CHAPTER 9

CORPORATE GOVERNANCE STRUCTURE, MERGERS AND TAKEOVERS IN INDIA IN THE POST-LIBERALIZATION REGIME - PROPOSALS AND POLICIES

9.1 Introduction

This chapter is designed as an epilogue to the study of the nature, causes and consequences of merger and acquisition activities in India in the post-liberalization regime, that we have undertaken. A study of mergers and TOs and their effect on the economic health of a country cannot be concluded without a study of the corporate governance (CG) dimension of corporate analysis. In fact, we have already mentioned in Chapter 2 that some economists like Kitching (1972: 40-63), Samuels (1972: 1-11), etc. have pointed out that corporate performance under mergers is largely attributable to the effective role of corporate management in modern joint stock companies, characterised by the separation of ownership and control.

We will however, discuss the governance of private corporate sector in India, characterised by limited liability joint stock companies where ownership is scattered among the various shareholders and there is distinct separation between ownership and control. Divorce between ownership and control has been the hallmark of joint stock companies all over the world, although there exists a basic difference between the structure of Indian joint stock companies with that of their foreign counterparts. Control in Indian companies has largely been exercised by families with minority shareholdings. This is in contrast to the subsidiaries of foreign MNCs, where professional managers have exercised greater authority, under the overall supervision of their parent companies.

This chapter aims at providing an account of the activities of the corporate control market, namely corporate mergers, acquisitions and TOs from the position of CG in India, in the post-NIP regime. In Section 9.2 we have briefly introduced the concept of CG both from the theoretical point of view and also from the Indian perspective. The salient proposals of the proposed policy framework of CG in India are also provided in this section. In order to estimate the status, quality and effectiveness of contemporary CG scenario in India and the relevance of mergers and TOs therein, the first and foremost step would be to identify the structural features of the Indian CG system of the private corporate sector including the market for corporate control. Section 9.3 concentrates on a review of the current Indian scenario with respect to the various dimensions of CG of private corporate sector in our country. This section also reviews the various policies regarding the different dimensions of CG adopted or recommended in India till 1998 and posits the implications of these policies, which might directly or indirectly affect the prevailing characteristics of CG in India and the position of mergers and TOs therein. Section 9.4 concludes the chapter, where we
have raised certain related issues of CG pertaining to the Indian situation, that might throw some light on the on-going process of designing of an appropriate code of CG for India.

9.2 Some Conceptual and Policy Issues of Corporate Governance

9.2.1 Firm as a governance structure

Separation of ownership and management means that decisions are increasingly taken by people who do not receive the profits of the enterprise. The profit maximisation hypothesis would be legitimate only if the owners succeeded in motivating their managers to behave in their own personal interests, with suitable methods of managerial compensation. However large scale of operation means an associated large risk of aggregate profits, which no single individual (including managers) would be willing to bear. In view of this, the notion of firm as a unitary profit-maximising entity requires replacement. A more apt notion would possibly be to view it as a collection of different stakeholders (such as shareholders, debtholders, board of directors, top-management, middle management, workers, suppliers and customers) with conflicting interests, many of which do not relate to firm profits. The decisions made by the firm would then depend significantly on the organisational mechanisms within the firm that serve to mediate the interests of these different stakeholders. This brings the attention to the intra-firm organisation (Mookherjee (1999: 74)). When we want to assess the ramifications of internal organisation, the neoclassical version of firm as production function with profit maximisation objective needs to be replaced by firm as ‘governance structure’ (Williamson (1998: 44)). Jensen and Meckling (1976) have provided a similar description of the ‘firm as a nexus of contracts’.

Such modern firms essentially have two separate dimensions — internal an external. The internal dimension, as we have just seen, is concerned with intra-institution interactions and here rises the question of internal monitoring and control via the appropriate choice of CG mechanism as discussed in Chapter 2. The internal control system of the firm headed by the board of directors as well as its interaction with the stock market becomes relevant here. The role of corporate internal control system is of relevance so as to prevent the loss of investor capital and other social resources when factor and product market discipline is disrupted (e.g., in situations where firms fail to supply the product that customers desire at a competitive price). The external institutional setting within which the firm operates involves the firm’s interface with the legal, political, institutional and regulatory system of the country that defines the nature of external contract enforcement mechanisms. The sustainability of mergers and acquisitions as an instrument of corporate control involves activation of both internal structures of control and the external environment in which the firm works.
9.2.2 Importance of CG in India

CG has attracted explicit attention in India from academics, government, the popular press and businesses themselves with the adoption of the structural adjustment and globalisation policy by the government in July 1991 when the economy opened up of its industrial sector to international competition and increased private ownership. India’s increasing integration with the world market, and more and more companies tapping external sources of finance from the capital markets have generated public concerns regarding the effective protection of investor interests, especially those of the small investor, increased transparency of operations within firms and industry and the need to move towards international standards in terms of disclosure of information by the firms. More importantly, the role of large shareholders as banks and institutional investors have increasingly come under scrutiny in view of their reportedly passive role in CG. Apart from this, the interests of the other stakeholders in a company are also being extensively reviewed in India and abroad as part of CG analysis.

The uphauling of the industrial policies in India’s agenda for economic reforms has resulted in a radical change of environment for the corporate sector, boosting in the process, a market for corporate control. We define corporate control as the right to determine the management of corporate resources; that is right to determine the composition of the management team, including right to hire, fire and compensate senior managers. When a bidding firm acquires a target firm — say, HLL acquires Tomco — these control rights to the target firm are transferred to the board of directors of the acquired firm (Khanna (1998: 19)). Market for corporate control is the arena in which alternative management teams compete for the rights to manage corporate resources (Jensen and Ruback (1983: 5-50)). In this market, competing management teams make offer to shareholders for the right to manage the business which these shareholders own. Like all markets, this requires a number of buyers (bidders) and sellers (targets), to approximate a price mechanism. For this market to perform efficiently in the sense of effective utilisation and management of corporate resources that will ensure improved performance of companies after the consolidations take place, it ought to take place within the orderly framework of regulations. Here comes in the relevance of CG.

9.2.3 The Policy Framework on CG in India

The amendment of the Companies Act 1956 was being contemplated at the policy level with institutional changes in the corporate structure in India since the economic reforms in 1991. Accordingly, efforts were being made to rewrite the Companies Act. However, as the Companies Bill 1996 was not approved by Lok Sabha, the Ministry appointed a committee (K.R. Chandrate Committee) to review it. Two independent panels — Onkar Goswami Committee, sponsored and commissioned by the Confederation of Indian Industry (CII), a major body of the big industrialists of India, and Dave Panel set up by the Association of Merchant Bankers in India — were simultaneously constituted to review — CG with particular reference to the Companies Bill, 1996. The Onkar Goswami draft report on CG was presented in
January 1997 [1]. It examined in detail the issues related to CG and had made certain suggestions regarding these aspects. CG, according to this report, deals with laws, procedures and implicit rules that determine a firm's ability to take managerial decisions vis-a-vis its claimants -- the shareholders and creditors.

Based on the draft report prepared by Dr. Omkar Goswami, but with some modifications and additions, a draft code on CG was prepared by a task force of the CII. CII's task force comprised the leading industrialists, CEOs and academics like Mr. Rahul Bajaj, Mr. Subodh Bhargava, Mr. Jamshyd N. Godrej, Dr. J.J. Irani, Mr. Tapan Mitra, Mr. Dhruv M. Sawhney, Mr. R.C. Bhargava, Mr. C.K. Birla, Dr. Onkar Goswami, Mr. Rajive Kaul, Mr. K.R. Shenoy and Mr. Shailendra Swarup [2]. The draft code was released in New Delhi on 22 April 1997. The 10-page draft report titled "Desirable Corporate Governance in India — A Code" was divided into various heads such as role of directors, desirable disclosures, capital market issues, creditors' rights and the role of FI nominees. This report is presumably the first Indian paper of its kind. The code has accounted for some common shortcomings in the management of companies and sought to slap penalties on both erring companies and interfering lenders. The draft report was circulated and invited industry reactions [3].

Meanwhile, the Working Group on Companies Act, of which Omkar Goswami was also a member, was constituted in August 1996 at the behest of Mr. P. Chidambaram, the then Union Finance Minister, to rewrite the Companies Act and present it for public debate by early 1997. Omkar Goswami was made a member of the Working Group. Some of the recommendations of the Chandrate Committee report have been incorporated in the new bill of 1997.

The Group, set up by the Government, submitted its “Unanimous Report” on the desirable amendments in Companies Act, 1956, in 1997, so as “to facilitate a healthy growth of the Indian corporate sector under a liberalized, fast changing and healthy competitive environment” and thus smoothen the process of CG in our country. The Group had felt that “the need of the day is to bring out the latent dynamism of Indian companies so that they can consolidate and grow, as also enhance shareholder value and thus become significant players in an environment that will result in even greater competitiveness with the advent of capital account convertibility” (Taxmann (1997a: 2)).

The Companies Bill 1997 and the most recently promulgated Ordinance on Companies (Amendment) Bill 1997 have amended several provisions of the existing Act and introduced new provisions incorporating some internationally accepted CG practices aimed at strengthening corporate democracy, protecting the interests of minority shareholders and providing increasing flexibility to the corporates in responding to market conditions. Some of the salient proposals of the Companies Bill 1997 and the Ordinance on Companies (Amendment) Bill 1997 regarding CG are:

- Provision for self-regulation of companies, minimum government regulation, and stricter disclosure norms for listed companies:
• Allowing companies to make inter-corporate investments and loans without government approval. This provision has been promulgated into an Ordinance in November 1998. Under the liberalized norms for inter-corporate investments, companies have the liberty to invest their free reserves and equity without government approval. Companies would also be permitted to invest beyond 30% of the equity in any one company. One company can now build 100% equity of the other company without government clearances, subject too satisfying the new norms.

• Limit on the number of public companies in which a person can be a director reduced from 20 to 15.

• Streamlining and simplification of winding up process of companies, laying more emphasis on the employment of professionals as liquidators.

• Allowing companies to buy back their own shares. Although a company was previously allowed to repurchase its shares in the context of a reduction of capital, now a company no longer has to obtain a court approval in order to purchase its own shares and no longer has to call a meeting of the creditors. However, the buyback must not exceed 25% of the paid-up capital and free reserves of the company purchasing its own shares, or other specified securities, and companies are debarred from buying back through subsidiaries or group companies (Taxmann (1998: Section 68)).

Accordingly, certain changes are becoming visible on the CG front. There is also an ongoing discussion on CG suitable for India with the change in the corporate environment since 1991, brought about by the policy initiatives. In order to obtain an insight into the contemporary activities of the corporate control market, namely corporate mergers, acquisitions and TOs, from the position of CG in India, we need an idea of the way the Indian corporate sector is governed. This would involve an identification and analysis of the characteristics of Indian corporations in the contemporary scenario, which would define the scope of corporate structure in which the corporate control market operates in our country.
9.3 Dimensional Features of Indian Corporate Governance System

Mayer (1998) has pointed out that CG may affect corporate performance through influencing managerial incentives, disciplining, financing and investment decisions, corporate restructuring and instilling commitment and trust. These items in turn are activated through several structural and institutional factors pertaining to a corporation namely the ownership pattern, the financial structure, the structure and functioning of company boards and the associated internal control systems and the legal, political and regulatory environment within which the firm functions. These aspects comprise the dimensional features of any CG system. We will study these features for the Indian case.

9.3.1. Ownership and holding pattern of companies

The brand of CG to be adopted in a country stems almost entirely from the way capital is raised there. This is true for India as well. It has already been discussed in Chapter 5 that financial liberalization has permitted Indian corporations to raise large amounts of capital through share issues in India. This has created a particular ownership structure for the companies. The corporate sector of India is characterised by the coexistence of public and private domestic companies and MNCs together with a rise in the number of listed companies since 1991 (discussed in Chapter 5).

Appendix 9.1 provides a picture of the equity ownership pattern of 60 listed companies involved in mergers and acquisitions in India over 1994 to 1998. The equity distribution of the companies is recorded with respect to the latest balance sheet available to us. Hence the dates vary from company to company. These companies form a subset of the firms included in the 550 cases of mergers and acquisitions of various types in the manufacturing sector as listed in Appendix 3.1 of Chapter 3. The data in Appendix 9.1 has been compiled from the balance sheets provided in various issues of the Bombay Stock Exchange Directory. Inability to the access of data has barred us from including more companies into our sample. Moreover, not all the companies comprising our enlisted in our overall sample of 550 mergers and TOs are listed companies. Also, even among the listed companies, the equity distribution pattern is not available for some companies in the Bombay Stock Exchange Directories. As such, we had to limit our study of the equity distribution pattern to just 60 listed companies.

We have classified these companies as 'acquiring' or 'acquired' by using the numbers 1 and 0. 1 denotes acquiring companies and 2 denotes the acquired ones. In some cases the same company figures out as acquiring and acquired at two points of time over the relevant time-span. Such type of companies is denoted by 1/0. This exercise is represented in the second column of Appendix 9.1. We have identified 44 acquiring companies and 28 acquired ones.

In Table 9.1 that follows, we have drawn a frequency distribution for each of the different types of shareholders for the 60 acquiring and acquired companies. The different shareholders are (I) the foreign shareholders, (II) the government and government-sponsored FIs (III) the corporate bodies, (IV) directors and their relatives
(which is a measure of family ownership), (V) top 50 shareholders not considered elsewhere and (VI) others (i.e., the small investors). In Table 9.2 we have computed the average equity shareholding in the companies for each of the different types of shareholders on the basis of the information provided by BSE directory. We have done this exercise for the acquiring companies, acquired companies and also for all the 60 companies in general. Certain observations emerge from these two tables.

Table 9.1

Frequency Distribution of the Equity Holding in some of the Acquiring and Acquired Companies in India

<table>
<thead>
<tr>
<th>Companies with shareholdings of</th>
<th>(0%–10%)</th>
<th>(10%–20%)</th>
<th>(20%–30%)</th>
<th>(30%–40%)</th>
<th>(40%–50%)</th>
<th>(50%–60%)</th>
<th>(60%–70%)</th>
<th>(70%–80%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Holding (%)</td>
<td>26</td>
<td>6</td>
<td>8</td>
<td>4</td>
<td>9</td>
<td>5</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Govt./ Govt. Sponsored FIs (%)</td>
<td>16</td>
<td>20</td>
<td>18</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Bodies Corporate (Not covered under I&amp;II) (%)</td>
<td>11</td>
<td>8</td>
<td>14</td>
<td>14</td>
<td>6</td>
<td>5</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Directors and their Relatives (%)</td>
<td>55</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Top 50 Shareholders (Not covered under I, II, III and IV) (%)</td>
<td>56</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Others (%)</td>
<td>8</td>
<td>16</td>
<td>18</td>
<td>10</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>
Table 9.2

Average Equity Holding in some of the Acquiring and Acquired Companies in India

<table>
<thead>
<tr>
<th></th>
<th>Foreign Holding (%)</th>
<th>Govt./Govt. Sponsored FIs (%)</th>
<th>Bodies Corporate (Not covered under I&amp;II) (%)</th>
<th>Directors and their Relatives (%)</th>
<th>Top 50 Shareholders (Not covered under I, II, III and IV) (%)</th>
<th>Others (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiring and Acquired Companies</td>
<td>I 21.64</td>
<td>II 17.82</td>
<td>III 27.87</td>
<td>IV 3.45</td>
<td>V 3.36</td>
<td>VI 25.86</td>
</tr>
<tr>
<td>Acquiring Companies</td>
<td>20.96</td>
<td>19.37</td>
<td>28.88</td>
<td>2.79</td>
<td>2.94</td>
<td>24.86</td>
</tr>
<tr>
<td>Acquired Companies</td>
<td>24.76</td>
<td>15.10</td>
<td>25.66</td>
<td>3.34</td>
<td>4.07</td>
<td>27.10</td>
</tr>
</tbody>
</table>

Observations

1. Overall Distribution of Equity

It is observed from Table 9.2 that the major blocks of shares in the acquiring companies, acquired companies and acquiring and acquired companies taken together, are held by the foreign shareholders, the government and government sponsored FIs, the corporate bodies and the general public consisting of small shareholders. The directors and their relatives as well as the top 50 shareholders hold relatively much less equity in comparison to the other classes of shareholders. This would imply control with minority ownership in private companies in India. Apart from this, there is large role for intercorporate holdings of shares in public companies, relative to the holdings of individuals and trusts, as is visible from the extent of shares held by corporate bodies shown in Table 9.2. The general public hold the largest share for the acquired companies while the largest share of equity in the other two categories of companies are held by the corporate bodies. Significant shareholdings by corporate bodies reveal to some extent, substantial holdings in a company by other group companies. This is also revealed by Table 9.3, which shows that equity holding by non-financial corporations in India, which are primarily intercorporate cross-holdings, are much higher than in UK and US and are more comparable to...
Japan and Germany (Sarkar and Sarkar (1999: 206-207)). This reveals to some extent, a system of “insider control” of firms by business groups/families and other group companies. That similar characteristics of Indian corporations are not new and existed even in the 1950s is documented in Hazari (1966b).

In spite of the fact that the reporting of equity ownership data in Table 9.3 is not uniform across countries with respect to time, certain broad inter-country comparison can still be made regarding the extent of shares held by FIs, families and small shareholders.

### Table 9.3

**Comparative Corporate Ownership Structures for Select Countries including India**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Corporations</td>
<td>46</td>
<td>64</td>
<td>69</td>
<td>68</td>
<td>36.3</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>46</td>
<td>62</td>
<td>45</td>
<td>29</td>
<td>12.7</td>
</tr>
<tr>
<td>Banks (all types, including bank holding companies/ lending institutions)</td>
<td>--</td>
<td>1</td>
<td>22</td>
<td>14</td>
<td>6.6</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>5</td>
<td>17</td>
<td>17</td>
<td>7</td>
<td>4.0</td>
</tr>
<tr>
<td>Pension/ investment funds (Public and Private)</td>
<td>26</td>
<td>34</td>
<td>1</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>11</td>
<td>7</td>
<td>3</td>
<td>8</td>
<td>2.1</td>
</tr>
<tr>
<td>Others</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Non-Financial Corporations</td>
<td>--</td>
<td>2</td>
<td>24</td>
<td>39</td>
<td>23.6</td>
</tr>
<tr>
<td>Individuals</td>
<td>49</td>
<td>18</td>
<td>24</td>
<td>17</td>
<td>40.8*</td>
</tr>
<tr>
<td>Government</td>
<td>--</td>
<td>1</td>
<td>1</td>
<td>4</td>
<td>--</td>
</tr>
<tr>
<td>Foreign</td>
<td>5</td>
<td>16</td>
<td>7</td>
<td>12</td>
<td>9.8</td>
</tr>
<tr>
<td>Others</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>15.3</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


Note: * Individuals include top 50 shareholders.

### Foreign Shareholding

Table 9.2 indicates that foreign holding in the 60 listed companies involved in mergers and acquisitions that figure out in our sample have been substantial. We see from Table 9.1 that 36 out of 60 consolidating firms, i.e., 60% of the firms in our sample have foreign equity holding greater than 10%. The inter-country comparison of this aspect provided by Table 9.3 indicate that the percentage of equity held by foreign sources is higher than that in US and Japan and comparable to that of US and Germany. In Chapter 6 we have already indicated the extent of foreign holding in India in the 1990s in the form of DFI, portfolio investment by the FIIs and issue of GDRs over the relevant period.
b. Shareholding by FIs and Mutual Funds
The government and government-sponsored (controlled/promoted) FIs comprise the three major term-lending development finance institutions, the Industrial Development Bank of India (IDBI) with 75% government ownership, the Industrial Credit and Investment Corporation of India (ICICI) promoted by government-owned mutual fund and insurance companies and Industrial Finance Corporation of India (IFCI) with 100% government ownership. Such FIs also include the state finance corporations, the government-owned mutual fund, the Unit Trust of India and three government-owned insurance companies, the Life Insurance Company (LIC), the National Insurance Company (NIC) and the General Insurance Company (GIC). By Section 4A(1) of the Companies Act, 1956, the ICICI, IFCI, IDBI, LIC and UTI were regarded as public FIs. These FIs and institutional investors are typically substantial blockholders in large Indian companies. Apart from holding significant equity positions, the FIs are also major debt holders.

Table 9.1 shows that 44 out of 60 sample firms in Appendix 9.1 have FI holdings greater than 10%; at the same time, 55 firms have FI holdings between 0 to 30%. It also becomes evident from Table 9.2 that FI holdings in Indian firms, although lesser than that by foreign holding, corporate bodies and general public is quite substantial. Table 9.3 however demonstrates that different types of FIs in India separately hold much smaller blocks than those in US, UK, Germany and Japan. But since nearly all of these FIs are government controlled and fall under the purview of the Ministry of Finance, from this perspective, these together form a more homogenous group than that in other countries.

c. Family-owned Firms
Many large companies in India are owned or controlled by industrial houses. Hazari (1966 b), in his study of the corporate sector in India defined an industrial house as being characterised by family ownership, centralised decision-making, and as having several legally separate companies engaged in highly diversified activities ranging from industry to trade, finance and insurance. Such family-owned conglomerates like the Tatas, Birlas, Dalmias etc. are still very common in India.

Appendix 9.2 enlists 120 family-owned listed firms that figure out in our selected sample of 550 mergers and TOs in India over 1994 to 1998 presented in Appendix 3.1 of Chapter 3. The information collated in Appendix 9.2 has been obtained various annual issues of different business journals of India like Business Standard, Business Today, etc. that had listed the top 500/1000 companies of India. Along with financial information regarding the firms, these issues had also presented the name of the chief executive officer/business group of each of the top companies. The latter information has enabled us to identify the promoter families for a number of those companies involved in mergers and acquisitions that figure out among the top 500 or 1000 companies. There may be other firms in Appendix 3.1 that may be family-owned. But they may be unlisted companies or even if listed do not come within the ambit of top firms. However, Appendix 9.2 comprising the 120 family-owned companies undergoing corporate consolidation activities in India over 1994-1998 provides substantial information at least qualitatively because it is based on the information of the corporate giants over this period.
A characteristic of family-owned companies is that the shareholding by the directors and their relatives may be substantial. Appendix 9.2 contains 43 of the 60 companies that we consider in Appendix 9.1. However, while nearly 72% of the 60 companies that we consider in Appendix 9.1 are family-owned companies, it emerges from Table 9.1 that 55 out of these 60 companies have 0-10% shareholdings by directors and their relatives, only 2 companies have 10-20% shareholdings by directors and their relatives and only 3 have higher shareholdings of directors and their relations. Together with this, Table 9.2 shows that the directors and their relatives hold relatively much less equity in comparison to the other classes of shareholders. Thus, there is a paradox, which needs to be resolved. For this, let us look into the extent of shareholding by the corporate bodies. Table 9.2 shows that 41 out of 60 firms have shareholding by corporate bodies exceeding 20%. Also, Table 9.2 reveals that for the acquired and acquiring firms taken together and also separately for the acquiring and acquired firms, the percentage of shareholding by the corporate bodies is substantial. This means that holdings in family-owned companies are made through group companies. Such companies had presumably developed as complex web of companies and cross shareholdings to take advantage of the various government incentives that encourage industrial growth. This has left them with small yet controlling stakes in group-companies. This phenomenon is readily evident from most of the Tata group of companies shown in Appendix 9.1 and Appendix 9.2 where the shareholdings by the directors and their relatives are less than 1% whereas the holdings by the corporate bodies exceed 20%.

Many Indian companies have traditionally had low promoter holdings mainly because of loan conversion by term-lending institutions (imposed by the mandatory "convertibility" clause by the government, till the announcement of the NIP in 1991) and the old MRTP restrictions that prevented them from having majority holdings. The wealth tax and previous licensing regulations also contributed to the dilution of the Indian owners' equity base. The foreign firms, however, could not have a majority holding in their Indian affiliates because of the FERA 1973, which diluted equity to less than 50%.

Moreover, for accounting purposes there is seen a large gap in the number shares claimed to held by the promoters and the number of shares held by corporate bodies. Some of these shares are held by unconnected companies as part of their treasury operations. However, such operations are unlikely to be able to account for such a large proportion of shares. This portion is, in all probability held in non-group investment and control in the bigger family group businesses to avoid attracting the provisions of the old MRTP Act and the Companies Act (Dutta (1997: 30)). These non-group investment and trading companies are the hidden reserves of the family business in India.

To sum up, in India, there is a tendency among the large business houses to concentrate investments in a smaller portfolio, where management control becomes critical. Another critical point is that the Indian family business retains control through chains of holdings, where the wealth of the family remains under control but never gets appropriated to the family or the individual.
d. Small Shareholders

Table 9.2 demonstrates that the percentage of holdings by general public in the sample companies in Appendix 9.1 is substantially large for the acquiring, acquired, and also for the acquiring and acquired companies taken together. This is also corroborated by Table 9.1 that shows that out of 60 Indian companies for which we could obtain the equity distribution pattern, 36 companies have more than 20% shareholding by the general shareholders. These general shareholders are mostly the small shareholders. The trend of ordinary investors being attracted to buy company shares in India in the 1990s indicates that the ordinary people are becoming more and more inclined to participate in the equity market. This is similar to the trends in USA and UK, where too there are a large number of small shareholders. This similarity with the advanced capitalist countries is shown in Table 9.3 which exhibits that percentage of equity held by individuals including top 50 shareholders in India is high enough to compete with US and UK.

On the basis of the observations made above, the holding pattern of an average Indian public company appears to be as follows:

1. Substantial foreign holding in Indian companies;

2. Promoters, generally holding relatively small stakes (often controlling as little as 10-15% of stock), but controlling the companies;

3. FIs and the mutual funds holding substantial stakes in many domestic companies and emerging as significant players in corporate control, but till recently remaining passive players in major strategic decisions;

4. Large numbers of small shareholders, still constituting an ineffective minority in most companies, though expansion of the capital market in the 1980s has increased their role in financing investments.

9.3.2. The Role of FIs as Shareholders and Directors

It is evident from Appendix 9.1 that out of the 60 listed companies for which equity distribution pattern is presented, 59 companies had FI participation in its equity in varied levels. By virtue of their equity as well as debt holdings, the nominees of these FIs and institutional investors are typically represented on company boards, as in the case of Germany and Japan. In fact most of their current portfolios came into being through the conversion of loans into equity, through the (now defunct) convertibility clause in loan contracts. Almost all FI debt contracts until recently have carried a covenant that it will be represented on the board of the debtor company via a nominee director (CII 1998). Recently, the FIs on the recommendation of the Basudeb Sen Committee, on the nomination of directors on company boards have decided to put nominee directors, only on boards of committees where their stakes are sufficiently high. Such a policy has been adopted perhaps in view of the fact that FI nominees are relatively few compared to the large number of companies to be monitored.
**FIs attitude as stakeholders prior to 1991**

The FIs in India emerged as powerful institutions with strong organisational capacities to assess long-term industrial projects and played a prominent role in India’s industrialisation drive through nurturing them in their early stages. They provided long-term finance, undertook the activity of underwriting the equity issues and thus helped deepen the weak capital market. They also played a significant role in fostering CG through their representation in company boards (Khanna (1999: 3232)).

Because the FIs in India have significant voting rights and because most are controlled by the government through the Ministry of Finance, they can potentially act as a single blockholder and collectively block resolutions detrimental to their interests. In this sense, they could intervene and replace inefficient management in the necessary cases. However, as has been seen in Germany and Japan, FIs in India have been seen to be by and large extremely passive to CG. As in other other countries this perception of FI passivity both in respect of debt governance and equity governance is largely based on anecdotal evidence based on newspaper and journal reporting. One such instance is the Swraj Paul/Escorts affair of the eighties. In early 1983 there was a landmark battle between the family business and the FIs. London-based Swraj Paul tried to take control of the Delhi-based Escorts Limited, the flagship company of H.P. Nanda. Paul began to mop up shares from the market to take control over the company and Nanda began to fight him off. The FIs held 52% of Escorts as against Nanda’s 15%. Paul reportedly began to use strong lobby to get the institutions to back him and remove Nanda management that drove Nanda to court. A series of legal battles ended with the court’s ruling that the institutions had to back the existing management unless it could give clear reasons for withdrawing such support [4].

**The reaction at the policy level**

The Onkar Goswami Committee, sponsored and commissioned by the Confederation of Indian Industry (CII), a major body of the big industrialists of India presented a draft report on CG in January 1997. Among other issues, the Goswami report has criticised this practice of the government financial sector institutions (commercial banks, term-lending institutions and public FIs) as corporate shareholders, of supporting the existing management, irrespective of performance, by generally not exercising their voting power. In this sense, the Report has considered the FIs as inefficient monitors, so much so, that the Committee has put forth a radical recommendation that in the long run, to achieve a stable environment for CG, the government should become a minority shareholder in all its FIs, in the sense of relinquishing their majority control. However, this policy recommendation of the Goswami Committee seems unrealistic as it is too naive to expect that the government as a proprietor of the FIs would abstain from exercising its ownership rights, in the way it likes.

The Report says that neither the government nor the FIs realises that the stability of the existing management is hardly a virtue by itself, particularly that this does not translate itself to greater transparency, cleaner practices and higher shareholder value. Supporting existing management implies not questioning managerial decision, not suggesting ways in which the company can improve its profit, and more or less going
along with every board resolution in a way, which the management desires. Since 
companies know this, the nominee directors get far less data than what they could 
justifiably demand by being large shareholders and debt holders. Agenda papers are 
either thin or strategically voluminous and often arrive just a few days before the 
board meeting [5].

The Goswami Committee Report on CG [6] had also mentioned that the reasons for 
the failure of the FIs to enforce good CG are -- lack of personal incentives for 
nominee directors of FIs to monitor their companies, a perverse anti-incentive 
structure within public sector FIs and the lack of senior-level competent personnel 
within FIs who can properly discharge their responsibilities [7]. It alleged that 
government institutions are not concerned about the adverse income and wealth 
consequences arising out of wrong decisions and inaction, their poor incentive 
structure do not reward performance and punish non-performance, and most of all, 
they remain highly susceptible to the pulls and pressures from various ministries 
which have nothing to do with commercial accountability and which often destroy the 
bottomline [8].

The Working Group on Companies Act, of which Omkar Goswami was also a 
member, was constituted in August 1996 at the behest of Mr. P. Chidambaram, the 
then Union Finance Minister, to rewrite the Companies Act and present it for public 
(Taxmann (1997a)), nor the Working Draft of Companies Bill 1997 (Taxmann 
(1998)) have been explicit regarding the role of FI nominees in company boards.

**FIs towards a more activist role in CG**

Notwithstanding the general perception of passivity of institutional shareholders that 
has proved to be detrimental to minority shareholders, there is an emerging trend of a 
more proactive policy stance on the part of the FIs on CG issues. The participation of 
the FIs in the governance of corporates is gradually increasing in India with 
liberalization. The government FIs, which are both shareholders and lenders, seem to 
be realising their responsibility of earning higher rates of return on their investments 
and this has started to be the criterion for them to intervene or not to intervene in 
board-room decisions.

ICICI is reported to be the first FI to enforce its own brand of CG through its 
nominee directors who are on the boards of various companies [9]. Among the 
directors, in principle, the institutional nominees appointed by the FIs, not only have 
the fiduciary responsibility to the institution they belong but also are morally 
responsible to the ordinary shareholders who often look up to these institutions to 
protect their interests. In 1996, ICICI had asked all the directors nominated by it to 
file status reports on the happenings at various board meetings. It may be taken as a 
signal to the corporate sector that the FIs through monitoring the performance of 
nominee directors are becoming active rather than hitherto passive shareholders in 
companies.

Attention to the passivity problem of the Indian FIs have been drawn by several 
committees, including the Bhagwati Committee on TOs and the Onkar Goswami
Committee on CG. Certain stands have been taken by the FIs in recent years that indicate towards more proactive governance on their part (Sarkar and Sarkar (1999: 211)).

- FIs have been asked by the Finance Ministry to take ‘full responsibility for CG in companies where they have substantial stakes. The objective is to boost investor confidence and pep up the capital market. The government has issued a four-point directive to FIs asking them to insist on
  - making adequate disclosures
  - moving towards internationally accepted accounting standards
  - maintaining distance between the CEO and chairman where applicable
  - holding regular board meetings with proper recording and dissemination of proceedings.

- FIs have in recent times pressed for change in management of underperforming and defaulting companies, one of which is Narmada Cement that figures in our sample of mergers and TOs in India over 1994 to 1998.

- FIs have successfully opposed a move by the ACC to make preferential issue to the Tata group that will enhance the latter’s stake, citing as justification the need to protect the rights of minority shareholders of ACC.

- FIs have implemented new norms for the appointment of nominee directors, which have drastically cut down the total number of such directors on company boards. According to the new criteria for nomination, FIs are required to place their nominees only in companies where their combined exposure is above Rs. 50 crore or their shareholding is above 26% or in the event of companies showing signs of problems such as default on loans.

- FIs are insisting on setting up of audit subcommittees comprising ‘adequate’ number of non-executive independent directors of the company board in each and every large and medium firm with a view to bringing in substantial financial discipline on the part of the management and checking against executive malpractice. This is expected to strengthen internal control structures and safeguard shareholder interests.

- The UTI is asking leading companies where it has sizeable stakes to make presentations outlining their plans and expected performance after the declaration of half-yearly results. This CG exercise is performed to give confidence to unit-holders. Several big companies like Reliance have made presentations to the UTI, LIC and GIC.

Case Study – The MRL Episode
The imbroglio in Modi Rubber Ltd. (MRL) had commenced in 1996. In July 1996, unhappy at the losses, deteriorating performance and family squabbles at MRL, the FIs, then holding over 52% (40% was held by LIC, GIC and UTI and the balance, by IDBI and IFCI) of equity in the company, tried to remove Mr. V.K. Modi and Mr.
B.K. Modi, both directors of the company from the board. As they were unable to do so, they decided to invite public bids and threatened to auction off their stakes in the company, which would in all probability lead to a change in management [10].

Modi Rubber, the flagship of the B.K. Modi/V.K. Modi group was the second largest tyre company in the country, with a 17% market share in 1996. Its sales had crawled up from Rs. 595 crore in 1991-92 to Rs. 1064 crore in 1995-96. Although MRL then had a production capacity of of nearly 5 million tyres per annum, production of the company had stagnated to around 2 million tyres per annum. In 1991-92 it was 2.09 million, which marginally rose to 2.4 million in 1995-96. Profits had tumbled from Rs. 87.4 crore in 1991-92 to Rs. 12 crore in 1995-96. MRL also had huge investments in its group companies like Modi Alkalies, Modi Xerox, Modi Cement, Modi Champion, Modi Olivetti, Gujarat Guardian and Bihar Sponge Iron -- in all of which MRL has significant stakes.

The two brothers, B.K. Modi and V.K. Modi, the two executive directors on the board of MRL had been warring which upset the working of the company, leading to a dwindling of its fortunes. Its share price was quoting at a dismal Rs. 68 in December 1996 and it had a market capitalisation of Rs. 180 crore. The FIs, which together initially held over 52% in MRL. Of this, 40% was held by LIC, GIC and UTI and the balance by IDBI and IFCI. The Modis held about 22% of the company and the rest was with the public.

The FIs in 1996 decided to sell their stake through auction and call for open offers and in this way select a new team to run it. They took the decision on the ground that because of conflicts within the board, the company's fortunes were dwindling. Moreover, over Rs. 1,200 crore owed by the Modi group remained unpaid as the Modis had made the division of family assets a precondition to meeting this liability.

However, the FIs later changed their plans. To arrive at an amicable end to the dispute between the two Modi factions, they initiated a move to appoint an executive chairman in MRL and curtail the powers of the warring brothers on the board. Stripping the two Modi factions of their executive powers was supposed to be a major step towards restoring administrative control and initiating good governance in the company.

The FIs have in 1999 taken the radical step of divesting their cumulative stake in Modi Rubber Ltd. (MRL) in a coordinated fashion, to the highest bidder (Economic and Political Weekly, November 6, 1999: 3151) – an action that has raised a controversy in the Indian industry. Six FIs – IDBI, IFCI, ICICI, UTI, GIC and LIC – together hold 44.5% of MRL’s equity. The VK Modi group, the promoter, is reported to hold around 23% of the company’s equity. For the quarter ended June 1999, the company has made a profit but it is considered to be a relative laggard in the tyre and tube business. This, along with the company’s management style, made it qualify as a target for divestment by the FIs, as per the recommendations of the Basudev Sen Committee report of 1997. The core issue involved in MRL is accountability of the management to the shareholders. The committee had recommended that that the FIs should exit the inefficient companies. For the last one year, the FIs have been
negotiating a price with the promoters of MRL but have not been able to agree on one. As a result, they decided to sell their stake to the highest bidder. The Modis have objected to this stand of the FIs and they want to have the right of first refusal and a negotiated price.

9.3.3. Board of Directors

The Indian corporate board structure is single-tiered as in US and Japan. Each company is governed by a board of directors comprising the Chairman and Managing Director (who can be the same person) and other board members who comprise the two types of directors. They are the executive directors (managing directors or whole-time directors) who take care of the day-to-day management of the company, and the non-executive ones, as in A-A as well as German boards. The non-executive directors are the shareholder representatives on company boards. The nominee directors of the FIs in Indian companies also belong to the class of non-executive directors. The non-executive directors are professionals who are brought into the corporate boards mainly as shareholder nominees. They have a fiduciary role but are not in charge of the day-to-day operations of the company. Management invites non-executive directors on to the company board supposedly to provide an objective an objective counterweight to management, ensuring that neither the company nor the minority shareholder suffers. The non-executive directors are ideally required to provide a constructive and critical supervision of executive management and not only react to issues placed before the board but also take an enlightened interest in strategic business issues.

Existing laws regarding corporate directors

According to the Indian Companies Act 1956, any company with a paid-up share capital of Rs. 5 crore on and after 17.4.1990 must mandatorily have a managing or whole-time director or a manager, the appointment of whom must generally be with the approval of the Central Government (Sections 269(1) and (2)). Although as in UK, there is no specification about the number of executive and non-executive directors, yet every public company is required to have at least 3 directors, by Section 252(1) of the Companies Act, 1956 appointed by the company in general meetings. The board is empowered to appoint additional directors. The permissible maximum number of directors in a company is fixed under the articles of the company as first registered. However, when the number of directors exceed 12, approval of the Central Government is required vide Section 259(b) of the Companies Act.

Eligibility norms to become a director of a company is given by Section 257 of the Companies Act which states that any member of a public limited company who is not a retiring director is eligible for appointment as a director provided that

- he is proposed by himself or any other member not less than 14 days before the AGM, and
- the proposal is in writing and accompanied by a deposit of Rs. 500, which is refundable if elected.
In such an event, the company has to inform all its shareholders of the candidature, by serving individual notices not less than 7 days before the AGM, or by advertising the fact in an English and a regional language newspaper of the city where the company has its registered office.

According to Section 275, no person shall, except in certain special circumstances, hold office at the same time as director in more than 20 public companies, not including alternate directorships, or directorships in private companies. Boards are required to meet at least once in every three months and four such meetings are required to be held every year, vide Section 285 of the Companies Act, 1956. Subject to the provisions of the Act 291(1), the board of directors of a company shall be entitled to exercise all such powers and to do all such acts and thing, as the company is authorised to exercise and do. Again, by 292(1), the board of directors of a company shall exercise the following powers on behalf of the company, and it shall do so only by means of resolutions passed at meetings of the board:

(a) the power to make calls on shareholders in respect of money unpaid on their shares;
(b) the power to issue debentures;
(c) the power to borrow money otherwise than on debentures;
(d) the power to invest the funds of the company; and
(e) the power to make loans.

Section 299 makes it mandatory for directors to disclose their interests in any contract or arrangement of the company to the board. Section 300 stipulates that interested directors cannot participate or vote in the board’s proceedings regarding such contracts. And, Section 301 stipulates that every company shall keep registers of all contracts to which its directors have had interest (for all the laws mentioned refer to Taxmann’s (1997: 1.207-240)).

The legal responsibility of a non-executive director is however, still ambiguous in our country and is subject to controversies and debate. The Companies Act makes no distinction between executive directors and non-executive directors in terms of liability. This is evident from Section 5 (Taxmann (1997: 1.15)) of the Indian Companies Act, 1956. According to this Act, “officer who is in default” means all of the following officers of the company, namely:

(a) the managing director or managing directors;
(b) the whole-time director or whole-time directors;
(c) the manager;
(d) the secretary;
(e) any person in accordance with whose directions the Board of directors of the company is accustomed to act;

(f) any person charged by the Board with the responsibility of complying with that provision:

Provided that the person so charged has given his consent in this behalf to the Board;

(g) where any company does not have any of the officers specified in clauses (a) to (c), any director or directors who may be specified by the Board in this behalf or where no director is so specified, all the directors:

Provided that where the Board exercises any power under clause (f) or clause (g), it shall, within thirty days of the exercise of such powers, file with the Registrar a return in the prescribed form (under Rule 4BB and Form Nos. 1AB and 1AC of General Rules and Forms).

However, in practice, in India, the non-executive job is largely seen as a ceremonial one. In many cases the non-executive director is inducted in the board because he happens to be a friend or a relative of the promoter. However, retired corporate executives, bureaucrats, bankers and well-known professionals or executives of other group companies are also inducted in the boards. Many directors are on numerous boards and virtually become professional directors.

Policy Recommendations
(i) Role of Directors in good CG
The Working Group of the Companies Act, 1997 (Taxmann (1997a: 18)) has stressed the role of company's directors in good CG. The Group "felt that the key to effective CG is the well-functioning of the boards of directors of companies, who would zealously perform their dual role: appreciating the issues put forward by management and honestly discharging their fiduciary responsibilities towards shareholders." A director, should in principle, be able to detect and resist any move made by the management which could go against shareholders' interests. For example, if an unrelated diversification proposal is placed before a board, the directors should question the viability of the project, rather than accepting the decisions of the management. The fiduciary responsibility of a director entitles him to be in a position to know about all the happenings within the company, so as to maximise shareholders' wealth, as reflected in the increased dividends and rising share prices. In this sense the director of an Indian company has responsibilities similar to those of A-A corporations.

(ii) Directors' Responsibility Statement
In connection with the general demand for framing a model code of CG for India, the Working Group of the Companies Act, 1997 (Taxmann (1997a: 34)) has felt the need to define the scope of the Directors' responsibilities. With this end in view, the Group has recommended a specific model of the Directors' Responsibility Statement (DRS), which is to be published in the company's Annual Accounts. According to the
stipulations of the DRS, the proposed Companies Act requires the directors to prepare financial statements for each financial year, which give a true and fair view of the state of affairs of the company at the end of the year and of the profit or loss of the company for that period. In preparing these annual accounts, the directors are required to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent.

The directors must also specify whether applicable accounting standards have been followed and if not, disclose and explain any material departures in the financial statements. The annual accounts must be prepared on the going concern basis, unless it is inappropriate to presume that the company will continue in business.

The directors are also responsible for the maintenance of adequate accounting records in compliance with the proposed Companies Act, 1997, for safeguarding the assets of the company, and for preventing and detecting fraud and other irregularities.

The Working Group however strongly holds that the code of CG should not be limited to the DRS. Professionals like company secretaries, chartered accountants, lawyers, consultants, as well as PIs and their nominee directors could also be covered by a code of CG, as their actions impinge upon corporate functioning. The actions of the shareholders and the representative bodies at general meeting, and the manner in which corporate meetings are conducted, are also matters of CG.

(iii) Appointment of Directors on Board
The Working Group on Companies Act, 1956 (Taxmann 1997a: 27) has drawn attention to the fact that over the last several years, Section 257 has been misused by a number of shareholders who try to use this provision to extract personal concession from management. Typically, they approach a company with a large and dispersed shareholder base a day or two before the 14-days deadline and propose themselves or someone else as director. The company faces two costly options:

• to send notices to individual shareholders, which can cost several lakhs of rupees,

• to advertise, which is also costly.

Since these shareholders know the cost implications, their objective is to misuse Section 257. To prevent this, the Group makes recommends Section 257 of the Act should be amended so that any member must have the consent of 100 shareholders or of 1% of the voting rights before he can suggest his or someone else’s candidature as director. Moreover, the candidate should be accompanied by a deposit of Rs. 50,000 which would be forfeited only in the event of the candidate not getting the votes of even 1% of the voting shareholders present in the AGM.

(iv) Disclosure Requirements by Directors
The Working Group on Companies Act, 1956 has also endorsed the disclosure laws (Sections 299, 300 and 301) of the Companies Act, 1956. It has recommended in the interest of the shareholders that it should be explicitly stated in the notice of the AGM of all public limited companies that a register of the type mentioned in Section 301 of
the Companies Act, 1956 is maintained by the company in its registered office, and is open for inspection by any shareholder of the company (Taxmann (1997a: 19)).

(v) Responsibility of the Non-Executive Directors on Company Boards
The Goswami Committee Report has however, advocated the amendment of Section 275 of the Companies Act so that a person, on a maximum, can hold as many as 10 directorships so that he can properly discharge his duties. This has also been advocated by the CII code of CG [11]. Also, the Goswami Committee has recommended that Section 285 of the Companies Act needs to be amended in the line whereby the non-executive directors pre-commit something in the region of 20 to 25 working days per year to discharge their duties in the board and as members of committees [12].

(vi) Liability of the Non-Executive Directors on Company Boards
The Working Group has recognised that although Section 5 of the Companies Act, 1956 does not explicitly include non-executive directors in the list of “officer who is in default”, yet as case suggests, the liability of non-executive directors for certain offences of the company is acting as a deterrent to securing the services of professionals as non-executive directors. Typically, a non-executive director has far less information about the day-to-day running of the company and whether it is complying with all the provisions of various corporate laws than a managing or whole-time director. The Group recognises this informational asymmetry and recommends that there should be an explicit proviso in Section 5 (“officer who is in default”) which excludes non-executive directors, except in cases where such a person is a signatory of any declaration made by the company (Taxmann (1997a: 61)).

The recommendations of the Working Group seems to be based on the premise that since the non-executive directors do not look into the day-to-day operations of the company and only act on the information that the board chooses to put on them, they should not be legally held for operational inefficiencies. In A-A system however, independent professionals are appointed as non-executive directors, who can be made responsible for company mismanagement.

(vii) Mode of Appointment of Non-executive Directors
The Onkar Goswami Report on CG has criticised the mode of appointment of the non-executive directors in Indian companies, as also their performance. With respect to the appointment procedure, it has pointed out that while the key to good CG is a well functioning board of directors with a core of independent and acclaimed non-executive directors, the boards of most Indian public companies fail to make a mark in this respect as they choose the riskless option of selecting the non-executive directors from a small coterie. Here, the Report has made the recommendation that the Indian listed companies with an equity base of above Rs.100 crore must have a nomination committee consisting of the managing director and two or three non-executive directors to search for skilled non-executive directors [13].
9.3.4 Employee Compensation

As the Japanese corporations have recognised, sustained competitiveness by any company hinges upon the quality of human resources. This, in turn, has much to do with employee loyalty and commitment. The Working Group on the Indian Companies Act, recognises that a widely acknowledged method of securing greater employee participation, giving the right incentive signals and rewarding loyalty as well as years of service, and in the process aligning the interests of employees with the interests of shareholders, can be made through Employee Stock Options (ESOP).

In the traditional theory, there exists a water-tight distinction between a worker (who should be paid only wages, salaries and bonus) and shareholders (who should get dividends). ESOP gives the workers a share of profits and in this way considers them as another important stakeholder of the company. The purpose is to ensure more employee loyalty and participation. Such issue of equity shares to their employees is permitted in India too, with the following conditions imposed under Sebi guidelines, 1.3.1996 (Datey (1997: 87)):

* The issue should not be more than 5% of paid up capital of a company, in any one year;
* Promoters and part time directors will not be entitled in the issue;
* Director who is an employee but not a promoter is eligible;
* Pricing will be as per norms prescribed by Sebi for preferential issues;
* The issue should be to permanent regular employees and a certificate to that effect should be submitted to stock exchange;
* Companies are free to devise the ESOP scheme for issue of shares/warrants or debt instruments/bonds with warrants, including the terms of payment.

The provision for ESOP is once again prescribed by the Working Group on Companies Act, 1956. With respect to ESOP, the Working Group (Taxmann (1997a: 27)) recommends that ESOP should be explicitly incorporated in the new Companies Act. These options can be in the form of warrants, or other securities that have pre-specified dates of conversion in the future. This will require amending Section 81 of the Act. In order to prevent misuse, ESOP should be permitted up to 5% of the increased capital of a company (i.e. existing plus proposed issue). The Working Group also recommends that the capital rules for ESOP should be framed by Sebi for public listed companies, and by the Central Government for all other companies. Such rules should allow buy-back of options according to the principles of buy-back discussed by the Group. In addition, the Government should consider taxing these options as long-term capital gains.
9.3.5 Executive Compensation

Existing norms

(i) Remuneration to Executive Directors
The existing provisions of remuneration to directors allow executive directors to be remunerated either by way of monthly payment or at a specified percentage of the net profits of the company, or a combination of both provided that except with the approval of the central government such remuneration shall not exceed 5% of the net profits if there is one such director and if there is more than one such director, 10% for all of them together. The Central Government restrictions are in terms of Sections 198, 309 and Schedule XIII of the Companies Act, 1956 (Taxmann (1997: 1.145-146; 1.247-248: 1.531-532)).

According to Section 309, the remuneration payable to the directors of a company, including any managing or whole-time director, shall be determined, in accordance with and subject to the provisions of section 198 and this section, either by the articles of the company, or by a resolution or by a special resolution, passed by the company in a general meeting.

Section 198 states 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 any financial year shall not exceed 11% of its net profits for that financial year computed in the manner laid down in Sections 349, 350 and 351, except that the remuneration of the directors shall not be deducted from the gross profits. The aforesaid percentage shall be exclusive of any fees payable to directors under subsection (2) of Section 309, whereby a director may receive remuneration by way of a fee for each meeting of the board, or the committee thereof, attended by him.

Part II of Schedule XIII of the Companies Act, deals with the remuneration payable payable by companies to its “managerial persons”, by which, subject to the provisions of Sections 198 and 309, a company having profits in a financial year may pay any remuneration, by way of salary, dearness allowance, perquisites, commission and other allowances, which shall not exceed 5% of its net profits for one such managerial person, and if there is more than onesuch managerial person, 10% for all of them together. However, where in any financial year during the currency of tenure of the managerial person, a company has no profits, or inadequate profits, it must pay remuneration to a managerial person, by way of salary, dearness allowance, perquisites, and any other allowances, not exceeding ceiling limit of Rs.10,50,000 per annum or Rs. 87,500 per month calculated on the following scale.

(ii) Remuneration to Non-executive Directors
Nonexecutive directors may be remunerated either by way of monthly, quarterly, or annual payment with government approval or by way of commission by special resolution, provided that the remuneration paid to one, or all of them taken together, does not exceed 1% of the net profits of the company if the company has a managing or whole time director or manager and 3% of the net profits in any other case.
Policy Prescriptions

(i) Remuneration to the executive directors
With respect to the managerial remuneration as well as that of the managing directors and executive or whole-time directors, the Working Group on Companies Act considered that the present regime of managerial remuneration is adequate and has worked satisfactorily. The Group concluded therefore that Sections 198, 309 and Schedule XIII of the Companies Act are ample enough to give sufficient flexibility to profitable companies to attract the best talents. Therefore the view of the Group is that the core of these provisions should remain unaltered, at least for the next five years. However, the Group recommended that Sections 310 (provision for increase in remuneration for any director to require government sanction), 311 (increase in remuneration of managing director on re-appointment or appointment after Act to require Government sanction) and 637A (power of Central Government to fix a limit with regard to remuneration) are to be deleted (Taxmann (1997a: 22-23)).

Remuneration to non-executive directors
The Working Group of Companies Act, 1956, recognised, in line with the A-A mode of CG, that to attract the non-executive directors, there is a need for the Indian companies to restructure their fees and design an incentive compatible package that compensates them for the opportunity of their time. Although the Working Group considered the remuneration to the non-executive directors as adequate, yet it recommended a rise in the maximum sitting fee of the non-executive director, from Rs.2000 to Rs.5000 and also recommended that this should be revised at least once every 5 years to account for inflation (Taxmann (1997a: 19-20)).

9.3.6 Capital Market
We have already discussed the role of capital market in India in the post-liberalization regime in Chapter 5 and Chapter 6 of this thesis. We have observed in Table 5.9 that the number of listed companies in India has risen since 1991 and has reached the second position in the world in 1997. The number of listed companies in India has grown significantly since the initiation of capital market reforms as a part of the overall structural adjustment programme in 1991. It is evident from Table 5.3 in Chapter 5 that in BSE only, the number of listed companies has increased by 129.26% from 2556 in 1991 to 5860 in 1998. Table 5.3 also shows that in 1995 and 1996, the number of listed companies in India in BSE, MSE, NSE and OTCEI were 7313 and 8390 respectively. That means there was a rise in the number of listed companies by 14.73% between 1995 and 1996. We cannot gauge the extent of change in the number of listed companies in 1997 and 1998 in all these exchanges because of lack of adequate data.

Capital market reforms since 1992 have been brought about through abolition of CCI, the Sebi Act of 1992, change in laws governing foreign portfolio investments, etc. Capital market reforms have also involved other institutional changes that have helped increase market efficiency by reducing the transaction costs, i.e., brokerage costs, market impact cost, paperwork, fraud and counter-party risk in the secondary capital market. These are the introduction of screen-based trading to ensure
transparency in operations, move towards nationwide integrated markets, the guaranteeing of all trades by a clearing-house and the dematerialisation of securities. Some of these aspects are discussed in Chapter 5.

However, the implication of capital market developments in recent years for CG has been that the mechanisms available for equity governance by large and small investors alike have been trying to improve relative to past standards. That is, with detailed disclosure requirements, greater investor protection norms, screen-based trading and move towards integrated markets are all aiming at a situation to emerge where investors can be increasingly well-informed about true company performance and can also react quickly to any market information. The daily turnover of shares on the BSE rose from Rs. 0.13 billion in 1980-81 to Rs. 3.7 billion in 1993-94, which was almost a thirty-fold increase.

Although we cannot ignore the existence of investor over-optimism and speculative bubbles in India after liberalization in 1991, what is evident is that the greater institutionalisation of the Indian capital market together with a rise in the number of corporates tapping the equity market for finance since 1992, have led to increased participation of households and institutional investors in the equity market. However, with respect to the availability of capital for corporate TOs, it is relatively illiquid, as legally, debt is not available for TOs. As we will see, only recently, government has allowed banks to fund loans for TOs, which is similar to the practice of leveraged buyouts in US.

9.3.7 Mergers, TOs and the Market for Corporate Control
With liberalization, we have observed in India, a distinct trend among promoters and established corporate groups towards consolidation of market share and diversification into new areas through merger and TO activities. However, although the market for corporate control was technically existent in India even before liberalization in 1991, it had been relatively inactive by A-A standards but more active in comparison to Japanese and German standards.

Need for Regulations in Corporate Control Market
Mergers and TOs are dynamic corporate events and all the various permutations and combinations of the moves of the relevant parties and the resulting outcomes cannot be envisaged. Thus, it is important that such critical processes like substantial acquisition of shares and TOs, which can significantly influence corporate growth and contribute to the wealth of the economy through rational allocation and optimal utilisation of resources, take place within the orderly framework of regulations. The regulations have to be so devised that they outline the principle, which could be the guiding lights for the unexpected events that could crop up later.

In the absence of any guidelines, it is feared that TO bids would fuel unhealthy speculation in the shares of companies targeted by predators. They could also create problems for the government as any stand taken by FIs is likely to invite the charge that the government is taking side in a TO dispute. The major objectives of any framework of regulations governing TOs are perceived to be:
* Protection of stakeholders' (particularly, the shareholders') rights and interests.

* Allowing a free, fair transparent and equitable market for corporate control.

* Curbing malpractices in such transactions.

**Regulations in Corporate Control Market Prior to 1991**

The first attempt in regulating TOs in India were made in a limited way by incorporating Clause 40 in the Listing Agreement that provided for making a public offer to the shareholders of a company by any person who sought to acquire 25% or more of the voting rights of the company. Apart from this, prior to 1991, mergers, acquisitions and TOs were regulated by Companies Act, 1956, Industries (Development and Regulation) Act, 1951, MRTP Act, 1969, FERA, 1973, Sick Industrial Companies (Special Provisions) Act, 1985, Section 72A of the Income Tax Act, 1961 and SCRA, 1956 (with respect to transfer of shares of listed companies vide clauses 40A and 40B). Moreover, in the event of a hostile bid for the company, the board of a company, under Section 22A of the SCRA, had the power to refuse transfers to a particular buyer, thereby making it almost impossible for a TO to occur without the acquiescence of the existing set of managers. To this extent, the scope of hostile TOs (as against friendly TOs) was limited in India prior to 1991. The refusal to transfer share by the company board could be on two grounds:

- that the transfer was against the interests of the company, or
- against public interest.

**Stature of the Corporate Control Market in India before Liberalization**

Although prior to 1991, mergers and acquisitions were restricted under Indian law, in terms of industrial licensing laws and restrictive statutory provisions, TOs, mergers and acquisitions were not unknown. In fact, business houses like the Goenka group, or the Manu Chhabria group grew largely through acquisitions; earlier on some business houses such as the Bangur group grew mainly by taking over erstwhile Anglo-Indian firms (Bagchi (1999: 58)).

Merger and acquisition activities continued to take place in the manufacturing sector in India during the 1980s. Since 1986 onwards, both friendly TO bids on negotiated basis and a few hostile bids too, through hectic buying of equity shares of select companies from the stock market have been reported frequently. There are many instances of corporate raids by NRIs as well as by Indian industrial entrepreneurs on domestic corporate undertakings. Table 9.4 shows several raids made by NRIs on Indian corporate undertakings during 1988. Apart from the NRIs, prominent industrial groups in the country have also been in active TO bids. Some such important TOs in the 1980s are shown in Table 9.5. BIFR has also been active for arranging TOs of the sick undertakings, which could be rehabilitated. They are basically institutionally motivated TOs. Table 9.6 shows some of the BIFR induced mergers of the 1980s. In general, over the period 1988-92, there had been about 121 completed TOs and mergers and in addition thereto 37 TO bids were found unsuccessful (Sen and Vaidya (1997: 142)).
Table 9.4

Acquisition of Domestic Companies by NRIs in India in the 1988

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Acquiring Company</th>
<th>Acquired Company</th>
<th>Type of unification bid</th>
<th>Acquisition Bid Successful or Abortive</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Swaraj Paul Escorts Ltd. &amp; DCM Ltd.</td>
<td>TO</td>
<td>Abortive</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Sethia Group Escorts Ltd. &amp; DCM Ltd.</td>
<td>TO</td>
<td>Abortive</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Hinduja Group Ashok Leyland</td>
<td>TO</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Hinduja Group Enmore Foundries</td>
<td>TO</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Hinduja Group IDL Chemicals</td>
<td>Strategic Interest</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Hinduja Group Astra IDL</td>
<td>Strategic Interest</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Chhabria Group Shaw Wallace</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Chhabria Group Mather and Platt</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Chhabria Group Hindustan Dock Oliver</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Chhabria Group Dunlop India</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Chhabria Group Gordon Woodroffe</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Chhabria Group Falcon Tyres</td>
<td>Acquisition crucial stake</td>
<td>Successful</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Chhabria Group Genelec</td>
<td>Acquisition of controlling interest</td>
<td>Successful</td>
<td></td>
</tr>
</tbody>
</table>

### Table 9.5

**Acquisition of Domestic Companies by Prominent Domestic Industrial Groups in India in the 1980s**

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Acquiring Company</th>
<th>Acquiree Company</th>
<th>Type of Amalgamation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Goenka group</td>
<td>Ceat Tyres</td>
<td>TO</td>
</tr>
<tr>
<td>2</td>
<td>Goenka group</td>
<td>Herdilia Chemicals</td>
<td>TO</td>
</tr>
<tr>
<td>3</td>
<td>Goenka group</td>
<td>Polychem</td>
<td>TO</td>
</tr>
<tr>
<td>4</td>
<td>Spartek</td>
<td>Neivali Ceramics</td>
<td>TO</td>
</tr>
<tr>
<td>5</td>
<td>Mahendra &amp; Mahendra Ltd.</td>
<td>Automotive Pressing unit of Guest Keen Williams</td>
<td>TO</td>
</tr>
<tr>
<td>6</td>
<td>M&amp;M</td>
<td>Allwyn Nissan</td>
<td>TO</td>
</tr>
<tr>
<td>7</td>
<td>Blow Plast</td>
<td>Universal Luggage</td>
<td>TO</td>
</tr>
<tr>
<td>8</td>
<td>MRF</td>
<td>Crystal Investment and Finance</td>
<td>TO</td>
</tr>
<tr>
<td>9</td>
<td>Jindals</td>
<td>Shalimar Paints</td>
<td>TO</td>
</tr>
<tr>
<td>10</td>
<td>Tata Tea</td>
<td>Consolidated Coffee Ltd.</td>
<td>Acquisition of 50% equity in December 1989.</td>
</tr>
<tr>
<td>11</td>
<td>Nicco Ltd.</td>
<td>Furmarmite Nicco</td>
<td>Merger</td>
</tr>
<tr>
<td>12</td>
<td>Tata Chemicals</td>
<td>Tata Fertilisers</td>
<td>Merger</td>
</tr>
<tr>
<td>13</td>
<td></td>
<td>Hindustan Computers, Hindustan Reprographics, Hindustan Telecommunications and Indian Computer Software Co.</td>
<td>Merger to form HCL Ltd.</td>
</tr>
</tbody>
</table>

Table 9.6

BIFR-motivated TOs in India of the 1980s

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Acquirer Company/Group</th>
<th>Acquiree Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ITC Ltd.</td>
<td>Punjab Anand Batteries Ltd.</td>
</tr>
<tr>
<td>2</td>
<td>Saha group</td>
<td>Kothari Electronics</td>
</tr>
<tr>
<td>3</td>
<td>Somani group</td>
<td>Alind (Aluminium Industries Ltd.)</td>
</tr>
<tr>
<td>4</td>
<td>Shri Krishna Keshav Labs. Ltd.</td>
<td>Jayawanti Chemicals</td>
</tr>
<tr>
<td>5</td>
<td>Workers Cooperative</td>
<td>Kamani Tubes</td>
</tr>
<tr>
<td>6</td>
<td>RV Pandit</td>
<td>CBS Gramophones</td>
</tr>
<tr>
<td>7</td>
<td>Sitari Finance and Leasing Co.</td>
<td>Swadeshi Cement</td>
</tr>
<tr>
<td>8</td>
<td>RP Tantia</td>
<td>Sagar Spinning</td>
</tr>
<tr>
<td>9</td>
<td>Kaveri Engg. Industries</td>
<td>Southern Hydro Carbons</td>
</tr>
<tr>
<td>10</td>
<td>Laxmi Machinery Works</td>
<td>Kunal Machinery</td>
</tr>
<tr>
<td>11</td>
<td>Shanmugan Chettiar</td>
<td>Tripur Cotton</td>
</tr>
<tr>
<td>12</td>
<td>Arun Dhandhania Ratnesh Enterprises</td>
<td>Mewar Cotton</td>
</tr>
</tbody>
</table>


Stature of the Corporate Control Market after 1991

With the liberalization in 1991, the Government omitted the relevant sections and provisions from the MRTP Act, 1969 involving pre-entry scrutiny, by the MRTP (Amendment Act), with effect from 27.9.91 (Sections 20-26 and Sections 28-30G of Chapter III, “Concentration of Economic Power” were omitted). With this, the need for prior approval of the Central Government for merger and acquisition activities were abolished. The availability of flow of funds through GDRs and Euro-issues has reduced the problem of finance. This, together with the dismantling of the FERA controls in 1991, has led to a rise in the number of mergers and TOs, actual and proposed the extent of which is shown in Table 1.1 of Chapter 1.

Regulations in Corporate Control Market after 1991

Currently, TOs are regulated through the Substantial Acquisition of Shares and TOs Regulations, first promulgated in 1994 by Sebi and then replaced by a more comprehensive act in 1997. Mergers are however left outside the purview of these regulations and are governed by the Companies Act, 1956. The Sebi regulations on TOs were modelled closely along the lines of the UK City Code of TOs and Mergers. The Indian regulations have borrowed substantial concepts from and procedures from the UK code, e.g., the term “persons acting in concert”, the compulsory requirement of making a public offer on acquisition of a particular level of shares, the emphasis on following the spirit, rather than the letter, and so on. However, the essential difference is that the Indian TO regulation is a law while the UK City Code is not [14].

Current regulations, by making disclosures of substantial acquisitions mandatory, have sought to ensure that the equity of a firm does not covertly change hands between the acquirer and the promoters. Moreover, the right of the existing management to withhold transfer of shares under Section 22A of the SCRA, dealing with free transferability and registration of listed securities of companies has been withdrawn in the recently introduced Depository Regulations Act, 1996, with effect...
from 20.9.1995. However, under Sections 250 and 409 of the Companies Act, target companies can shelter against raiders if the proposed transfer prejudicially affects the interests of the company.

Under current regulations, the acquisition of 15% of shares/voting rights triggers a minimum public offer of 20%. Further, promoter groups, holding a stake of 10% and above are allowed to consolidate their position through the provision of a ‘creeping’ TO of up to 5% of shares without attracting the mandatory public offer requirement. Buyback of shares (Appendix 9.3) has been recently introduced and the TO code will not include companies that are planning offers under the buy-back norms. However, TO defense mechanisms as poison pills for incumbent management as in US and UK are not allowed under the current regulations.

*Policy Proposals of the Government regarding CG through the Market for Corporate Control*

The Working Group of the Companies Act, 1956 has pointed out that there is an important element that has been missed out by the new TO code, which ought to be rectified as soon as possible. This has to do with the notion of “full buy-out”, which is not so popular in India. According to the Working Group, “in many OECD countries, when a person, group, or body corporate acquires over 90% or 95% of the equity of a public listed company, it is incumbent upon the residual shareholders to sell their shares to the buyer at a fair price that is set by the regulatory authority. This is not legislated for India”.

The Working Group argues that a key feature of corporate democracy is that all shareholders, which own a given class of equity must be treated alike. Without full buy-out provisions, the residual shareholders face one of two options, both of which are inimical to this aspect of shareholder democracy. First, they may hold out for a higher offer, which is palpably unfair vis-a-vis the other shareholders who sold their stake. Or, second (and more likely if the company gets de-listed), these shareholders may get squeezed by the buyer to accept a lower price, which is unfair to them. Therefore, in the interest of shareholders and companies, the Group recommends that in the event of any person, group or body corporate acquiring 95% of the shares of a public listed company — either through a TO or otherwise — and the company getting de-listed, residual shareholders should sell their shares to the 95 owner at a price based upon the Sebi guidelines (Taxmann (1997a: 14)).

*Implication of the Regulations and Policy Recommendations*

The main objective of the regulations governing TOs is to provide greater transparency in the acquisition of shares and the TO of ownership and control of companies through a system based on disclosure of information. Instead of discovering that the management of the company one owns has covertly changed hands, resulting in huge gains for the promoter, a shareholder could now expect to be informed each time, and at what price a firm’s equity changed hands. Moreover, if the shareholder had less faith in the new owners, he could sell the shares without incurring a loss, since Sebi’s regulations stipulate that a buyer must make a public offer to buy shares at the same price at which the acquisition is made. The current regulations on TOs in India thus seem to have taken a liberal view towards TOs.
subscribing in the process to the A-A theory of CG where TOs are thought to play an important role in building corporate synergy, in raising shareholder value and in keeping companies on their toes.

Also, the recommendations from time to time by the industry bodies as well as by the government, have spoken in favour of a free market for corporate control. This attitude may be confirmed by the Onkar Goswami Report on Corporate Governance which advocated for a transparent market for corporate TOs because it felt that TOs have the merit of creating economies of scale for firms and giving them synergy gains, enhancing shareholder value both in the short and in the long run and imposing a threat on management to perform for the shareholders. The Working Group on Companies Act had also recognised that a key feature of corporate democracy is that any shareholder has full freedom to sell, purchase, transfer and acquire shares and that enhancing shareholder value through consolidation and growth of companies would bring out the latent dynamism of Indian firms (Taxmann (1997a, 2, 11)).

Given the supposed merit of TOs, the Goswami Report [15] subscribed to the idea of a dynamic market for TOs with minimum restrictions on financing such acquisitions. Without allowing financial markets to freely fund TOs, the Report said the only two types of raiders would be entrepreneurs from cash-rich industries and foreign investors who can garner funds from abroad.

In this connection, the Report stated that the government should allow far greater funding to the corporate sector against the security of shares and other paper; allow setting up of medium-term leveraged buy-out funds and that the Companies Act should liberalise inter-corporate flow of funds within group firms. Moreover, FIs should create mergers and acquisitions subsidiaries to facilitate new entrants in the industry, catalyse TOs by dynamic groups, and also facilitate the FIs to exit from poor debt or equity exposure via the capital market. Once TO finance is easily available to Indian entrepreneurs, the trigger should increase to 20%, and the minimum bid should reflect at least a 51% TO.

Only recently in early 1998 has the government has allowed the banks and FIs to lend money to finance corporate TOs, albeit indirectly, as bonds or debentures to be raised by the predator [16]. These bonds and debentures are to be specifically issued by companies for specific end-use, i.e., to finance acquisitions. Subscriptions to such instruments can be made through the private placement route or the public issue route, depending on the nature of the issue and whether the proposed acquisition comes under the TO code.

9.4 Conclusion

On the basis of a structured study of the various dimensions of CG of India that we have carried out in the previous section, we have constructed Table 9.7. This table has been compiled on the basis of Table 2.5 of Chapter 2, which in turn has been derived from Kaplan (1997: 252). Table 9.7 enables us to note the similarities and
differences of the Indian CG structure with the other CG systems posed above. This would, among other things, enable us to derive an idea of structure of CG in India.

Table 9.7 reveals that the ownership pattern in the Indian corporate sector is characterised by high FI holding, high holdings by minority shareholders and low holding by promoters who exercise control over the company. The board of directors is composed of primarily insiders, and the FI nominees. The capital market is substantially illiquid, there is no concept of main bank system as it prevails in Japan and the TO market is moderate, being somewhere in between that prevailing in US and Japan/Germany.

Table 9.7

A Comparison of the Indian Corporate Governance System with the US, Japanese and German Governance Systems

<table>
<thead>
<tr>
<th>Ownership</th>
<th>US</th>
<th>Japan</th>
<th>Germany</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Diffuse Non-corporate</td>
<td>Less Concentrated: High Bank / High Corporate / Low Management</td>
<td>Concentrated: High Family / Corporate / Bank</td>
<td>High FI/ High Minority Shareholder/Low Promoters</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>Primarily Outsiders</td>
<td>Primarily Insiders Management / Supervisory</td>
<td>Primarily Insiders/ Also FIs</td>
<td></td>
</tr>
<tr>
<td>Capital Markets</td>
<td>Very Liquid</td>
<td>Somewhat Liquid</td>
<td>Relatively Illiquid</td>
<td>Highly Illiquid</td>
</tr>
<tr>
<td>Banking System</td>
<td>–</td>
<td>Main Bank System</td>
<td>Universal Banking</td>
<td>–</td>
</tr>
<tr>
<td>Executive Compensation</td>
<td>High</td>
<td>Low</td>
<td>Moderate</td>
<td>Low by International Standards, now improvement proposed by the Working Group through the amendment of the Companies Act, 1956</td>
</tr>
<tr>
<td>Takeover/Control Market</td>
<td>Major</td>
<td>Minor</td>
<td>Minor</td>
<td>Moderate</td>
</tr>
</tbody>
</table>

Source: Compiled on the basis of Kaplan (1997: 252).

9.4.1 India’s Position in Relation to the CG Systems of US and Japan

In the US, financial intermediaries play only a limited role in controlling the managers of large corporations. Authors (Gilson and Roe (1992; 287-329); Grundfest
(1990: 89-114), Roe (1990: 7-41)) have ascribed this to various reasons, e.g. restricted growth and range of operations of banks, and their ability to oversee managements by a web of regulatory barriers arising out of banking, insurance, tax and security laws, especially following the Great Depression. As a result, American managers are primarily controlled by shareholders – existing and potential and motivated particularly by the nature of earning disclosures to equity markets. In fact, CG in US has been viewed as control of managers by their shareholders through the pattern of intermittent control exercised by the equity market.

In Japan, on the other hand, the conglomerates tend to be monitored on a relatively continuous basis by a financial intermediary. A Japanese corporation has a main bank, which is its largest creditor and also holds a substantial equity position. Also the lending of the other banks to the concerned corporation are also often monitored by the main bank. In cases of poor performance by the corporation, the main bank intervenes, often to impose new management or strategies, or to bail out the company. In other words, the functioning of the main bank substitutes the TO mechanism operative in US. Another notable feature of Japanese conglomerates are the extensive cross-holding patterns. A Japanese keiretsu typically consists of a number of semi-independent firms manufacturing related products and each holding a large amount of each other's stock. This serves to restrict inducements to opportunistically exploit suppliers or customers.

As we have mentioned in Chapter 2, there is also a structural difference between US on the one hand, and Germany and Japan, on the other, regarding the free operation of a market for corporate control enabling raiders to mount hostile TO bids against the wishes of the incumbent management. Although such a scenario is common in US, it is extremely rare in Japan and Germany. In Japan, this may be attributed partly to the life time employment system and also partly to the pattern of large proportion of shares in a company held by its stakeholders and only a small portion remaining with general public. For Germany, we may ascribe this to many factors, including the company's corporate culture, the 1976 co-determination act, the employee representation on the corporate supervisory boards and the concentration of share ownership (Singh (1999: 187-188).

The two principal mechanisms used in the US to regulate the supply of specialised inputs are vertical integration, and contracts with independent suppliers enforced through courts. Japanese firms on the other hand, tend to be less vertically integrated, and rely more on subcontracting with independent suppliers. Contracts enforced by the courts are also rare in Japan, with long-term relationship based on trust and reputation serving to regulate subcontracting relationships with suppliers.

Certain problems relating to supply of specialised management, marketing and technical expertise, and specialised inputs continue to render useful patterns of intercorporate holdings, or vertical integration in India. In this respect, Indian corporate groups resemble more the Japanese than the American pattern. However, the basic structural difference is the weaker control exercised by FIs in Indian companies. The FIs in India do not appear to play the continuous monitoring role that the main bank plays in the Japanese keiretsu system. Neither are the stock markets
historically liquid so as to foster corporate TOs, although market for corporate control has recently received a thrust towards development after economic reforms (Mookherjee (1999: 80-81)).

On the whole, what emerges from an analysis of the dimensions of CG prevailing in India is that the CG structure in India is a blend of the A-A type and the Japanese variety of CG structures. However, as observed in the various draft codes, be it of a private body called the CII or of the Working Group of the finance ministry, the thrust is mainly in the A-A direction, with the shareholders as the primary interest group whose interests are to be served.

9.4.2 In Search of a “Good” CG Code for India

However, in Chapter 2 we identified that CG basically deals with the accountability of firm management to all the stakeholders, i.e. owners, employees, consumers and suppliers and the greater is the accountability in terms of transparency, disclosure, etc., the better the quality of CG. From this standpoint a regulation cannot be foolproof unless the interests of all the parties involved in the running of a company can be reasonably taken care of. In this sense, all attempts to structure a code for CG in India seem to be limited and incomplete. This and certain other issues germinate regarding the CG of India, answers to which may enable the policy makers to structure an appropriate CG code for the country.

Role of ‘other’ stakeholders in CG

The A-A notion of CG considers the governance of firms to be effective if it is gainful to the shareholders in the sense of increasing shareholder wealth. Since it is the shareholders, which are the ultimate owners of the company, the terms shareholder value and company value are often used simultaneously. This view considers as a solution to corporate efficiency, the TO of the existing management of an actual or supposedly inefficient unit, and it supposes that by doing this, it can be gainful to the major stakeholder, namely the shareholders. Enhancing shareholder value also appears to be a major objective of the Working Group on Companies Act (Taxmann (1997a: 2)). The theory advocating TOs as a panacea to corporate inefficiency does not take into account the position of the other stakeholders.

Recently there has been an alternative view that argues that good CG should go beyond maximising shareholders’ interests and encompass the interests of other stakeholders of the company. This view has not drawn much attention because of the difficulty of implementation of such an objective. The vast empirical literature on CG therefore continues to accept the maximisation of shareholder value as the prime objective of good and effective governance.

However, it must be recognised that all input factors — labour, suppliers, customers and other societal groups — are impacted by the activities of purposive organisations and thereby become stakeholders. The production function of the firm, therefore become multi-vectored in the sense of having to take account of the goals and preferences of alternative stakeholders. So even if we hold that value increases are
available to the shareholders after a merger, the gains come at the expense of other stakeholders in the firm. Expropriated stakeholders under the redistribution hypothesis may include not only the above mentioned stakeholders but also the bondholders, the government (in the case of tax savings) and organised labour. This issue has been raised in the section on the effects of mergers and TOs in Chapter 2.

In recent years, this broader viewpoint of residual claimants has been well documented. For example, when labour unions are granted a portion of the common stock of the firm, this formalises labour’s position as a residual claimant. Or, consumers’ lawsuits against business firms dramatise their ability to assert their stakeholder position in formal terms. Cornell and Shapiro (1987: 5-14) analyse the dependence of corporate policy on the existence of noninvestor stakeholders. They recognise that firms issue both explicit contractual claims such as wage contracts and product warranties, and implicit claims such as the tacit promise of continuing service and delivery of expected quality to customers and job security to employees.

It is a reality that any TO involves a cost in terms of change and uncertainty and risk for all the stakeholders, in varying degrees. In this sense, probably the greatest risk is borne by the employees. But they are ignored in any discussion of CG. Even in India, the laws are clearly intended to protect investors and shareholders. Moreover, proper incentives to align employees with shareholder interests, such as stock options ought to be designed to create long-term attachment of employees to the corporate entity. This will make possible long term planning for the company and could ensure long run economic development. Recently some effort is taken in India at the policy level in aligning the interests of workers with shareholders but the effect is yet to be seen.

**Market-orientation versus Bank-orientation**

However, in all fairness, the stock market in India today with a pronounced thrust towards corporate control activities as a vehicle for corporate restructuring, is part of the economic scenario. In this context, there is the fundamental question of a choice between the market-orientation (as the A-A economies) and bank-orientation (as in Japan with its main bank system and Germany with its Universal Banks) with respect to CG that requires attention. An active market for corporate control, with hostile TOs is a central feature of stock market dominated economies of US and UK. However, finance-industry relationship is differently organised in Japan and Germany. There, banks play a bigger role and have a long-term relationship with corporations.

Stock markets have some supposed benefits like encouragement of savings, efficient allocation of investment, management disciplining through competitive selection for control, etc. But there is an alleged disadvantage too — in terms of short-termism and speculation: investment geared to quick gains. On the other hand, it is argued in the relevant economic literature that agency costs and information problems are generally lower in bank-oriented systems compared to stock market systems. As a result, bank-dominated systems can better ensure long-term financial commitments to client corporations.

Recent research links the competitive failure of the A-A economies (relative to those of Japan and Germany for example) to the difference in the operation of the market
for corporate control and other features of the financial systems in these countries. In this perspective, whether we should follow a bank-based financial system or a market-based one, will have definite CG implications for the economy.

**Role for the FIs in CG**

For efficient CG, a system of effective internal controls is needed. As in Japanese CG, in India too, FIs theoretically can have a strategic role to play in the internal control of Indian firms, in their capacity of being large stakeholder (both shareholder and creditor, and thus providers of liquidity to corporations) by successfully monitoring the performance of firms. Yet in reality it has repeatedly been observed that passivity of FI nominees at board meetings is very common. Nominee directors have no incentive for monitoring companies on whose boards they are members since they are neither rewarded for good monitoring nor punished for non-performance, save some criticism. But recently, as cited earlier some change in the attitude of the FIs is visible, as we have witnessed above. Moreover, the Working Group, has, in 1997 recommended some change in the Companies Act, 1956, in favour of executive incentive and compensation. This, if effective, could have the prospect of signaling the beginning of a new era in Indian CG.

**9.4.3 Summing Up**

We have just stated above, on the basis of an evaluation of the various characteristics of CG in India, that the CG position in India appears to stand somewhere in between the A-A paradigm and that of Japan and Germany. Given the fact that the government of India has already been making effort at formulating a code of CG (apart from the proposed amendment of the Companies Act, 1956, the Sebi has set up the Kumar Mangalam Birla committee on CG in 1999 and the government has also prepared a new competition law bill, designed as an anti-trust law, with a view to regulating the growth of monopolies and curbing monopolistic expansion), it seems to be the right juncture to make an attempt at assessing the path of CG that might be best-suited for the country.

Experiences in USA and UK have shown that while mergers and TOs do happen, they do not always increase shareholder value. Lubatkin (1983: 218-25), in summarising the empirical evidence on post-merger performance, observes that bidding firms, on average, do not exhibit any significant gains in the post-merger in the post-acquisition period. Nor are the mergers always sustainable as have been documented in economic literature (Ravenscraft and Scherer (1987), WT Grimm & Co. (1985: 92), Fray et al (1984: 46-55)).

Also, there are fears that increasing capital market dominance of company affairs will lead to some form of short-termism and speculation and long term strategy of growth and development will not be given its due. Also there is no evidence that the market for corporate control works in such a way as to always punish the inefficient and unprofitable companies and reward the efficient ones. Empirically size seems to be an important criterion in the corporate control market (Singh (1998: 189)). Again, cultural integration is one of the most intangible and hence one of the most difficult aspects of mergers and TOs. Often mergers between two companies require a change
in mindset — employees find it difficult to embrace yesterday’s competitors, gladly. For example, in the case of horizontal integration, there is generally a competition at the sales level between the two merged companies, in their pre-merger days. Here cultural integration imposes costs on the employees and also has CG implications. The huge transactions costs associated with mergers and TOs as also the possibility of very large unfavourable redistributions of wealth, as pointed out by Schleifer and Summers (1988), should also be taken care of. Also, a freely functioning market for corporate control is likely to increase industry concentration especially in economies with large conglomerate enterprises as in India. These are some of the costs associated with merger and TO activities, that are to be taken care of, by the policymakers while selecting the appropriate paradigm in designing the code for CG in India.

We have seen in the previous chapter that concentration of market power has risen in India with the mergers and TOs. Also, the post-merger profitability of consolidated firms has fallen for a number of companies. These two evidences raise two different but related questions regarding the CG policies for India. The first evidence raises the issue of sustainability of mergers as an instrument of CG in India. The second evidences probes into a deeper question relating to the desirability of mergers and TOs as instruments of effective CG in the Indian situation.

Singh (1998: 190) has identified several serious problems in the prevailing CG system in India. Some of these are conflicts of interest and lack of cohesion among many controlling families, large interlocking and associated adverse effects, total exclusion of minority investors from the firm’s decisions regarding corporate restructuring, etc. One way of solving these governance problems would be to take the route of TOs, as is done in the A-A system of CG. However, in view of our empirical findings, it would be prudent to suggest that burden of the strategy of CG based on TOs could be very costly for the country right at this moment and it may not always generate the desired results. The need of the hour, therefore, is to formulate a code of CG that would minimise some of the problems of CG in India, stated above. One alternative route would be to follow the Japanese and German models of CG and assign relatively greater role to the lead bank system and less to stock-market activism, in view of the fact that lead bank system has lower transactions cost and can handle problems of short-termism, asymmetric information and agency costs more efficiently than the stock-markets (Singh (1998: 191)). Together with this, there is also the need of suitable reforms of the various institutional mechanisms, like the different areas of company, tax, labour and real estate laws, and also a more active and responsible monitoring role for FIs, so as to resolve the agency problem in Indian industries (Mookherjee (1999: 86)). Only if these efforts are taken simultaneously, can we expect an “appropriate” code of CG to be formulated in India that would ensure maximum returns to the stakeholders and, in the process, enforce corporate discipline.

It is indicated by our analysis that an attempt is definitely being made by our policymakers to recast the institutional, organisational and legal arrangements in line with those practiced in the established market economies. But many more structural changes in the lines mentioned above and otherwise, need to be brought about, to
make the CG transparent and derive definite policy recommendations suitable for India at this juncture. The length of our time series is too short to sketch the direction of CG. So we need some patience to know the final outcome.
NOTES AND REFERENCES


8. See 5 above.


10. For the details on MRL, refer to:


11. “Non-executive directors should constitute at least 30% of board”, *Economic Times*, 23.4.97.


13. See 12 above.


Also refer to:

“Greater funding to pvt sector needed”, *Economic Times*, 3.2.1997.

16. Lahiri, J. (1998) “Banks, FIs can now indirectly fund takeovers”, *Economic Times*, 12.2.98. Also refer to:

“For efficient takeovers”, *Economic Times*, 13.2.98.