LEGAL FRAMEWORK OF CORPORATE GOVERNANCE: INDIAN PERSPECTIVE

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INTRODUCTION

It raised the pressure on investors on companies to strengthen the corporate governance system by separating the roles of chairman and CEO after the number of corporate financial scandal in the early part of the decade. The worldwide wave of deregulation, privatization, take over, pension fund reforms and the growth of private savings are the reasons why the corporate governance become so prominent today. These include Globalization, Privatization, Unethical business practices and security scams. Corporate governance observes at the complete governance of corporations over their governance structures, company law, privatization, exit from the market and insolvency from their very beginning in entrepreneurship. Corporate, financial and market integrity is particularly central to the health and stability of our economies. Bradley speaking, corporate governance refers to "the process, mechanism, principles, and structure by which the company's business and business is effectively managed, directed, and governed. Its aim is to increase long term shareholder value by improving corporate performance and accountability while taking other shareholder's interests into account. The structure of corporate governance specifies the relationships and the distribution of rights and responsibilities, mainly among three groups of participants, i.e. the board of directors, shareholders and stakeholders. The system outlines the rules and procedures for making decisions on corporate matters, it also provides the structure through which the goals of the company are set, as well as the means to achieve and monitor the performance of those goals. Corporate governance's fundamental concern is to ensure the means by which managers are held accountable for the use of assets to capital providers. As part of corporate governance, issues of fiduciary duty and accountability are often discussed. Instead of strict statutory requirements, it allows a more constructive and flexible response to raise standards in running and managing the company.

HISTORICAL PERSPECTIVE OF CORPORATE GOVERNANCE: ANCIENT INDIA

The roots of corporate governance practices in India found since ancient era. In Ramrajya, the concept of trusteeship was practiced. After Rama's departure from Ayodhya, Bharat took charge of Ayodhya's management. Bharat's role was Trusteeship, i.e. as a representative of his kingdom, he managed the kingdom. This is the best example of owners' and management separations. It has also been a successful practice of governance in Indian history. Though for fourteen years Bharat had managed Ayodhya, he was totally detached from wealth and power. In Mahabharta, the same kind of governance was observed. Krishna's Kingdom was the presidential state. Krishna and Balrama were kingdom presidents, not kings. Absolute ethics was at the foundation of governance in both cases and these absolute ethical values were derived from the Vedas. The Indian principles give the concept of VARNASHRAM (Four Quality and Efficiency-based class of people). Because of division of labour there was less chance of the few people accumulating wealth and power. The principles also emphasize that an individual should have a single source of income. The Indian ethos further divides the activity of the individual into four parts i.e. (PURUSHARTH - Dharma, Artha, Kama, and Moksh).

CORPORATE GOVERNANCE PRACTICED DURING PRE-INDEPENDENCE

In India, most of the organizations were run jointly or owned by a family until the beginning of the seventeenth century. The partnership was the dominant form of organization during that period. The

1 Rajesh Chakrabarti (2007), "Corporate Governance in India Evolution and Challenges", Journal of Applied Corporate Finance, December Volume 8
partners were barely unlimited personal obligations for any of the company’s obligations. Many companies such as JRD TATA have also impregnated these principles and set up such a large TATA group empire. While earlier management of governance in India focused more on managing the agency system. Companies Act came to the picture in 1956 and the main focus of the act was to govern the functioning of joint stock companies and protect the investor’s rights. But contemporary laws have been sufficient power to control unethical practices that lead to inefficiency, nepotism and corruption. Earnings management practices have increased and incentives have been given to firms to develop complicated structures with large compensation “Under the Table” at senior level. The financial manipulations, corporate bankruptcy and reorganization system also created Indian corporate’s worse picture. India’s system was driven by the 1985 Sick Industrial Companies Act, which deems a company “sick” only after all its net worth has been eroded and referred to the Industrial and Financial Reconstruction Board (BIFR).

Between 1987 and 1992, only few companies emerged successfully from the BIFR. In addition, the legal process took the average of 10 years to liquidate the assets of the company by that time were almost worthless. So the creditor’s right’s protections remained only on a paper.

POST LIBERALIZATION GOVERNANCE PRACTICES IN INDIA

Liberalization began in India in 1991, leading to wide-ranging changes in both legislation and regulations. The establishment of India’s Securities and Exchange Board (1992) after liberalization was a very important development in the field of corporate governance and the protection of the rights of minority investors. SEBI’s important function is to monitor stock trading. Companies allocating preferential share to their promoters at discounted prices after 1992 due to Harshad Mehta scam and those companies disappearing with the money of the investor lead to several investigations to fix corporate governance practices in India. The CII (Confederation of Indian Industry Code) made the first such endeavour to evolve existing governance practices and suggestions for improvement and modification on the same. Created in 1996, the committee was chaired by Rahul Bajaj. In 1998, they had submitted their code. During this period, SEBI also set up two committees to deal with corporate governance issues, the first was chaired by Kumar Manglam Birla and submitted its report at the beginning of 2000; the second by Narayan Murthy and submitted its report three years later. Through the formulation of clause 49, the discussions and suggestions of these two committees become important means to bring about effective changes in corporate governance in India.

In addition, in conjunction with the initiatives taken by SEBI, the DCA (Department of Company Affairs), the Government of India’s Ministry of Finance had begun to rethink existing practices and to implement the necessary modifications. Different committees were formed to reform India’s existing 1956 Companies Act, which is still the backbone of corporate law. Kumar Manglam Birla chaired the committees in 2000, Naresh Chandra in 2002 on corporate audit and governance, and J. J. Irani at the end of 2004 on corporate law.

RECOMMENDATIONS FROM VARIOUS INTERNATIONAL GOVERNANCE COMMITTEES

1. The Cadbury Committee

In December 1992, the Cadbury Committee published the Code of Best Practice recommending that boards of publicly traded UK corporations should include at least three external directors and that the board chairman and chief executive officer's positions should not be held by one individual. The underlying presumption was that these recommendations sponsored by the government would result in increased oversight of the board. Corporate analyses the relationship between top management turnover and performance as a presumption test. Corporate finds that CEO turnover increased as a result of the Code’s publications, that the relationship between CEO turnover and performance was strengthened as a result of the Code's publication, and that the increase in turnover sensitivity to performance was concentrated among firms that adopted the recommendations of the Cadbury Committee.

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6 The Cadbury Committee, 1991
In May 1991, the Cadbury Committee was appointed by the United Kingdom's Conservative Government (UK) with a broad mandate to “address the financial aspects of corporate governance.” In December 1992, the Committee issued its report recommending, among other things, that the board of directors of publicly traded companies should include at least three non-executive (i.e., external) directors as members and that the chairman and chief executive (CEO) positions of these companies should be held by two different individuals. The apparent reasoning behind the recommendations of the Committee is that the quality of board oversight will be improved by greater independence of a corporate board. In order to appreciate the potential significance and recommendations of the Cadbury Committee, it is important to appreciate the environment surrounding the creation of the Committee. The Committee was appointed in the first place, following the scandalous collapse in the late 1980s and early 1990s of several prominent UK companies, including Ferranti International PLC, Colorol Group, Pollypeck International PLC, Bank of Credit and Commerce International (BCCI) and Maxwell Communication Corporation.

These and other failures were popularly attributed by the broadsheet press to weak governance systems, lax board oversight, and a single top executive vesting control.

THE COMPANIES ACT OF 1956

Companies in India are governed by the Companies Act, whether listed or not. The Act is governed by the Company Department Act (DCA). India began its program of economic reforms in the 1990s. Again a need was felt for a comprehensive review of the 1956 Companies Act, which became by this time the bulkiest and archaic with 781 sections and 25 schedules. Among other things, the Act deals with rules and procedures concerning a company’s incorporation; the prospectus and allocation of ordinary and preferential shares and debentures; a company’s management and management; annual returns; frequency and conduct of shareholder meetings and proceedings; accountability; board of directors; prevention of mismanagement and oppression of minority shareholder rights; and the power of government investigation, including CLB powers. Three unsuccessful attempts to rewrite the company law were made in 1993, 1997 and then in 2003. Companies (Amendment) Bill, 2003, which included several important corporate governance provisions, was withdrawn by the government in anticipation of a further comprehensive review of the law. Since 1956, there have been as many as 24 amendments to this Act, 52 of which relate to corporate governance and corporate sector development through the Companies (Amendments) Act, 1999, the Companies (Amendment) Act, 2000 and the Companies (Amendment) Act, 2001.

Important amendments with overall corporate governance implications are listed below:

1. The Companies (Amendment) Act, 1999
   - Buy back of shares (Section 77A)
   - Issue of sweat equity shares (Section 79A)
   - Establishment of investor education and protection fund (Section 205(c))
   - Liberalization of inter-corporate loans and investment norms.

2. The Companies (amendment) Act, 2000
   - Penalties increased by almost ten times for non-compliance in various Sections of the Act.
   - Issue of shares with differential rights (Section 86).
   - Passing of resolutions by postal ballot (Section 192A).
   - Directors’ Responsibility Statement (Section 217(2AA))
   - Additional powers and duties of auditors (Section 227)
   - Minimum number of directors including election of small shareholders’ director (Section 252)
   - Maximum number of directorships in companies reduced from 20 to 15 (Section 275)
   - Audit Committee (Section 292A)

3. The Companies (amendment) Act, 2009
   Some of the remarkable changes to the company law that have a direct impact on improving corporate governance standards are explained below:
   - Passing of resolution by Postal Ballot (section 192A).
   - Instead of transacting the business in the general meeting, public listed company, resolutions relating to such business as the central government may, by notification, declare to be conducted only by Postal Ballot.

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7 The Companies (Amendment) Act, 1999
8 The Companies (amendment) Act, 2000
9 The Companies (amendment) Act, 2009
- The company when decides to pass resolution by postal ballot, it shall send a notice to all shareholders by registered post.
- If a resolution requires requisites majority of the shareholders by means of postal ballot, it shall be deemed to have been duly passed at a general meeting convened in that behalf.
- Under Directors' Responsibility Statement (217(2AA)) section, the board's report shall include a 'Directors' Responsibility Statement'.

**INDIAN CORPORATAE COMMITTEES AND ITS GUIDLINES**

Some major committees for corporate governance in India are:
- Kumar Manglam Birla Committee, 1999.
- Dr. J. J Irani Committee on Company Law, 2005

1. **Kumar Manglam Birla Committee, 1999:**
   - The recommendations of the Birla Committee are compulsory recommendations and non-compulsory recommendations.
   - Compulsory recommendation includes the composition of the Board of Directors and Audit Committee, the Board's Board of Directors' Remuneration Committee, management or implementation methods.
   - Non-obligatory recommendations include the role of chairman, pay committee policy, shareholder rights, postal ballot, etc.

2. **Naresh Chandra Committee Report, 2002:**
   - The Naresh Chandra Committee was appointed by the Department of Company Affairs on 21 August 2002 as a high-level committee to review various corporate governance issues.
   - The report of the Naresh Chandra Committee on 'Corporate Audit & Governance' submitted on the following counts the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance established by the Securities Exchange Board of India,
   - Representation on the board of a company of independent directors.
   - The audit committee's composition.
   - The Naresh Chandra Committee has established strict guidelines that define the relationship between auditors and their clients. In a move that could have an impact on small audit firms, the committee recommended that an audit firm should not derive more than 25 percent of its business from a single corporate client together with its subsidiary, associates or affiliated entities.
   - The Committee has further recommended the following:
     - Squeeze the noose around the auditors by asking them to make a variety of disclosures.
     - Calling all listing companies' CEOs and CFOs to certify the annual accounts of their companies, as well as suggesting.
     - Establishment of quality review boards by India's Institute of Chartered Accountants (ICAI), India's Institute of Company Secretaries (ICSI) and India's Institute of Cost and Works Accountants, rather than a similar US Public Supervisory Board.

3. **Narayan Murthy Committee Report, 2003:**
   - Under the corporate governance committee established by SEBI under N. R. Narayana Murthy, reference terms were as follows:
     - Reviewing corporate governance performance and
     - To determine the role of companies in responding to market - circulating rumours and other price-sensitive information.
   - Two sets of recommendations, mandatory recommendations and non-obligatory recommendations, emerged from the committee.
   - Mandatory recommendation includes audit committee composition, related party transactions, proceeds from initial public offerings, risk management code of conduct for the board or appointment of nominee directors, etc.
   - Non-obligatory recommendation relates to moving to a scheme that provides for unqualified corporate financial statements, train board members and evaluate the performance of non-executive directors by a peer group comprising the entire board of directors, excluding the manager being evaluated.
4. Dr. J. J Irani Committee on Company Law, 2005:
- On 2 December 2004, under the chairmanship of Dr. J. J. Irani, the Government of India established an expert committee on Company Law.
- Set up to structurally evaluate the views of several stakeholders on the development of the Indian Company Law on the concept paper promulgated by the Union Ministry of Corporate Affairs, the J. J. Irani Committee has suggestions that will go a long way in laying a sound foundation for corporate growth in the near future years.
- The main features of its recommendations pertaining to corporate governance are as follows:
  - Number of Directors & their duration in company.
  - Age of Directors.
  - 1/3rd of Independent Directors (along with definition of Independent Director).
  - Maximum No. of Directorship hold by Individual.
  - Remuneration Policy.
  - Sitting Fee Structure for Directors.
  - Requisite Board Meetings in a year.
  - Number of Independent Directors in Audit Committee.
  - Constitution of Remuneration Committee.
  - Protections of Minority shareholders’ rights.
  - Appointment of Auditors.
  - Certificate Issued by CEO & CFO.
  - Subsidiary Company Transactions.
  - Disclosure of directorship & shareholding pattern of the company.
  - Responsibility of the Board in Public Subscriptions.
  - Roles & Responsibilities of Independent Directors.
  - Appointment of Stakeholders Relationship Committee.
  - Appointment of Nominee Directors.
  - Interactive Dialogue between professional bodies and corporate sector to enable evolution of corporate governance codes.
  - Appointment of Regulators to monitor the end use of funds collected from the public.
  - Appointment of Auditors.
  - Credit Rating Mechanism should be followed by corporate.
  - Whistle-blower concept (Irani Committee Report on Company Law (2005))

REGULATORY FRAMEWORK OF CORPORATE GOVERNANCE

There has been a significant increase in the corporate form of business establishments over the past three centuries since the initiation of economic liberalization in Indian. The elimination of several licensing hurdles, financial market reforms, in particular capital market reforms, the introduction of modern technology - based trading, the strengthening of the capital market regulatory system has increased retail investor confidence foreign and domestic institutional investors do not hesitate to invest in Indian capital market savings. The primary market and the secondary market reforms have improved the profitability, the liquidity and the transparency in the capital market investment and reduced risk in it.\[10]\ The investors' confidence is improved in the capital market investment. At the same time, corporate misconduct and frauds have also increased as seen in the developed countries.\[11]\ Capital market frauds such as the Harshad Mehta Case, corporate frauds such as the Satyam Computers case, the Sahara case, the Kingfisher case have affected investors trust and behaviour. In order to overcome this and regain the investors' interest in the capital markets, the following are several legal and regulatory steps taken by the government during the actions established between private actors:

1. The Company Act, 2013: The new Company Act, 2013 replacing the fifty-six years old company legislation of independent India has put forward a series of provisions relating to corporate governance apart from simplification and liberalization of other aspects of company formation and administration. This is major reform of independent India in the area of company legislation.

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\[11\] Bhuvnender Choudhary and Manish Kumar, 2011, “Corporate Governance Concept Frame and Mechanism”, IJRFM, Scope & Future, Volume 1, Issue 3 July.

\[12\] The Company Act, 1956
Corporate Governance under the new Company Act, 2013 has broadened its meaning and scope. It includes among other things a complete module for fixing the liability on the corporate entity. It is perspective to the companies rather than the nature. The major provisions relating to the Corporate Governance introduced in the new Company Law can be broadly grouped into eight groups namely:

- Increased reporting standards.
- Higher auditing accountability.
- Risk management.
- Emphasis on investors protection.
- Composition of director’s board members and their responsibilities.
- Board committees.
- Inclusive Corporate Social Responsibility.
- Compulsory whistle-blower mechanism.

2. The Securities Contracts (Regulation) Act, 1956: It covers all types of government tradable paper, shares, stocks, bonds, debentures, and other forms of company-issued marketable securities. The SCRA defines stock exchange behaviour parameters as well as its powers.

3. The Securities and Exchange Board of India Act, 1992: This act set up the independent regulatory authority on the capital market, SEBI, with the objective of protecting investors’ securities interests and promoting and regulating the securities market. In 1995 and 1999, this act was amended twice to clarify the ‘disclosure’ standards and further empower SEBI to protect investor interest and develop a secure stock market.

4. The National Depositaries Act, 1996: This act established depository shares and securities, creating a legal framework for securities dematerialization.

5. Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI): Section 129 of the New Companies Act inter alia provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under s 133 of the New Companies Act.

Conclusion and Suggestion

In line with the issues mentioned above, there is a greater onus upon the directors of the companies to adapt to the standards and best practices provided in various laws and guidelines. Other than the laws and norms prescribed by various institutions from time to time, the companies are also expected to act responsibly towards the society as a whole because the corporates are so huge in the current times, that they affect each and every individual citizen of the country equally. The burden on the companies is already reduced as they are made to follow a set of guidelines and they are not required to make any amends to that. It is also required that the stakeholders also participate in the decision making processes to make it a contributory job altogether.

It is evident from above that it is essential that good governance practices must be effectively implemented and enforced preferably by self-regulation and voluntary adoption of ethical code of business conduct and if necessary through relevant regulatory laws and rules framed by Government or its agencies such as SFBI, RBI. The effective implementation of good governance practices would ensure investors confidence in the corporate companies which will lead to greater investment in them ensuring their sustained growth. Thus good corporate governance would greatly benefit the companies enabling them to thrive and prosper.

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13 The Company Act, 2013
14 The Securities Contracts (Regulation) Act, 1956
15 The Securities and Exchange Board of India Act, 1992
17 Prathiksharavi, Corporate Governance in India, June, 2018, https://blog.iPLEADERS.in/corporate-governance-india/

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