III. The Development of Corporate Law in India

The reform of corporate governance is a worldwide phenomenon. In the last decade India has engaged in an ambitious series of reforms. In order to better understand the context of these reforms, we briefly discuss the corporate governance situation in India prior to these reforms.

Modern corporate governance in India dates back to the later half of the 1800s under the British Raj. By the time of Independence in 1947 India had functioning stock markets and a comparatively well developed model of corporate governance. Following Independence the Indian government pursued socialist policies that led to the growth of the state owned sector and a greater role for the state as the primary provider of debt and equity capital. The results included a decline in corporate governance. By 1991 the financial position of the Indian government was quite precarious. This led it to embark on a series of market oriented reforms involving a retraction of the state from the corporate sector and a general liberalization of the economy. By the mid 1990s Indian Industry began to search for capital to expand into the competitive spaces being left open by the liberalization policies. The need for capital, amongst other things, led to the first forays into corporate governance reform in India starting with the Confederation of Indian Industry’s Code for Corporate Governance in 1998 which was quickly followed by the government enhancing corporate governance via listing requirements and amendments to the Company Law in 2000.

In many respects the saga of modern corporate governance in India is the story of the prodigal son – a promising start followed by a decline with much more recent attempts at enhancing governance. The details of how this happened are briefly described in the next few paragraphs.

A. Origins of Modern Corporate Law in India (1866 to 1947)

India, unlike a number of emerging markets, has had functioning stock markets since 1875 where much of the activity was organized in the form of joint-stock limited liability companies. In light of the early presence of corporations in India it is not surprising that the regulation of corporate governance started relatively early. From 1866 onwards there were
many pieces of legislation governing corporate governance, trust activity, banking activity, and securities regulation (Bagchi (1972), Rungta (1970)).1 Moreover, it appears that Indian Industry grew considerably during World War II because the Chinese and Japanese economies, which were in some sense competitors, were damaged by the war and by wartime activities on their territories.2 Thus, by the time of independence in 1947, India appeared to have well functioning stock markets, an active manufacturing sector, a large corpus of corporate and securities laws, and a well developed banking establishment (Chakrabarti (2005), Goswami (2003)). Although there were certainly corporate governance abuses, the general state of corporate governance and the overall economy in India placed it in an enviable position amongst many de-colonized countries.3 This position was, however, about to receive some serious setbacks.

B. Independence to Liberalization (1947 to 1991)

Following Independence the Indian government put into place a number of policies that had the effect of weakening corporate governance in India. This started with a series of Industrial Policy Resolutions which entrusted the state with much greater responsibility for managing the economy (Mohan & Aggrawal (1990)). The changes wrought by these resolutions included a much expanded state owned sector.4 The government was to become the sole provider of many goods and services.5 This led to the nationalization of certain industries (in particular financial institutions such as banks and insurance companies) and the removal of private firms and competition from large sectors of the economy. This would have reduced the competitive pressure to be efficient. Moreover, Indian state owned enterprises (SOEs) were not simply being run to maximize profits, but for a variety of additional reasons as well (Goswami (2003)). In light of this, it is unsurprising that such firms would not focus their corporate governance on efficiency.

1 See the Indian Companies Act 1866; Indian Companies Act 1882; Indian Trusts Act 1882; Indian Companies Act 1913; Reserve Bank of India Act 1934; 1956 Indian Companies Act (in the process of being re-written); 1956 Securities Contracts (Regulation) Act (defines powers and conduct for stock exchanges); 1985 Sick Industrial Companies (Special Provisions) Act (bankruptcy provisions for financially distressed companies – also being re-written); 1992 Securities and Exchange Bureau of India (SEBI) Act (sets up SEBI – regulator of stock markets). For more discussion of the growth of Indian Industry since the beginning of the 20th Century see M.D. Morris, The Growth of Large Scale Industry up to 1947, in D. KUMAR (ED.) CAMBRIDGE ECONOMIC HISTORY OF INDIA VOL. 2 553 – 676 (1983). Note that even prior to the 1866 Act there were corporations in India, primarily in the Bengal (Calcutta) area.


3 [Discuss some corporate governance abuses in India pre-1947 (see Rungta (1970)].

4 Some of these changes bear considerable similarity to the suggestions laid out by the leading Indian Industrialists in the 1944 Bombay Plan. The Plan was to be a blueprint for economic growth in India and many of its suggestions seem to have been adopted by the first few Indian governments.

5 There were also some industries where only the state could start new firms (Goswami (2003)). There appeared to be a belief that the private sector, domestic and foreign, could not be relied upon to provide these goods and services and that they may have incentives that do not enhance social welfare (Chakrabarti, (2005); Bombay Plan (1944)). One expects the suspicion of private enterprise may have deep historical roots as the growth of the British Empire was tied to the success of the East India Company which had some very serious negative consequences for India. See___.
This was accompanied by a series of enactments that worked as entry barriers to certain markets and to investment. First, there were a series of enactments that required industrial enterprises to obtain a number of licenses from various government agencies to conduct business or to expand capacity (commonly known as the “license raj”) (Goswami (2003)). The requirement to obtain the government’s approval provided opportunities for rent-seeking and corruption that likely led to a less competitive environment for many Indian businesses. The lack of competition would have benefited incumbents, but would also have hindered further growth in corporate governance by reducing the competitive pressure to be efficient.

Second, the government erected barriers to both foreign investment in India and to foreign competition. There were large trade barriers and tariffs accompanied by limits on how much stock a foreign entity could own in an Indian enterprise and requirements for firms to purchase their goods from primarily indigenous producers (Mohan & Aggrawal (1990), Goswami (2003)). This insulated domestic firms from foreign competition and, when combined with the extensive licensing requirements, insulated domestic firms from much further domestic competition.

This was compounded by how private sector firms were capitalized and the incentives of the various capital providers to monitor management. The primary source of capital for many Indian firms was debt capital. This was made available by the state through a variety of state owned and operated development finance institutions (DFIs) (World Bank Report (2005), Chakrabarti (2005), Goswami (2003)). The employees of the DFIs were not assessed based on whether the firms they provided funding to made a profit, but rather on the total amount of loans that had been made. This, of course, created an incentive to maximize the amount of loans rather than providing loans to businesses with viable business plans. DFIs then had little incentive to monitor management. Indeed, the DFIs often favored management due to a variety of reasons including corruption and political gain.

Although the DFIs were often the primary credit providers other creditors did exist and would have had some incentive to monitor management. This was, however, hampered by the glacial speed of India’s bankruptcy process. There were inordinate delays in the process of restructuring and liquidating a firm (e.g., it could easily take 10 years to liquidate a firm) and this would have placed these non-DFIs creditors in an unenviable situation (Anant & Goswami (1995), Goswami (1996)). Indeed, it was not very common for private creditors to provide credit to anyone but blue chip companies or companies backed by government guarantees. Thus, these creditors were unlikely to exercise real oversight over management.

Even if creditors could not or did not monitor management, perhaps shareholders could. Here once again there were problems. First, the primary providers of equity capital were the DFIs. Although most DFIs would invest primarily in the form of debt, they might also invest in the form of equity when their internal debt ratios would prohibit them from investing any more as creditors. Indeed, for many companies the DFIs had collectively well over 50% of the equity stock. However, the DFIs had, as before, little incentive to act as careful monitors of management and used to routinely appoint nominee directors to the boards of these corporations that would rubber stamp the decisions of management (World Bank Report (2005), Goswami (2003)).
If the DFIs did not exercise oversight then what about other minority (non-management) shareholders – they might be able to exercise oversight. There was certainly provision in the Companies Laws for minority shareholders to raise oppression and mismanagement concerns at various adjudicative fora. However, they were unlikely to have their grievances redressed (Goswami (2003)).

First, the Indian judicial system was full of delays and years could pass before such litigation would be adjudicated. Second, there appeared to be many irregularities in the share transfer and registration process which would have further delayed minority shareholders in bringing their cases. Third, the disclosure of ownership structure and related party transactions was very opaque in India making it even harder for minority shareholders to achieve redress. This was exacerbated by the very high tax rates for corporations and individuals, which led to a tremendous amount of tax evasion achieved by devising highly complicated cross-holding structures. Although this aided tax evasion, it had the by-product of making ownership structure even more opaque to minority shareholders. Finally, even if someone tried to buy up shares in the corporation from the DFIs the government could block share transfers that might result in a change in the board that the government considered “prejudicial to the interest of the company or the public interest”. Given that government (via the DFIs) tended to vote with management one can easily see how this would lead to entrenchment of management and little scope for effective oversight by other shareholders.

Of course, even if non-management shareholders and creditors exercise little oversight it may be that management has incentives aligned with maximizing wealth as most management were the promoters and initial investors in the company. Here too capital structure played an invidious role. Because the DFIs provided so much of the capital (both in debt and in equity) the promoters could maintain control with as little as 15% of the equity of a firm and, given the amount of funding they received in the form of debt, the promoters could have maintained control of a firm by providing only 3% of its capital (Chakrabarti (2005), Goswami (2003)). With such excessive leverage the promoters could recover their initial investment very early on. Moreover, with so little invested in the firm the promoters and management would face incentives that might diverge quite widely from the rest of the shareholders. The prospect for self-dealing and moral hazard would loom large in this environment.

Of course, such a system should have led to considerable looting by management and many failed companies. Although the looting did occur, the system was insulated from some of the consequences of failed companies both by the slow bankruptcy process and by the fact that the state could takeover failing businesses and keep them afloat to maintain employment. The employment dislocation that would otherwise follow such policies did not eventuate, but at the cost of increasing the effective debt burden for the state (Anant & Goswami (1995)).

Thus, by 1991 the Indian corporate scene had changed considerably from its pre-Independence situation leading India to become a laggard in corporate governance. For

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6 Cites to specific provisions.
7 Cites to specific provisions.
SOEs the familiar story of lack of competition and little profit incentive contributed to the inefficiency of the enterprise and to its atrophied corporate governance. For private firms corporate governance was ineffective for a number of reasons. First, the DFIs as large shareholders and creditors played little to no monitoring role given how their incentives were set up and the political background against which they were to act. Second, the non-DFI creditors could exercise only limited oversight given the very slow pace of bankruptcy proceedings in India. Third, minority shareholders (non-DFA shareholders) faced considerable obstacles in enforcing their rights. There were lengthy judicial delays, little information about related party transactions, opacity in ownership structure (largely motivated by tax evasion) and irregularities in transferring shares. Fourth, promoters could start firms by putting up only the smallest sliver of their own capital. When this is combined with the ineffective oversight by other parties then the potential for mismanagement and fraud becomes quite large. Moreover, these private firms faced little competitive pressure to improve their efficiency because of the “license raj” system, which limited domestic competition, and the high trade and other barriers limiting foreign competition. Finally, the employment dislocation that might have been caused by inefficient management leading to failed firms was not felt in its entirety because the state could take over failing firms and keep their work force employed. This would have reduced the political cost of supporting inefficient management.

This is a recipe for dysfunctional corporate governance and that is precisely what India had. From the outside India had the laws and the legal system to enforce corporate governance but the operation of the system, inconsistent disclosure, and largely ineffective boards of directors led it to be a failing system of governance. Indeed, Indian firms that were looking for capital had to rely primarily on internal sources or on the capital provided by the DFIs (Bhattacharyya & Rao (2005), World Bank Report (2005)).

### C. Liberalization and Corporate Law Reform (1991 to present)

The sheer weight and cost of this system came crashing down on the Indian economy in 1991 when the Indian government, in response to a financial crisis, embarked upon a general program of liberalization. It was the advent of these 1991 reforms that would lead to the corporate governance reforms that I am examining in this paper. Liberalization was to take the form of selling off some of the SOEs and beginning to sell off or rationalize the state’s interests in other firms. Further, the DFIs were now to be assessed on “bottom line” measures rather than the amount of loans sanctioned. Moreover, trade barriers were to be reduced, foreign investment permitted (and even encouraged) and the “license raj” to be eased thereby permitting for increased domestic and foreign competition (Goswami (2003), Krueger (?)). Thus, post-1991 India would have new competitive spaces opening up (where the SOEs would no longer be the sole provider of goods or services), old industries becoming more competitive with the inflow of foreign competition and new domestic competition, and government institutions more motivated by efficiency than before. Following this the government created the securities market regulator – the

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8 Indeed, the DFIs were no longer provided the kind of subsidized access to funds they had in the past and they were sometimes merged with private entities (World Bank Report (2005)). The primary DFIs before 1991 were: - IFCI, ICICI, IDBI, UTI, LIC, GIC and Public Sector Banks. Now there are 3 sets of Institutional Investors – the DFIs, new private sector Mutual Funds, and Foreign Institutional Investors.
Securities & Exchange Board of India (SEBI) in 1992 and slowly granted it increasing powers and the mandate to regulate the stock markets in India. This was significant because SEBI could take on an adjudicatory role and thereby relieve some pressure on the court system and provide more timely resolution of disputes.

It is against this backdrop that corporate governance reform would develop in India. Indeed, one of the more unique things about Indian corporate governance reform is that it was initiated and initially pushed by private industry. Although there were scandals in the Indian stock markets following liberalization (and even before it), it was when industry got involved that reform moved forward quickly (Goswami (2003)). The Confederation of Indian Industry (CII) drafted the first corporate governance code in India and it was that code that formed the basis for Clause 49. Indian industry pushed governance reform because access to capital was necessary to take advantage of the opportunities created by liberalization and to stay ahead (or at least with) the competition. However, given the generally poor level of governance, Indian corporations could not seriously expect domestic and foreign investors to provide capital without some greater assurance. Indeed, some outside enforcement (e.g., via SEBI or the Exchanges) might be needed to bolster the credibility of any governance reform. Thus, the corporate governance reform movement in many respects was motivated by a desire to access capital markets to fund investment in new business opportunities or to enhance chances in current endeavors. Reform was also supported by the increasing presence of foreign investors, the Indian financial press being quite active, and the desire to access US capital markets (Goswami (2003)).

Following the 1998 CII code, SEBI decided to form the Kumarmangalam Birla Committee (KMBC) and commission a report on corporate governance reform leading to changes in the listing agreement of the stock exchanges. The KMBC’s draft set of recommendations came out on September 30, 1999 and became effective as Clause 49 of the listing agreement with the Exchanges on February 21, 2000 – a stunning 5 months later. Firms failing to meet the requirements of Clause 49 could be delisted. The details of Clause 49 are provided in Appendix 1, but a quick overview is provided below.

Clause 49 had both mandatory and non-mandatory requirements. In the mandatory camp were a number of reforms designed to require more independence on boards. This involved prescribing minimum percentages of independent directors (50% or 33% depending on whether the Chairman was an executive director) and significantly tightening up the definition of “independence”. In addition to this, Clause 49 mandated the number of meetings per year, expected boards to develop a code of conduct and imposed limits on the number of directorships a director could simultaneously hold. Clause 49 also enhanced the

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9 Cite to 1992 Act.
10 The judicial process in India is so slow that sometimes Indian Investors associations file cases on behalf of minority shareholders as “public interest” litigation to hasten the process. [cites and discussion]
11 The stock market scandals often involved misdealings by brokers and traders rather than the more standard corporate governance concerns. See____.
14 Cites.
15 Now there is the possibility of financial penalties from Section 23 E of 2004 Act. Cite.
power of the audit committee both by requiring financial literacy, experience and independence, and by expanding the scope of activities on which the audit committee had oversight. Executives were also expected to be more personally involved in corporate affairs as seen by the requirements for certification by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of financials and overall responsibility for internal controls. This was combined with considerably expanded disclosure obligations (on many things including accounting treatment and related party transactions) and enhanced requirements for holding companies when overseeing their subsidiaries. These series of changes appear aimed at making Boards and Audit Committees more independent, powerful and focused monitors of management. Moreover, the enhanced disclosure would aid institutional and foreign investors in exercising oversight as well.

A number of further committees were formed which made a series of recommendations (Naresh Chandra Committee, Department of Company Affairs Report, Malegam Committee, and the Narayana Murthy Committee) leading to further changes in the listing requirements. Additionally, amendments were made to the Companies Law and some proposals are still under consideration. Moreover, the corporate governance of banks was reformed at this time as well. Reforms continue in India with some parts scheduled to come into effect soon and others still being debated and re-written in the Indian Parliament.

Although there were some changes to the statutory law during this period, most of the changes were in the listing requirements. This is not too surprising. Changes in listing agreements carry the penalty of de-listing, which although significant, is less personally painful for executives than violations of the statutory law which could involve direct financial penalties and potentially jail time. Moreover, listing requirements are generally enforceable only through SEBI and the Exchanges which can utilize enforcement discretion thereby softening the impact of the changes. This would have dulled opposition to the reforms because the cost of non-compliance looks less severe. Indeed, a strategy of first changing listing requirements looks very much like an attempt to first “test the waters” in a relatively low cost way and then if the change “sticks” to proceed with statutory changes thereby providing firms with sufficient time to adapt before penalties became more significant. Such a strategy is less likely to encounter political opposition and may still provide enough assurances to encourage the investment of capital in India. This is certainly a plausible way to describe the reforms that have been occurring in India.

Indeed, consistent with this the next series of important reforms are statutory changes which are likely to be tabled in front of Parliament later this year (based on the J.J. Irani Committee’s (2005) recommendations). The changes will apply to all firms in India (not just those listed on the exchanges). The proposed changes are summarized in Appendix 1 and compared to the changes wrought by Clause 49.

From our perspective a number of things are noteworthy about the Irani committee’s recommendations. Although it tightens up certain things and loosens others

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16 Reference to Murthy Committee (2003); Chandra Committee, Malegam Committee… .
17 Chakrabarti, (2005). In banks the system of nominee directors is being phased out and the banks use the CAMELS system (Capital Adequacy, Asset Quality, Management, Earnings Liquidity and Systems and Controls). See id.
relative to Clause 49, the overall sense is that the statutory law will permit greater customization and self regulation (e.g., requiring shareholder approvals for executive compensation) for all companies.\textsuperscript{18} Moreover, this will be accompanied by greater protections for smaller shareholders, especially in merger transactions. Finally, the process of enforcement is to be streamlined, the bankruptcy system upgraded, and the actual legal provisions rationalized and simplified (eliminating redundancies and so forth). These changes are not inconsistent per se with Clause 49. This is because Clause 49 is specifically targeted at listed companies and one might expect tighter regulation for these kinds of companies (as they raise capital from the general public) compared to all firms (listed or not) which may raise capital from smaller and perhaps better informed sets of people.

One could, of course, view the Irani committee as taking a more cautious approach to governance reform than Clause 49. This is perhaps not that surprising given that India attracts much more capital now than it did before Clause 49 (indicating that the marginal gain from governance reform now may not be as large), statutory law may carry greater penalties for its violation, and there were many firms who had difficulty complying in a timely manner with Clause 49 indicating that further reform may be fairly costly.

\textsuperscript{18} The CII seems to generally support these reforms as well. See____.
## Appendix 1

Comparing Clause 49 and the JJ Irani Committee Recommendations

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<th>Characteristic</th>
<th>Clause 49</th>
<th>JJ Irani Committee</th>
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| **Independence** | • Requirement – 50% independent directors if Chairman is executive director or 33% if Chairman is not.  
• Definition - not related to Board or one level below Board and audit partners must have no prior relationship with the Company for the last 3 years.  
• “Material” - There is no requirement for the relationship to be “material”.  
• Financial institutions - are considered independent. | • Requirement – 33% for companies with public interest.  
• Definition - not related to employees of the Company and no prior relationship with the Company for one year.  
• “Material” - board to review what is “material” on an ongoing basis.  
• Financial institutions - not considered independent. |
| **Board Requirements & Limitations** | • Meet 4 times a year (maximum gap of 3 months between meetings)  
• Limits on number of committees a director can be on (10), but only 5 for which director can be Chair of committee.  
• Develop Code of Conduct. | • Meet 4 times a year (maximum gap of 4 months between meetings).  
• Limits of number of directorships (15). |
| **Audit Committee Composition** | • At least 3 directors (two-thirds must be independent).  
• All financial literate.  
• At least one having accounting or financial management experience. | • No minimum number of directors (majority need to be independent).  
• No requirements for financial literacy.  
• At least one should have accounting/financial management knowledge. |
| **Audit Committee Role & Powers** | • Audit Committee Meetings – 4 meetings (gap between meetings not exceed 4 months).  
• Audit Committee role is broad – review statutory and internal auditors as well as internal audit function. | • Audit Committee Meetings – number not specified. |
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<th>Subsidiary Companies</th>
<th>Other</th>
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| - Related party transactions, | - CEO & CFO:  
  - financial statements  
  - effectiveness of internal controls  
  - legal transactions  
  - inform audit committee of any significant changes in the above. | - At least one Independent director of Holding Company should sit as a director on Board of material non-listed Indian subsidiary.  
- Significant transactions report to Holding Company Board (along with subsidiary board’s minutes). | - Whistleblower policy is optional  
- Independent directors loses status as “independent” if served 9 years at company  
- Training board members  
- Evaluate non-executive board performance. |
| - Accounting treatments and departures, | - Auditor or Company Secretary:  
  - Compliance with corporate governance | | - Whistleblower policy and protection for whistleblower is encouraged. |
| - Risk management, | | | |
| - Proceeds from offerings, | | | |
| - Compensation for directors (including non-executives and obtain shareholders’ approval), | | | |
| - Details of compliance history for last 3 years. | | | |
| - Corporate governance reports (and disclose adoption, if any, of mandatory and non-mandatory requirements). | | | |

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<th>Subsidiary Companies</th>
<th>Other</th>
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</table>
| - Related party transactions, | - CEO, CFO & Company Secretary  
  - financials  
  - CEO and CFO:  
  - internal controls (with audit committee approval). | | |
| - Executive compensation, | | | |
| - Unusual transactions, | | | |
| - Director’s background. | | | |