PRAVEEN B MALLA

CORPORATE GOVERNANCE

HISTORY, EVOLUTION AND INDIA STORY

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History, Evolution and India Story

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Dedicated to the memory of my

Late father

M.R. Rao

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Preface

As a corporate governance researcher, I have always been on the lookout for a book that explains the concept in a very simple yet forceful way. For me, complicating simple ideas is a science and simplifying complex ideas, an art. And I prefer the latter.

This book is aimed at the novice student of corporate governance who wants to understand the basics of the concept. There are no pretensions about this book. Wherever needed, the language is allowed to lisp and at times I indulge in providing a flight to the readers' thoughts. I have written the book the way I would want to read it. I hope that the novice reader will not be let down. Some ideas are reiterated across chapters, deliberately. My agenda is very simple: the novice reader should have a fairly strong understanding of the concept by the time she completes reading the book.

Ever since the corporate form with limited liability emerged, the problems of corporate governance made their way into corporations. It is difficult to say precisely when this term was first coined. But both the academics and researchers concur that not before the year 1932 was corporate governance viewed seriously.

The recent proliferation in corporate governance literature has focused on ways that corporations work. The firm behavior was earlier modeled on the 'black-box' argument of the neo-classicists who asserted that firms are nothing more than production counters. All activities of the firm were so geared as to maximize profits. Finance literature has come a long way in explaining the various theories of firms and the behaviors associated with them. However, with the increasing awareness that mere economic and production-based explanations do not adequately describe the motivations for governance, researchers have focused on the behavioral side of the firm performance to justify the economic rationale of their typical behaviors.

Ronald Coase's seminal work in 1937 on the nature of the firms, where he emphasizes the importance of authority and direction that characterize the boundaries of the firm, has revolutionized the way researchers perceive firm behavior. His work gained further impetus with Alchian and Demsetz viewing the firm as a web of contractual relations. Monitoring team production could only be possible if the firm was characterized by contractual obligations. Subsequent development of agent-theoretic models, following Jensen and Meckling's seminal article "Theory of the firm: managerial behavior, agency costs and ownership structure", has focused on the behavioral motivations of individuals who run corporations.

However, the foundational argument of corporate governance as seen by the academic as well as other independent researchers can be traced back to the pioneering work of Berle and Means who observed, as early as in the 1930s, that the modern corporations having grown gigantically can separate the control over a firm from ownership. Erstwhile promoters who largely controlled and managed organizations, increasingly needed specialized skills. Professionals with the required skills were to be hired. Berle and Means' observation on the departure of the owners from the actual control of the corporations led to a renewed emphasis on the behavioral dimension of the theory of the firm.

The modern-day uproar over corporate governance problems—of insider trading, excessive executive compensation, managerial expropriation of shareholders' wealth, false reporting, accounting non-disclosures and self dealing, among others—are assumed to be related to the theory of separation of ownership and control.

Throughout the book, the connect to 'conflicts of interest' arising out of separation of ownership and control is constantly made through the different sections and chapters.

The importance and emergence of corporate governance in India is deeply influenced by the nature of relation that has existed between the corporate world on the one hand and the Indian state policies on the other. There are twin pressures exerting themselves on this relation. Between the post-Independence (post-1947) and pre-liberalization period, the 'relation' between the industry and the State was particularly susceptible to lack of accountability in terms of certain corporate governance norms. This period can be largely understood in terms of a relationship-based governance model prominently adopted in Japan and Germany. The structure of the relationship between the industry and the State did exist but it was rather flawed from the perspective of corporate governance norms.

In the post-liberalization period (post-1991), the onset of market openness brought its own set of challenges and opportunities. Though the State-industry relation has not completely abated, it appears that market-oriented governance models are able to provide important insights into the functioning of corporations. An understanding of corporate governance functioning in India thus requires incorporating insights from both the relationship-based and market-oriented models.

India is at the crossroads in terms of charting a new path of adopting a corporate governance model. It needs to take due cognizance of insights from both schools of thought and perhaps create a new balanced model for other emerging economies. Some readers may disagree with the thought that Indian corporate governance model is still at the crossroads. The recent Satyam scam has exposed the holes in the market-oriented model and historically, corporate mis-governance in India can be attributed to the existence of shades of relationship-based governance model. So none of the two predominant models can explain away the Indian context easily.

The last section closely examines and analyzes the events that have stymied the evolution of corporate governance in India, in contrast to most other studies that have dealt with the evolution of corporate governance as a post-liberalization, post-globalization phenomenon.

The relationship that existed between the industry and the State has been looked at in detail to explain my contention that corporate mis-governance has plagued Indian corporate sector right from the time of India's Independence. I argue from two different perspectives—systemic and relationship-based—to explain the reasons that created the space for corporate mis-governance. At the end, the arguments converge at a single underlying explanation: the nexus between the industry and the State has been largely responsible for the failure of the corporate governance system in the country. Readers may realize that some of the facts and figures in the India story are dated, but suffice it to say that such dated facts and figures have been deliberately used to expose the industry-State nexus. Though the latest facts and figures do not take away from the arguments, still they do not explain the nexus as strongly as the dated ones do. Since the section was designed to enlighten the reader with the evolution of the concept of corporate governance, I have taken the researcher's liberty in the use of such facts and figures.

The purpose of this book is not to discuss current and past scams. The Satyam scam happened while I was midway through my book. My well-wishers suggested that I factor in the scam while writing this book. But my concept for the book has been rather different than giving the novice readers cases on corporate scams. Such cases are best reserved for an advanced level reader and would probably be part of my next book, if I dare to write one.

Feedback from the readers to improve the book is eagerly solicited and would be highly appreciated.

Praveen B Malla

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List of Abbreviations

BIFR	Board of Industrial and Financial Reconstruction
BoD	Board of Directors
CALPERS	California Public Employees' Retirement System
CEO	Chief Executive Officer
CERC	Central Electricity Regulatory Commission
CG	Corporate Governance
CII	Confederation of Indian Industries
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
DFI	Development Financial Institution
DFID	Department for International Development
ESOP	Employee Stock Option Plan
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IMF	International Monetary Fund
IPO	Initial Public Offer
IRDA	Insurance Regulatory and Development Authority
KMBC	Kumar Mangalam Birla Committee
LIC	Life Insurance Corporation
MD	Managing Director
MIS	Management Information Systems
NFO	New Fund Offer
NGO	Non-Governmental Organization
NPA	Non-Performing Asset

OECD	Organization for Economic Co-operation and Development
PR	Public Relations
PSU	Public Sector Unit
SAIL	Steel Authority of India Limited
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SHSE	Shanghai Stock Exchange
SICA	Sick Industrial Companies Act
TCS	Tata Consultancy Services
TISCO	Tata Iron and Steel Company
TRAI	Telecom Regulatory Authority of India

Part I
Introduction

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Chapter 1

CORPORATION AND GOVERNANCE

Over the last decade and a half, corporate governance has become a central issue globally, *Why*? Modern-day business is beset with changing operating paradigms. With corporations growing larger and larger and the need for capital multiplying manifold, the need to enter foreign capital markets and access them for their capital requirements has given rise to new challenges in the governance of international business. The pre-transition era was justified by the need to protect domestic markets, but with corporations growing in gargantuan proportions, the need to open up domestic markets for the entry of foreign business became a necessity.

After the Second World War, when economies needed to be rebuilt the world over, increased cooperation amongst countries became indispensable for international movement of goods and services. Capital lying idle in some countries had to move out to lubricate the economies of other countries. This sowed the seeds for growing internationalization of business. Prior to this, protectionist regimes seldom allowed any foreign intruder into their national business scene. The growth of corporations that led to the demand for more and more capital, prodded the protectionist regimes to open up their economies and enable more foreign investment to flow into the domestic business. Control and command-based structures had to be done away with. Instead, a new form of governance structure, which was led by market-based economic systems primarily dominated by the private sector, had to be embraced. Now most governments the world over, are relinquishing State control over industry and the private sector is given incentives to accept the new challenges of globalization. This is evident from the transition efforts made by the East European and some Asian countries, including India, following the Russian reform process (perestroika) which was initiated by the change in leadership in the mid-1980s.[1]

Economies with efficient economic policies and stable political systems are a big draw amongst the investors. Countries that have opened themselves to world markets and that have good legal systems in place providing protection to investors, have attracted more capital in the process of globalization. As the demand for capital is growing in both the developed and the developing economies, the need for establishing good governance practices has gained momentum. Thus, corporate governance has become a pressing problem.

Despite the established checks and balances that protect shareholders, many a business has collapsed in the face of governance and investor confidence has been shattered. Some prominent scandals that have heated up the corporate governance discussion are Barings Bank, Enron, Adelphia, Tyco, and Parmalat. Closer home LIC-Mundhra scam as far back as in 1957, Home Trade, Ketan Parekh scandal, Securities Scam of 1992, C R Bhansali scam, debt default by Jindal Group, MESCO scam, or even as simple a governance let-down as Bombay Dyeing's failure to prevent 'creeping' acquisition of its shares by Arun Bajoria, have all lent voice against the growing corporate misdemeanors and a need to harness them.

Since this book's main purpose is to introduce you to the concept of corporate governance, it is imperative to take you through a chronological understanding of the subject. It is important to understand each of the words in *corporate governance* individually, and as we progress through the chapters, you will be exposed to a variety of terms that are woven around this concept.

CORPORATION

Origin of the Corporation

There are different versions of the exact period of the birth of the corporation. During the early Middle Age, corporations existed in the form of universities and ecclesiastical orders and were barred from making profits. While some authors believe that the early Middle Ages was the harbinger of the modern corporate form, others argue that since corporations during this period existed only to serve the society and also since economic motive that is so very ingrained in the corporation as we see today was absent, Middle Ages was certainly not the forerunner of today's corporate form.

Business history studies have been few and far between; that leaves us with scant literature to trace the exact origins of today's corporations. However, most business historians concur that not until the East India Company received a charter from Queen Elizabeth in 1600 AD to commence its trading business, was the real corporation born. Chartered corporations were semi- or quasi-governmental institutions that remained in business as long as they enjoyed the confidence of the crown. A charter was accorded to corporations by the crown with a specific purpose, especially that of bringing together individual investors in financing large-scale projects.

Prior to the formation of the East India Company, a few enterprising individuals engaged independently in trading. They would buy tea, raw silk and spices from India and sell them at a profit in their home countries. These individual traders owned their ships and deployed them in their trading business. But as business grew bigger and bigger, the need to raise more capital to shore up shipping vessels for transportation grew, necessitating individual traders to come together and form a syndicate.

A closer look at the operations of the East India Company suggests that it was truly the predecessor of the modern corporate form. It had its corporate headquarters in London at East India House which monitored its global operations in continents as diverse as Asia, Europe and North America. The Committee of Correspondence, the highest executive body within the company, headed by the Examiner of Correspondence was responsible for all the issues pertaining to policies and strategies. The day-to-day operations of the company were run by the Examiner's office along with the Corporate Secretary amongst other important functionaries.

Shareholders held quarterly meetings and one-fourth of the total number of directors were elected annually by them. Directors enjoyed a four-year term with the company and had the opportunity to rejoin the committee of directors after a one-year break.

Control was exercised by the head office at London over its territorial offices through the examination of the annual financial reports and intelligent analysis of such reports. The East India House put reporting structures and procedures in place and insisted on strict adherence to established norms. Thus in more ways than one, East India Company bears strong resemblance to today's advanced corporations. Hence, one is given to believe that the roots of the modern-day corporation lie in the incipience of the East India Company.

What is a Corporation?

Since this book focuses on corporate governance, it is important for one to understand the meaning of corporation. Throughout the book we will be discussing concepts related to the governance of corporations.

Not all forms of business organization are called corporations. Sole proprietorship, partnership and company are the best known and most widely discussed forms of businesses.

Sole Proprietorship

What comes to your mind when you see a beauty parlor, a small-sized eatery, a grocery shop or a medical shop? Most such small business ventures are funded and managed by individuals and hence the term 'sole proprietorship.'

You will observe that most businesses around you are sole proprietorships. Why? That is mainly because of the ease in obtaining a license and minimum capital requirement to set up such sole proprietorship businesses.

Sole proprietorship businesses exist as long as the business enjoys sustainable patronage and does not need huge funding requirements. Since the equity capital of this form of business is largely limited to the personal wealth of the proprietor, sole proprietorships usually tend to remain small in size.

The best thing about sole proprietorship is that business decisions can be taken at will and are subject to the business acumen of the proprietor. Nimbleness and speed are permanent features of this form of business. Should the proprietor wish to introduce a new product line or, say, serve a new market, she can do so in a jiffy. All business decisions are subject to the volition of the proprietor. There are no shareholders to convince.

Personal income and business income are one and the same in sole proprietorships. The biggest limitation of such a form of business is that it cannot grow beyond a certain point, unless the owner is enormously wealthy and is desirous of expanding his/her scope of operations.

Partnership: When two or more than two people come together to own and manage a business entity, it is called partnership. Each partner contributes towards the total capital of the business organization. Also, each partner may bring in a unique skill or expertise to the partnership firm.