization of Social Welfare, in the Jurisprudential Foundations of Corporate and Commercial Law,* Vol- 87, 2000.

[473] Henry TC Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden Ownership, South California Law Review,* Vol- 79, 2006.

[474] For example some shareholder may be in control group. See Grant Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity, Cardozo Law Review,* Vol- 30, 2005; See also Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009; Employee and pension- holding shareholders have different interests from non- employee interest, and even traditional shareholders may have different time horizons for wealth maximization that cannot be costlessly equalized through existing financial instruments.

[475] Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

[476] Henry TC Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden Ownership, South California Law Review,* Vol- 79, 2006; it is simply not true that the preferences of shareholders are likely to be similar if not identical.

corporate boards should be less responsive to shareholder interests and more power and discretion should be accorded to these boards.

Shareholder diversity has pushed many scholars, touting both board and shareholder primacy, in this direction. One sees this new pressure throughout the corporate law literature when a question arises as to the appropriate level of responsiveness of a system of corporate governance. Hedge funds, for example, may have shorter time horizons than other investors, and critics have cited this potential for short-term focus as a reason for dampening their influence[477][478]. Divergent interests among shareholders may point in a variety of different governance directions. That is, although shareholder heterogeneity provides general support for board primacy, it is relevant to almost any feature of corporate governance that makes the system more or less responsive to the shareholders, and it generally exerts pressure in the direction of making the system less responsive.

Thus, it is important to disentangle the two kinds of arguments that are generally made in response to the diversity of preferences exhibited by shareholders and other corporate constituents. One set of arguments, which go to the level of responsiveness in the governance system, make some sense. The other set, however, goes beyond responsiveness and continues to argue for particular and exclusive electorate-shareholders. These claims are often made together and are sometimes conflated. But they are very different aspects to governance system-corporate or otherwise.

5.3.3.1 System Responsiveness to the Electorate

The worries about an overresponsive system of corporate governance drive most board primacy theories[479]. The corporation, board primacy proponents argue, should be structured in a way that the board is relatively insulated from the whims of the shareholder electorate[480]. The fear of an overresponsive system of governance is the primary force motivating a shift in

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[477] Imam Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders, Stanford Law Review,* Vol- 60, 2008.

[478] Ronald J. Gilson and Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism, Stanford Law Review,* Vol- 60, 2008.

[479] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003.

[480] See Fn. 474.

power away from shareholders to the board. As mentioned above, it resolves into two kinds of concerns. First, a system that is too responsive to shareholders may give rise to various procedural inefficiencies. Put simply, being more responsive costs time and money. A system of shareholder initiative, for example, is viewed as problematic because it slows down corporate decision making and because of the potential cost of running the electoral machinery[481].

The main proponent of board primacy, Stephen Bainbridge, makes the point largely on the basis of Kenneth Arrow's models of consensus and authority decision making[482]. According to Bainbridge, shareholders with differing interests and levels of information would bog down corporate decision making[483]. Bainbridge, citing Arrow, argues that decision making by consensus works best when the participants have similar if not identical preferences and information. There are, initially, "mechanical difficulties" in achieving consensus among thousands of shareholders[484]. But even if such difficulties could be overcome, "active shareholder participation in corporate decision making would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information.[485]" Thus, Bainbridge concludes, corporate governance systems are and should be structured to enhance authority based decision making, with the board being the ultimate authority.

The second and greater drawback to more responsive corporate governance systems is that they give rise to tyranny of the majority. They are, in other words, too efficient at translating the will of a majority of the electorate into corporate action. This criticism comes in various guises. For some, the worry is that certain "special interest" shareholders will exploit other

[481] For an argument against shareholder proxy proposal on grounds of inefficiency, see Roberta Romano, *Less is more: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance, Yale Journal on Regulation,* Vol- 18, 2001.
[482] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.
[483] See Stepehen Bainbridge, *Participatory Management Within the Theory of the Firm, Journal of Corporate Law,* Vol- 21, 1996; ("the resulting conflicts of interest inevitably impede consensus- based decision making within the board.")
[484] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003.
[485] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.

shareholders rather than act for the good of all shareholders[486]. Others worry that shareholders generally will exploit other corporate constituents.[487] Either way, a more responsive system of corporate governance will enable these self-interested, sometimes transient majorities to manipulate corporations toward their own selfish ends.

Several of the board primacy theorists cite to this fear of "tyranny of the shareholder majority" Thus, it is the directors' job to "balance team members" competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[488] Accordingly, it only makes sense to Blair and Stout that "American law in fact grants directors tremendous discretion to sacrifice shareholders' interests in favour of management, employees, and creditors."[489] This need to "sacrifice" shareholder interests explains the desire to insulate the board from shareholder importuning.

Similarly, the long-term theorists want to insulate the board against shareholder pressure to maximize short-term gain. Institutional shareholders; the shareholder group with the greatest voice and power are biased toward short-term results, and as a consequence such shareholders have pushed companies to favour quick results over long-term growth. Insulating the board with five-year terms allows the directors to pursue a longer-term strategy without the risk of shareholder wrath. In turn, this will "benefit the corporation's other constituencies, which prosper if the enterprise's business operations prosper over the long term." Similarly, Mitchell argues that his self-perpetuating board would best free directors "to do what it is they do best, and that is manage (or provide for the management of) corporations for the long term." In order to accomplish this, "corporate management should be entirely separated from stockholder pressure." [490]

These arguments all point to a disconnection between the will of the electoral majority and the good of the corporation. In order to properly pursue the social good, the board has to be

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[486] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice,* Oxford University Press, 2008.
[487] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999.
[488] See Fn. 484.
[489] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999.
[490] Lawrence E. Mitchell, *Corporate Irresponsibility, America's Newest Export,* Vol- 101, 2001.

insulated from the shareholders. Thus, these reformers all seek to dampen the responsiveness of the corporate structure to shareholder concerns. As a result, the board is (or would be) freed up to follow its own discretion, even if it conflicts with a clear and uniform preference of the electorate.

5.4 Board Primacy and Shareholder Homogeneity

It is clear that shareholders have less homogeneous preferences than previously believed.[491] This, in all likelihood, provides some additional support for less responsive systems of corporate governance. It does not, however, counsel in favour of a corporate electorate restricted to shareholders. The recent recognition that shareholders are more diverse than once thought actually undercuts many of the arguments for their favoured position among corporate constituents. Board primacists, however, have generally eschewed such analysis and simply kept the shareholder electorate unchanged.[492] But there is nothing in the typical arguments in favour of a less responsive system that entails this result. The exclusive shareholder franchise just gets dragged along for the ride into board primacy positions. And board primacists' failure to reconsider the proper composition of the electorate leaves them in an increasingly untenable position. Some, like Blair and Stout, operate under the assumption that shareholder preferences are quite homogeneous and argue accordingly when it comes to the proper composition of the electorate[493]. Others, like Bainbridge, concede that shareholder preferences are less homogeneous than once thought and instead argue that they are still more homogeneous than those of other constituents, or of a combined electorate. Either way, the set of arguments from (relative) shareholder homogeneity to their exclusive entitlement to the franchise are similar.

A governance system in which a diverse body of voters elects a relatively insulated group of representatives should be especially appealing to civic republicans with no fixed sense of the good. Through the deliberative process and, if it comes to it, a vote, board members can come to a shared notion of the common good. Consensus among the voters or the board members, in other words, is overrated, especially when that consensus is bought at the price of

[491] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.
[492] See Fn. 488.
[493] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review*, Vol- 85, 1999.

excluding those with differing views from the process[494]. And claims of efficiency all depend upon what is being maximized, which is sometimes at the heart of the disagreement. Bainbridge couches this political breakdown argument in terms of Kenneth Arrow's scheme of consensus and authority decision making.[495] The arguments made with respect to shareholder diversity apply with even more force to other constituents because, according to Bainbridge, an electorate expanded to include other constituents, like employees, would be even more diverse. Thus, corporations are no place for consensus based decision making, and the vote should accordingly be limited to shareholders alone.

Bainbridge's version of this argument does not work that well as a general matter or as applied to this issue of the proper scope of the corporate electorate. Initially, his position that constituents with differing interests and levels of information counsel, according to Arrow, an authority based structure is incomplete. Arrow does postulate a tension between authoritarian and consensus-based governance[496].

But, as Brett McDonnell recently pointed out, "Bainbridge moves very, very quickly from recognizing the tension between authority and accountability to arguing that we should presume a legal structure that favours authority over accountability."[497] These moves, which McDonnell dubs "Arrowian Moments," occur throughout Bainbridge's work, and are noteworthy for their complete lack of substantive argument that the more authoritiarian, board centric solution is the correct one. In other words, recognizing the tension does not tell us where on the continuum we should be with respect to each institutional design feature and certainly doesn't tell us that we should always tilt toward the more authoritarian solution.

The argument for the exclusive shareholder franchise is also undercut by the revelation of shareholder diversity. The argument is that shareholders alone have a very good proxy for the degree of their interest in the firm, the number of shares owned, which allows us to perfectly

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[494] Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control, Washington University Law Quarterly,* Vol- 70, 1992.

[495] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice*, Oxford University Press, 2008.

[496] Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

[497] Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of the New Corporate Governance in Theory and Practice, Delaware Journal of Corporate Law,* Vol- 34, 2009.

calibrate their voting power. But the number of shares owned is not such a good proxy once we have shareholders with interests that go beyond the mere monetary value of their stock. There are bigger problems with this argument, however, than the fact that one of its assumptions shareholder homogeneity has been undercut[498].

The biggest problem is that a ready proxy for shareholder interest and the one share, one vote rule tells us little about whether or how voting power should be distributed among stakeholders[499]. The number of shares owned by particular shareholders may be a good indication of their interest in comparison to other shareholders; it tells us nothing, however, about their interest in comparison to, say, an employee, a creditor, or a customer. More specifically, it is not an independent reason to conclude that the present arrangement, which gives shareholders alone the right to vote, is any better at capturing the preferences of interested parties than, say, giving employees alone the right to vote and capturing everyone else's interest through contract. The difficulty in assessing how much to weight the aggregate shareholder interest or vote against the aggregate interests of any other group of stakeholders runs both ways and does not demand resolution in any particular direction.

Perhaps a simpler way to think about this point is in terms of a board with members who represent different constituencies[500]. On an eleven-member corporate board that represents the interests of many different stakeholders, the fact that one group of stakeholders has a particularly nuanced way of apportioning voting power amongst its own members tells us nothing about how many board representatives that group should be apportioned as a whole. That is, the one share, one vote rule is a good way of apportioning voting power among shareholders, but it tells us nothing about how voting power should be distributed among different stakeholders.

[498] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Directors_responsibilities_August2006.pdf/$file/Directors_responsibilities_August2006.pdf, last accessed on 25th May 2011.

[499] http://www.phosphagenics.com/site/DefaultSite/filesystem/documents/Corporate%20governance/CORPORATE%20GOVERNANCE%20PRACTICES%20AND%20CONDUCT.pdf, last accessed on 25th May 2011.

[500] This assumes that the various constituencies would elect their board representatives in separate elections, which by the way, is how the German system of codetermination works. David H. Brody et al., *Alternatives to the United States System of Labour Relations: A Comparative Analysis of the Labor relations Systems in the Federal Republic of Germany, Japan and Sweden, Vanderbilt Law Review,* Vol- 41, 1988. But the point here would be equally applicable in an election in which all constituencies vote in the same election and we need to decide how much to weight each vote.

This is not to say that the presence of an effective measure of stakeholder interest is irrelevant to determining whether any particular group of stakeholders receives the right to vote. Distribution of a corporate franchise operates, at one level, like that of a political franchise. Voting is a collective decision-making process designed to reflect preferences of those interested in the outcome of an election. For that reason, we usually tie the right to vote to the strength of one's preferences in the election[501]. Because we have no direct method of observing people's preferences, we are forced to rely on various proxies for the strength of their interest.

But, again, the fact that we have a good proxy for shareholder interest does not mean that we lack good proxies for other corporate constituents, or that shareholders, therefore, should receive all of the voting power. When assessing proxies for voter interest, we are usually looking for two things: does the proxy accurately capture voter interest, and is the proxy manageable. Shares are a relatively accurate, manageable proxy for shareholder interest, and therefore, shareholders are a group whose interests can be reasonably captured through voting (rather than merely through some other device, like contract)[502]. Employees are another group. Employment status is a good proxy: it is a good indication of interest in corporate decision making, and employees are pretty easy to identify. But there may not be good proxies for all corporate constituents.

The final, substantive argument for the exclusive shareholder franchise was that more diverse constituents, if granted the vote, would pursue their own special interests to the detriment of others in their group or, more generally, other stakeholders; shareholders, with their common interests, would not. Once again, before examining how this argument fares without the assumption of shareholder homogeneity, we should examine it on its own terms. The premise that democratic processes may allow a majority to exploit minority interests is well known.[503] The conclusion, though, is a bit perverse. The presence of a tyrannical majority is usually offered in support of structures designed to protect the exploited minority; here, though, it is offered as a reason for pushing the minority group out of the decision process altogether. That

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[501] Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

[502] See Fn. 499.

[503] James Madison described this danger of majority faction. The Federalist No. 10 (James Madison).

is, in such situations, we are usually worried about the exploitation of the minority interest, not the possibility that the majority or their representatives will feel put upon by having to consider interests other than their own.

This is not to say that tyranny of the majority is not an issue. It is an issue with corporate governance as it is with any democratic decision procedure. In corporate law, where there are many layers between shareholders and most corporate decision making and various protections for minority shareholders[504]. Minority shareholders in closely held corporations, for example, enjoy wide-ranging equitable protections through the "minority oppression" doctrine. Minority shareholders in publicly held corporations are protected by the fiduciary duty of loyalty, which prevents the majority shareholder from pushing through lopsided self-interested transactions that harm the corporation as whole. Such protections are a rational response to the possibility of an exploitive majority faction; eliminating minority interests from the corporate electorate just adds insult to injury.

Once shareholder diversity enters the picture, this argument, like the others, makes even less sense. The claim again comes down to one of relative diversity and the assumption that any marginal increase in the diversity of the electorate militates in favour of a less responsive system and restrictions on the scope of the electorate. In corporate governance, as in politics, there are many reasons to embrace more deliberative systems of governance. Some of those reasons have to do with the cost of more responsive systems putting every single corporate decision to a vote of an electorate, however defined, is a waste of time and money. Some of those reasons have to do with the heterogeneity of the electorate and the worry that permanent or even temporary majorities may pursue their own interests to the detriment of a minority[505].

But, in such cases, it takes only a slight departure from complete homogeneity to push in favour of a less responsive system of governance. For example, even shareholders who are completely unanimous in their support of maximizing shareholder value may still disagree

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[504] For the discussion of protections for corporate minority shareholders, see Anupam Chander, *Minorities, Shareholder and Otherwise, Yale Law Journal,* Vol- 113, 2003.

[505] See Stephen M. Bainbridge, *The New Corporate Governance: In Theory and Practice,* Oxford University Press, 2008.

on, say, the time frame for that, and thus may want to pursue very different strategies[506]. In an overly responsive system, a tyrannical majority may be able to exploit a minority given this, or really any, differentiation in preference profiles. As discussed above, this has already been recognized and built into corporate governance systems in the form of board duties and other devices[507]. The recent recognition that shareholder interests are actually more diverse than once theorized doesn't really add that much more weight to arguments for less responsive systems. Most of the arguments in favour of a less responsive system, such as the costs and potential for exploitation, apply regardless of the exact level of diversity within the electorate. So, in sum, what does increased shareholder diversity mean for the scope of the electorate or, more to the point, the exclusive shareholder franchise? Unlike the arguments for a more deliberate system, the arguments for a less expansive electorate, at least the ones based on shareholder homogeneity, were not very good to begin with. But even if we take them at face value, shareholder heterogeneity undercuts one of their critical assumptions. That is, to the extent that shareholders now have diverse interests, they are more prone to inefficient squabbling; more likely to produce damaging voting cycles; in better position to exploit their differences; and the one share, one vote system is less well-calibrated to their interests. Scholars attempt to salvage these claims by hanging them on the relative homogeneity of shareholder interests, but the claims are not fine-tuned enough to turn on these new, largely theoretical differences in preference profiles. Instead, shareholder diversity just makes these bad arguments worse[508].

So we are left with slightly stronger arguments for a less responsive governance structure and increasingly poorer arguments for the exclusive shareholder franchise (arguments that, for the most part, came out of shareholder primacy positions to begin with). To a large degree, this occurs because preference homogeneity, or the lack thereof, is viewed as having an equivalent effect on both the ideal level of board responsiveness and the composition of the board electorate. It does not.

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[506] See Grant Hayden Mathew T. Bodie, *Shareholder Democracy and the curious turn towards Board Primacy, William and Mary Law Review,* Vol- 51, 2010.

[507] See Fn. 504.

[508] http://www.molex.com/images/financial/pdf/CorpGovPrinciples.pdf, last accessed on 25th May 2011.

5.5 Board Primacy and the concept of Corporate "Good"

As time has proven shareholder preferences to be not quite as homogenous as envisioned, board primacists have continued to distance the decision-making processes from the shareholder electorate. An insulated board is in a better position to deliberate and reach decisions that advance the interest of the firm. But when it comes to defining the electorate, the very thing that makes such deliberation valuable the clash of different interests and opinions, the pull and haul of politics is viewed as so troublesome that voting must be limited to a single group of constituents.

The strange thing about this is that many public-choice style corporate scholars, firmly entrenched in the law and economics tradition, begin to look like civic republicans when faced with preference profiles that troubled them. They moved from wanting to aggregate voter preferences to wanting some distance between voters and their representatives. But what, exactly, is their sense of the corporate good? It is here that we see the strange feature of this move in the direction of board primacy. It is civic republicanism without any sense of what counts as the public good; or, to be more precise, not much accountability to any of the constituents besides shareholders who make up that public. Where does the sense of the corporate, or public, good come from? And how does the system of governance keep the corporate board honest in its duty to pursue those ends?

Those are questions that board primacy theorists have trouble answering. Shareholder primacy dictates that both the corporate and public good are best pursued by maximizing shareholder wealth. Within that framework, there may be debates about the best means of achieving that maximization, but the ends are agreed upon. Bainbridge fits within this category. Even though he has set up his "director primacy" theory in opposition to shareholder primacy, he still believes that shareholder wealth maximization is the proper corporate purpose[509]. His debates with shareholder primacists such as Lucian Bebchuk revolve around the best means for pursuing these agreed upon ends. However, other board primacists have difficulty in establishing the corporate good and the board's connection to it. Blair and Stout give a perfectly respectable answer as to corporate purpose: the board is

[509] See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance, New York University Law Review,* Vol- 97, 2003.

supposed to be advancing the interests of all corporate constituents and needs to be somewhat insulated in order to do that (as to not be dominated, at a minimum, by shareholder interests)[510]. The directors are viewed as the "independent hierarchs" serving the interests of the corporation, which "can be understood as a joint welfare function of all the individuals who make firm-specific investments and agree to participate in the extra contractual, internal mediation process within the firm." The list of possible individuals may include executives, employees, and shareholders, as well as creditors and even a local community. But when it comes to the composition of the electorate that will, ultimately, make the board accountable to all parties, they oddly fall back upon some of the arguments that turn on shareholder homogeneity, to argue for an exclusive shareholder electorate.

This is a strange turn for several reasons. Initially, it seems to run against the rest of their theory, which views the board as acting on behalf of all corporate constituents. On this front, the best they can do is argued that the exclusive shareholder franchise is not inconsistent with the rest of their theory, which is true, but it is certainly not dictated by it. Moreover, we are left with the question of why a board elected by shareholders alone would feel any pressure to act on behalf of all corporate constituents. True, board members are relatively insulated from shareholders, but with this scheme, they are even more insulated from other constituents. And although it may be true that most board decisions advance or retard the interests of all corporate constituents, such a generalization is not always true. In any case, it does not really cut one way or the other, because when all interests line up, then shareholders have no special claim to representation. It is one thing to say that the board should act on behalf of all corporate stakeholders, but it is unclear why they actually would.

The history of corporate constituency status should be instructive here. Thirty-one states have provisions that permit directors to take the needs of all corporate constituencies into account when making certain decisions.[511] Some constituency statutes apply only to change-in-control transactions, while others apply more broadly to all board decisions.[512] The purpose of these

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[510] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review*, Vol- 85, 1999.

[511] See Roberta Romano, *The State as a Laboratory: Legal Innovation and State Competition for Corporate Charters, Yale Journal on Regulation*, Vol- 23, 2006.

[512] New York, for example, provides that when considering a change or potential change in the control for the corporation, a director "shall be entitled to consider" the effects that the corporations' actions may have upon

statutes is to give directors the freedom to consider the impact of a board decision on stakeholders other than shareholders[513].

Blair and Stout's model suffers from a similar flaw in its incentive structure. Directing a board to consider the interests of various members of the team does not mean that they will do so. Blair and Stout argue that corporate law provides for such discretion, and much of their argument is a positive one[514]. However, to the extent they are making a normative case for the team production model, it is difficult to see where team members other that shareholders would have any leverage over the board or input into its composition. Although they acknowledge that exclusive shareholder voting rights "pose something of a problem for the mediating hierarch approach, "they make two arguments attempting to reconcile this anomaly. First, they argue that shareholders may have the best preferences for serving the corporation as a whole. As discussed above, they argue that shareholder homogeneity provides for a cleaner electorate with "fewer pathologies." Because of this, shareholders serve as the best possible electorate for serving the interests of the corporation as a whole. Second, they argue that shareholder voting rights may be "partial compensation for shareholders' unique vulnerabilities." These arguments are contradictory, of course; in one, the shareholders are acting as representatives for all stakeholders, while in the other they are using the vote to protect themselves against other stakeholders. Blair and Stout ultimately dismiss such concerns, however, by hearkening back to the relative impotence of the shareholder franchise. One wonders why they did not further consider the possibility of expanding the electorate to include other team members.[515]

The long-term theorists have not laid out their model as clearly as Blair and Stout, and thus it is more difficult to pinpoint where exactly they fit on the spectrum. Their chief problem with

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the corporations' various stakeholders, including current employees, retired employees, customers, creditors, and the communities in which it does business.

[513] For a recent summary of the arguments for or against constituency statutes, see Brett H. McDonell, *Corporate Constituency Statutes and Employee Governance, William Mitchell Law Review*, Vol- 30, 2004.

[514] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review*, Vol- 85, 1999.

[515]See Roberta Romano, *The State as a Laboratory: Legal Innovation and State Competition for Corporate Charters, Yale Journal on Regulation*, Vol- 23, 2006.

shareholder primacy seems to be its endemic short-term focus (although shareholder primacists themselves would dispute that the model is short-sighted)[516].

Mitchell presents a more complicated case. Mitchell is most aggrieved by the short-term focus induced by shareholder control.[517] Thus, his main concern is separating the board from short-term shareholder influence. But Mitchell also seems concerned about the cost in externalities generated by a share price maximization norm, whether it be short-or long-term. He criticizes the singular corporate focus on share price so strongly that he ultimately compares this focus to that of genetically engineered man eating sharks.

Bainbridge is at least more consistent here, wholeheartedly importing the idea that corporate actions should be directed at increasing shareholder wealth, and thus making the board answer, albeit weakly, to a shareholder electorate.[518] But Bainbridge is making the familiar mistake of assuming he knows what it is that shareholders want. He does not seem to care what shareholders actually want in particular circumstances; instead, he is content to make "shareholder wealth maximization" the constant and easily implemented goal of the board. He avoids the messiness of actual elections by assuming that boards will act in what he considered to be the best interests of the electorate.

Of course, is unclear what, exactly, it means to maximize the wealth of a shareholder electorate with a very diverse set of preferences[519]. Some shareholders will desire short-term share price maximization, while others will prefer long-term dividend maximization; some may have different ideas about the best way of pursuing wealth maximization. Others still will desire to maximize their overall utility by advocating for corporate activity that promotes social welfare goals. Elections can be useful devices for sorting out these various preferences into results that best map onto the preferences of the electorate.

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[516] Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999.
[517] Lawrence E. Mitchell, *A Critical Look at Corporate Governance, Vanderbilt Law Review,* Vol- 45, 1992.
[518] Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, Washington and Lee Law Review,* Vol- 50, 1993.
[519] See Grant Hayden and Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity, Cardozo Law Review,* Vol- 30, 2005; See also Grant Hayden and Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise, Vanderbilt Law Review,* Vol- 1217, 2009.

Thus, directing a relatively unresponsive board to maximize shareholder wealth gives them, at best, incomplete guidance. The only way to make it more complete is by building a system of governance that responds in some way to the actual preferences of shareholders. The problem with Bainbridge's argument is that just as the governance system should be getting more responsive to shareholder interests, he argues that it should be less responsive. What we are left with is a vision of shareholder "wealth" that bears less and less of a relationship to the well-being of actual shareholders.

So why should we expect a less responsive board to better manage this diverse set of interests? For Bainbridge, as for Blair and Stout, the answer is that corporate boards can be trusted to pursue proper ends. But Bainbridge goes a step further than Blair and Stout's notion of the board as a group of "meditating hierarchs" constrained by norms of trust: for Bainbridge, "the corporation's board of directors in fact is a Platonic Guardian." Such a claim would ordinarily be laughable, or accepted as a reductio ad absurdum of the whole board primacy project, if it weren't delivered with such seriousness. The resort to describing directors as Platonic Guardians is a complete surrender of any workable notion of what directors should be doing or why they would be expected to do it. We can't rely on philosopher kings to act as directors of our corporations for the same reason we can't rely on them to run our governments: Platonic Guardians do not exist. For that reason, we tend to favour more democratic decision structures with a little more accountability to the electorate[520]. Corporate constituents, other than shareholders, were never viewed as the proper board electorate in large part because their preferences were so heterogeneous. Now that shareholders are known to be more like those other constituents, they, despite holding onto the franchise, are to be further distanced from the board. This leaves the board in a curious position it must pursue the corporate good, but is not accountable to many of its constituents and is only weakly accountable to shareholders. The resultant corporate board, as Bearle and Means pointed out over seventy-five years ago, ends up resembling a communist committee of commissars: The communist thinks of the community in terms of a state; the corporation director thinks of it in terms of an enterprise; and though this difference between the two may well lead to a radical divergence in results, it still remains true that the

[520] http://www.heinz.com/our-company/corporate-governance/charters/corporate-governance-principles.aspx, last accessed on 23rd May 2011.

corporation director who would subordinate the interests of the individual stockholder to those of the group more nearly resembles the communist in mode of thought than he does the protagonist of private property. At least the commissars, though, had a well-defined notion of the public good[521].

[521] Roberta Romano, *The State as a Laboratory: Legal Innovation and State Competition for Corporate Charters, Yale Journal on Regulation,* Vol- 23, 2006; Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law, Valparaiso University of Law Review,* Vol- 85, 1999.

Chapter-6

Conclusion

The realm of corporate governance is as vast as ocean. If one looks at the concept of corporate governance as a whole then there are many niceties inherent in this concept which requires proper investigation. The historical development of corporate governance is very uneven. Series of corporate scandals led to the growing need of more effective corporate governance system which should not curb only corporate abuses but also laid down the proper functioning of this machinery. Series of Committee reports and combined codes were published highlighting the need of effective corporate governance. These reports acting as soft laws don't have any binding effect but indeed it laid down some of the most important principles of corporate governance to be followed by corporations.

The Board of directors are one of the main constituencies in corporate governance sector. They are known as the managers of the corporations who are legally responsible for the effective management of the corporations. An active well informed board is necessary to ensure the highest standard of corporate governance. If the evidence demonstrates the board is failing, the logical next step is reform. The consensus is that the board structure has a viable role to play and substantial changes should be made to improve the institution.

In corporate governance equally important issues are the size of the board and the strength of independent directors to disagree with the dominant interest group when company's interest so demands. In reforming the board structure the proportion of independent non-executive directors is very essential for enhancing the quality of corporate governance. Moreover, in corporate governance board committees plays an important role specially in terms of improving the decision making of the board as well as in enhancing the monitoring of management and accountability to shareholders. But board committees are not a remedy and it is not advisable to push for the establishment of board committees if there is need of non-executive directors to serve in these committees. In India, the real issue is the lack of qualified non-executive directors do to which problem is faced by the companies to establish effective board committees and effective board of directors.

Next comes the role of shareholders in the corporate decision making. Indeed, it is beyond any doubt, that shareholders are the owners of the corporations and there are many ways in which they can enhance their participation via through general meetings and increasing role of institutional investors. Considering the enormous importance of the issues to be discussed and decided at the general meetings and also keeping in view its potential of acting as a check and control on the activities of the board of directors and at the same time act as a platform for the shareholders to exercise their rights, it is certain that general meetings, no matter how expensive an affair, are absolutely essential for the well being of a company and all its stakeholders and hence, an integral part of an effective corporate governance regime.

Berle and Means explicated how in a corporation there is a division of ownership and management, but since the ownership is shared by many and is scattered, it is not able to control the management and as a result management can become corrupt and indulge in wrongful activities, however Institutional Shareholder has come out as a remedy to this fundamental problem arising out of this structural error. They can be the answer to check the immense power of the Board of Directors, however, for that they need to act in unification- "United We Stand and Divided We Fall". Ability to act together and reach a consensus is the reason behind the power that institutional investors wield. By and large, management is all ears to them if they make an effort to reach out and at times, they end up acting as partners discoursing on the important issues. Moreover, the concept of corporate governance has grappled the world and there has been increased activism on the international arena.

Over the last several years, it has become clear that one of the basic assumptions of corporate governance theory that shareholders have a homogeneous interest in wealth maximization is simply not true. Shareholders, it turns out, are much like other corporate constituents in that they have a wide range of preferences with respect to the corporation and its decision making. This discovery has moved many corporate scholars, especially board primacy theorists, to argue for further distance between the board and the shareholder electorate. These scholars, many of whom come out of a public choice, aggregative approach to decision making, have begun to look more like civic republicans, arguing for a more insulated governing body. But this leaves them in a curious position they are civic republicans but do not have any real sense of the corporate good and, more pointedly, they lack any way to tie their sense of the corporate good to the actual preferences of their preferred constituents.

There is, however, another potential path to explore in response to the news of shareholder diversity. We now know that other corporate constituents are more like shareholders, at least when it comes to preference diversity, than once believed. This undercuts one of the critical assumptions of many arguments for the exclusive shareholder franchise. That said, scholars have either left this issue alone or attempted to reformulate the arguments to hang on the relative homogeneity of shareholder preferences. This approach, however, is misguided, in large part because it conflates two very different concepts in a system of governance: responsiveness and the identity of the electorate. Hence, "board of directors" and "shareholders" are like two pillars of corporate governance. The debate of who leads whom in this field can be best concluded in this way. The role of corporate governance is to ensure that directors comply with their duties, obligations and responsibilities to act in the best interests of the company. They have the duty of loyalty towards their company, to give directions and remain accountable to their shareholders and other stakeholders. The failure of Company Law to address these issues were principally attributable to a lack of clarity as to the role, responsibilities and duties of directors and shareholders and fragmented nature of the companies legislation- layer after layer of recommendations have been added on to the existing Companies Acts in terms of directions and regulations. A modern framework transforming the various duties, obligations and responsibilities into a practicable and workable governance system was well overdue. The role of shareholders is as important as that of directors in corporate governance and this work basically have dealt with the role and responsibilities of these two important constituencies in corporate governance. The role of shareholders continues to be an important aspect in corporate governance debate. Traditionally, the shareholders were perceived as passive investors in their companies leaving it to directors to manage the companies' affairs without any effective control and mechanisms vested in shareholder to hold directors accountable for their actions. There have been significant developments ensuring shareholders are able to participate in the effective governance in the corporation through accountability, transparency and participation at annual general meetings. The shareholders activism implies the vigorous role played by the shareholders of the company in relation to the management in so far as the activities of the company are concern the interest of shareholders and other stakeholders.

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