



# Shareholders' rights and empowerment in India & U.S.

MASTER THESIS IN INTERNATIONAL BUSINESS LAW

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## 1. INTRODUCTION

Over the last couple of decades, business world has seen many corporate scandals and financial crisis which resulted in the fall of many large publicly traded companies in many countries. Those events acknowledge that those companies' corporate governance demonstrated serious failures of monitoring, which can be traced back to conflicts of interest on the part of board members and its auditors.<sup>1</sup> Thus, it has not been shareholders who have ruined progress of many large publicly traded companies across the globe. Yet they have borne the burden, with value of their holdings more or less wiped out in most cases of a company failure. The resulting push for legal reform has renewed the role of the shareholders in corporations as a subject of great debate.

Good corporate governance is mandatory to the efficient operation of a public held company, which helps company to create values and provide accountability and control systems. Shareholders are assigned with many important rights in corporate governance in common law countries and thus common law countries provide better investor protection as compared to civil law countries. Even though there are many legal developments taking place recently in the area of shareholders' empowerment in both common law and civil law countries, stockholders are unable to exercise their rights effectively in most real corporate scenarios. The current laws in most countries indirectly eviscerate explicit shareholder rights in most situations. Various statutory provisions and judicial decisions have the effect of blocking meaningful exercise of legitimate shareholder rights. Many believe that many of these legal rules were never intended to have such a negative effect on the exercise of shareholder rights and deserve reconsideration.

Stockholders are being the ultimate owner of a company their interests should be served with the highest priority along with company objectives and principles. In the Testimony

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<sup>1</sup> Simon Deakin and Suzanne J Konzelmann, "Corporate Governance after Enron" (2003)

from Tom Gardner, CEO of The Motley Fool Holdings, Inc., before the U.S. House Financial Services Subcommittee on April 21, 2010, he states: "we believe that shareholders will benefit most where there is a healthy balance of power between shareholders and management, overseen by the boards. At present, executives at American public corporations can all too often alter this balance of power to their benefit, and to the detriment of long-term shareholders, through their influence over the constitution of corporate boards of directors." He further states that our interest lies in promoting regulatory and legal regimes that both allow and incent boards of directors to assure that company managements make decisions that optimize the benefit to their shareholders, the owners of their businesses. I agree with him as I too believe that shareholder empowerment as a necessary mean to preserve shareholder interests over management interests.

I would like to make three major classifications of corporations in common law countries on the basis of shareholder rights & protection as (i) corporations with empowered shareholders where shareholders with much power to intervene and make their own proposals and decisions (ii) corporations with empowering shareholders where shareholders lack power to effectively suggest their own resolutions and/or their rights are not well exercised and thus needs empowerment (iii) corporations with little shareholder activism. For example, corporations in the UK where shareholders exercise comparatively greater power can be largely classified into the first category. Shareholders do not have power to intervene or their rights are restricted by far in most companies in U.S. and they can be broadly classified into the second group. Even though the situation is changing lately, shareholder activism is seldom seen in India and the corporations in India can be placed into third category. In my thesis, I would like to be more focused on shareholder rights and empowerment in category (ii) and (iii) companies and hence this thesis is more concerned to the role of shareholders in corporate governance of companies in U.S. and India.

In chapter 2, we take a focused look through shareholder rights in India, U.S. & U.K., and also a general analysis on shareholder rights in countries with English law, German civil law & French civil law origins. Chapter 3 discusses in detail about corporate governance reformations in India before and after the "Satyam scandal" which can be named as India's

Enron. The chapter also concentrates on shareholder activism as well as major roadblocks to shareholder activists. Chapter 4 focuses on the main areas in corporate governance where shareholders need to be empowered. It also discusses the major real corporate scenarios and the difficulties that shareholders face to execute their rights and the implications. Chapter 5 discusses about the potential advantages to corporate governance by empowering shareholders and chapter 6 deals with significant arguments disfavoring shareholder empowerment.

## **2. The status quo of corporate governance and shareholders rights**

The corporate governance arrangements of a company come from two sources: the corporate charter and the laws of the company's state of incorporation.<sup>2</sup> Both the sources and thus corporate governance structure can be changed with critical company decisions, for example, a merger decision. Shareholders being the ultimate owners of a public traded company, it is only right to entitle them with sufficient power which helps them to ensure that their interests are well served during the company's day to day functioning as well as while taking critical company decisions. Even though corporate laws of different jurisdictions provide shareholders various sort of rights, they are not serving the purpose in practice. Let us take a look at some of the corporate law principles and practices in common law countries - India, U.S. and U.K.

### **A brief look through shareholder rights in India:**

In India, tremendous power resides with the majority shareholder & promoters. Unlike in the United States & U.K., majority shareholder and promoters in India, rather than the Board of Directors, have the most direct influence on management of a company that can lead to suppression of minority shareholders' rights and can make an easy way to corruption.<sup>3</sup> Shareholder protection has steeply increased in the last decade with the introduction of Clause 49 of the Listing Agreement. The important rights of shareholders in India are briefly specified in the following paragraphs.

All shareholders in India have the right to participate and vote in company meetings and shareholder ballots. All matters of importance regarding a company's functioning require shareholder approval. Shareholders have a right to vote by proxy and are entitled to appoint another person as his/her proxy, irrespective of whether the proxy is a shareholder or not.<sup>4</sup> A proxy has the right to attend and vote, but cannot speak at the meeting. Shareholders can

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<sup>2</sup> Lucian Arye Bebchuk "The Case for Empowering Shareholders" (2003)

<sup>3</sup> Joshua Skolnick "India's Satyam scandal raises corporate governance concerns in Asia", February 17, 2009

<sup>4</sup> Reserve Bank of India "CORPORATE GOVERNANCE IN INDIA: CURRENT STATUS & RECOMMENDATIONS", April 2001

approach Company Law Board (CLB), the courts or SEBI for redress when their legal rights are violated. The minority shareholders can apply to CLB for redress against oppression and mismanagement, subject to the minimum requirement of not less than one hundred members or 1/10<sup>th</sup> of the total number of members whichever is less, or any member/s holding not less than 1/10<sup>th</sup> of the issued share capital.<sup>5</sup> The Companies Act requires all shares and all share transfers to be registered and the registers must be available for public scrutiny.

The Companies Act, 1956 (as amended by the Companies (Amendment) Act, 1999), India, mandates companies to have an annual general meeting of their shareholders. The notice of the AGM has to be posted to all shareholders 21 days prior to the meeting, containing the company's reports and accounts, the agenda, all resolutions that are to be discussed in the meeting and a proxy form. Shareholders accounting for at least 1/10<sup>th</sup> of the paid-up share capital have the right to call an extraordinary general meeting. If the request is supported by reason and signatures, it is incumbent upon the board to announce such a meeting and hold it within 45 days.

Ordinary resolutions such as election and removal of directors, appointment of external auditors, remuneration of directors, payment of dividend, approval of annual accounts and the routine matters relating to the conduct of a company are passed with the approval of more than 50 per cent of the shareholders present and voting. Special resolutions such as buy-back of shares, proposed merger or de-merger, changing the name of the company, altering the memorandum and articles of association or the registered address of the company from one state to another, voluntary winding up of the company and similar decisions require special resolutions with the approval of 75 per cent of those present and voting.

With respect to disclosure and transparency, shareholders have a right to receive copies of balance sheet and auditors' report. The balance sheet and profit and loss account should give true and fair view of the state of affairs of the company. Under the provisions of the Listing Agreement, all listed companies are required to make detailed disclosures.<sup>6</sup> The

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<sup>5</sup> The World Bank Group, "Corporate Governance Assessment And ROSC Module"

<sup>6</sup> Reserve Bank of India "CORPORATE GOVERNANCE IN INDIA: CURRENT STATUS & RECOMMENDATIONS", April 2001

companies are bound by law to make timely disclosure of material and price sensitive information including events having an effect on the performance of the company to the regulators as well as to every stock exchange where they are listed.

There are special legislative measures included in Indian company law to serve minority shareholders interest. Minority shareholders with qualified minority may initiate action against decisions of the majority in a court of law. According to section 399 of the Companies Act, 1956, a qualified minority consists of at least one hundred shareholders or one tenth of the total number of shareholders, whichever is less, or any shareholder(s) holding one-tenth of the issued share capital of the company fully paid-up. Moreover, minority shareholders who hold more than 25% of the shares will have the ability to obstruct special resolutions, seek intervention of the Company Law Tribunal (CLT) and, therefore, impede the functioning of the company at some level. The Indian company law protects minority shareholders' interest by providing an adequate platform at CLT to raise grievances in case of oppression or mismanagement by the majority shareholders of a company. It is important for corporations to ensure that board membership reflects the interest of minority shareholders. In this regard, the Independent Directors (IDs) have an important role to play in ensuring minority shareholders' interests are protected.<sup>7</sup> The IDs also need to be easily accessible for minority shareholders to convey or raise their concerns. Minority shareholders can also nominate candidates for the ID position.

As we see above, shareholders in India are equipped with necessary rights by law. Still the rights are not really executed, in other words, shareholder activism is minimal in India so far. The major task for the Indian corporate sector is that to discipline the dominant shareholder & promoters and protecting the minority shareholders. I explain these issues in detail in the chapter 3.

### **A brief look through shareholder rights in U.S.:**

Shareholders in U.S. face many obstacles on their way in order effectively execute their current rights. In the following sections, we will see the main rights that are assigned to shareholders under current corporate governance rules. Lucian Arye Bebchuk, School of

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<sup>7</sup> Reserve Bank of India "CORPORATE GOVERNANCE IN INDIA: CURRENT STATUS & RECOMMENDATIONS", April 2001

Law, Harvard University has given deep thoughts about shareholder empowerment in U.S. and his recent publications have been an important source for this section.

A central and well-settled principle of U.S. corporate law is that all major corporate decisions require a decision, or at least initiation, by the board.<sup>8</sup> Unlike other common law countries like U.K.<sup>9</sup> or India, shareholders may not initiate any such decisions, and they can change the course of the corporation only by replacing the board with a new board that will do so.<sup>10</sup> Thus U.S. companies are far from being an inherent corollary of the modern, large corporation.<sup>11</sup>

The basic and long standing principle of U.S. corporate law is that the power to manage the corporation is conferred on the board of directors.<sup>12</sup> Bebchuk also reminds us that the board's power is not only limited to the daily operation of the corporation, but board also has significant power over important corporate transactions. In addition to the rules that produce dispersed ownership, another set of rules, that are denying shareholders the power to intervene, make U.S. shareholders further weak. Bebchuk from Harvard Law Review Forum claims that even with the existing patterns of ownership, introducing shareholder power to intervene would considerably change the balance of power between management and shareholders and thereby have profound and largely beneficial impact on corporate governance. In general, shareholders have the power to reject a termination resolution put forward by the Board, as it commonly require an approval with vote by a majority of the outstanding shares. So, the power that shareholders have is only a veto power and they still lack the power to initiate a termination transaction.

With reference to Delaware General Corporation Law, the first step in a merger or consolidation transaction must be the approval of a merger agreement by the board. After such approval, the merger agreement is brought to a vote of the stockholders at an annual or special meeting and must receive approval by a majority of the outstanding stock.<sup>13</sup> Similar rules are applied for liquidation decisions as well as decisions to sell all corporate

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<sup>8</sup> Bebchuk, Lucian Arye, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>9</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>10</sup> Clark, Robert C., Corporate Law, 1986.

<sup>11</sup> Bebchuk, Lucian Arye, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>12</sup> Lucian Arye Bebchuk, Harvard Law Review Forum "The case for increasing shareholder power" (2005)

<sup>13</sup> Delaware General Corporation Law, TITLE 8, Chapter 1 §251(a), (b)

assets under Delaware law. In fact, the Delaware code specifically authorizes the board to abandon a merger or a proposed sale of assets that received prior approval from the shareholders.<sup>14</sup> Bebchuk learns that's under Delaware law and the law of other U.S. states, the power to declare dividends is granted exclusively to the board, and no shareholder approval is required.

Shareholders have the power to veto fundamental changes rather than the power to direct that they be made.<sup>15</sup> As we have seen the fundamental rules governing company winding up transactions, the rules controlling company charter amendments are very similar. Majority of outstanding stockholders votes are required to take effect any corporate amendment decision, but again only company board can initiate such proposals and bring them to vote. Stockholders are incapable of making such a proposal and bring it to vote<sup>16</sup> without management interest. Bebchuk, in his research paper in December 2004, depicts that "As for the state of incorporation, no state statute explicitly sets forth a procedure for reincorporating in other states. Reincorporation is generally accomplished by merging the corporation into a shell corporation incorporated in the desired new state of incorporation. Since state statutes allow for merger with a corporation incorporated in another state, it is possible to create a company that is identical in every respect but is simply incorporated elsewhere. As reincorporating takes procedurally the form of a merger, the rules governing merger decisions apply." Thus, Bebchuk acknowledges that under Delaware law, reincorporation requires a shareholder vote of approval, but again only the board can initiate such a vote.

It is worth noting that, under current corporate governance rules in the U.S., shareholders have the concurrent authority with the board to amend the company's by-laws.<sup>17</sup> The by-laws, however, are subordinate to the charter and cannot alter any of the arrangements set in the charter.<sup>18</sup> Bebchuk leaves an interesting thought that while shareholders have power to intervene in second-order rules, they are denied the power to intervene in high-level rules.

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<sup>14</sup> Delaware General Corporation Law, TITLE 8, Chapter 1 §271 (b)

<sup>15</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>16</sup> Delaware General Corporation Law, § 242(b); New York Business Corporation Law § 803 Authorization of amendment or change (a)

<sup>17</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>18</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

Under most state laws the default standard for uncontested director elections is a plurality vote, which means that a director is elected in an uncontested situation even if a majority of the shares are withheld from the nominee.<sup>19</sup> Since 2006 some companies have volunteered to adopt majority voting standards, but in many cases they have only done so when pressured by shareowners forced to spend tremendous amounts of time and money on company-by-company campaigns to advance majority voting.<sup>20</sup> Another reality is that shareholders very often unable to vote to replace directors immediately. This would be possible only in those companies in which shareholders have the power to call a special meeting or act by written consent and in which the board is not staggered.<sup>21</sup> When shareholders do not have such power or are not allowed to act by written consent as in most U.S. companies, they will have to wait at least until the forthcoming annual general meeting and, in case of staggered boards, at least until the next two annual meetings, which could be two years down the road. One can imagine that how disastrous a company can get to with two years of mismanagement. Lucian Arye Bebchuk finds that indeed most U.S. companies have charters that would force shareholders to wait a significant period of time before they can vote management out.

In practice, under the traditional U.S. regulatory framework, the ability of shareholders to propose nominees to the board is severely constrained. There are several reasons why sitting directors can easily coagulate enough consensuses to obtain the election of either themselves or their favorite candidates over candidates advanced by shareholders.<sup>22</sup> Directors send out proxies using corporate resources and information. Shareholders cannot easily piggyback on the proxy solicitation conducted by the corporation because, pursuant to federal law, directors can exclude shareholders' proposals concerning the election of directors from the corporate proxies. Adding nominees to the slot of candidates advanced by the board of directors is considered a matter regarding directors' election, and therefore shareholders can be denied access to corporate proxies in this regard. On the other hand,

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<sup>19</sup> Gregory W. Smith, COLORADO PERA, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>20</sup> Gregory W. Smith, COLORADO PERA "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>21</sup> Lucian Arye Bebchuk, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>22</sup> Marco Ventoruzzo, "Empowering Shareholders in Directors' Elections: A Revolution in the Making", February 24, 2010

shareholders could independently solicit their own proxies, but this is unlikely to happen because proxy solicitation can be extremely expensive (also in terms of potential liability for misstatements in the proxy documents). In addition, the corporation is not mandated to reimburse proxy expenses, even in case of complete or partial victory of the dissenting shareholders. On top of that, shareholders might face other procedural obstacles in their proxy fight, such as obtaining an updated lodger of shareholders of record in a timely manner.

Thus we can see that shareholders of U.S. companies either do not have enough power to effectively involve in corporate transactions or unable to exercise their rights efficiently. I shall discuss in detail about these concerns in the chapter 4.

#### **A brief look through shareholder rights in U.K.:**

U.K. law provides shareholders with better power than U.S. law<sup>23</sup> and Indian law, in particular, provides them with power to intervene in company operation. The default arrangement, which is provided by model provisions of the article of association supplied by the Companies Act, prescribes that the business of the company shall be managed by the directors.<sup>24</sup> This management, by the board, however, is subject to “any directions given by special resolution” of the shareholders. According to the Companies Act, shareholders always have the residual right to adopt through a special resolution any change in the articles of association and any corporate decision. A special resolution requires a majority of 75%, but this is a majority of 75% of the votes cast at the meeting rather than that all the voted that shareholders are entitled to cast.<sup>25</sup>

Shareholders have a common law right to propose resolutions at an annual shareholder meeting. Shareholders wishing to exercise this right are only required to give notice to shareholders of such proposals and to bear the cost of notice. Furthermore, the directors are required to call a general meeting once the company has received requests to do so from shareholders representing at least 5% paid up voting share capital. The threshold has been reduced from 10%.

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<sup>23</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>24</sup> Lucian Arye Bebchuk, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>25</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

Shareholders have got right to request the company to include an item in the business of the annual general meeting. As is the case for resolutions requested by shareholders, the company pays the expense of circulation of the agenda item if the request is received before the end of the financial year preceding the meeting. If the request is received after the end of the financial year, the expenses are borne by the shareholder.

Thus, we see that shareholders in U.K. are better protected and furthermore the UK Stewardship Code issued by the Financial Reporting Council (FRC), UK aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.<sup>26</sup>

### **An analysis on shareholder rights in common law & civil law countries:**

The analysis begins by considering shareholder rights under company laws. Because shareholders exercise their power by voting for directors, evaluations of shareholder rights focus on voting rights. These include voting rights attached to shares, rights that protect the voting mechanism against interference by insiders, and remedial rights. Investors may be better protected when dividend rights are tightly linked to voting rights, that is, when companies are subject to one-share-one-vote rules. The idea is that when votes are tied to dividends, insiders cannot appropriate cash flows by maintaining voting control despite controlling only a small proportion of the company's shares.<sup>27</sup>

Five other rights essentially describe how easy it is for shareholders to exercise their voting rights. These rights measure how strongly the legal system favors shareholders relative to managers in the voting process. The below interesting findings are based on the publication by the World bank Group.

- To vote in shareholders meetings in some countries, shareholders must show up in person or send an authorized representative. In other countries, by contrast, they can vote by mail, which makes it easier for them to cast their votes. In Japan, for example, about 80 percent of companies hold their annual meetings the same week, and voting by mail is not allowed.

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<sup>26</sup> Bob Tricker and Chris Mallin, "Corporate Governance", July 6, 2010

<sup>27</sup> Rafael La Porta, Florencio Lópezde-Silanes, Andrei Shleifer, and Robert Vishny, The World bank Group, "Which Countries Give Investors the Best Protection?"

- In some countries, the law requires that shareholders deposit their shares with the company or a financial intermediary several days before a shareholders' meeting. This practice prevents shareholders from selling their shares for several days around the time of the meeting and keeps shareholders who do not bother to go through this exercise from voting.
- Some countries allow cumulative voting for directors, which in principle gives minority shareholders more power to put their representatives on boards of directors.
- In some countries, the law provides minority shareholders with legal recourse against perceived oppression by directors. The mechanisms may include the right to sue directors (as in American derivative suits) or to force the company to purchase the shares of shareholders who object to such fundamental changes as mergers or asset sales.
- Company law also establishes the percentage of share capital needed to call an extraordinary shareholders meeting—the higher the percentage, the harder it is for minority shareholders to organize a meeting.

Two major facts emerge from the analysis of shareholder rights in the countries in the sample.<sup>28</sup> First, countries with a common law system afford comparatively the best legal protection to shareholders. They most frequently allow shareholders to vote by mail, they never block the sale of shares for shareholders meetings, they have the highest incidence of laws protecting oppressed minorities, and they generally require a relatively small percentage of shares to call an extraordinary shareholders meeting. Second, countries with French civil law origin afford the worst legal protection to shareholders. They have the lowest incidence of allowing voting by mail, a high incidence of blocking share sales for shareholders meetings, and a low incidence of laws protecting oppressed minorities, and require the highest percentage of share capital to call an extraordinary shareholders meeting.

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<sup>28</sup> Rafael La Porta, Florencio Lópezde-Silanes, Andrei Shleifer, and Robert Vishny, The World bank Group, "Which Countries Give Investors the Best Protection?"

In Australia and South Africa, two common law countries, a minority shareholder can vote by mail, can trade his/her shares during a shareholders meeting, is protected from certain expropriations by directors, and needs only 5 percent of share capital to call an extraordinary meeting. By contrast, in Italy and Belgium, whose legal systems are based on French civil law, a minority shareholder cannot vote by mail, cannot trade his shares during shareholders meeting, is not protected from expropriation by directors, and needs 20 percent of share capital to call an extraordinary meeting.

### **3. Corporate governance and shareholders activism in India: An inside look**

Corporate governance in a developing country setting takes on additional importance. Good corporate governance is vital because of its role in attracting foreign investment. The extent of foreign investment, in turn, shapes the prospects for economic growth for many developing countries. This chapter discusses about corporate governance reformations in India before and after the "Satyam scandal". The chapter also focuses on shareholder activism as well as major roadblocks to shareholder activists.

#### **Corporate governance movements in India:**

The historical development of Indian corporate laws has been marked by many interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product. The 1956 Companies Act built the functioning of joint-stock companies and protection of investors' rights. While the Companies Act has always provided an excellent framework, and clear instructions for maintaining and updating share registers, in reality minority shareholders had often suffered from irregularities in share transfers and registrations. Because of a vast majority of Indian corporate companies are controlled by promoters and families who while owning a significant proportion of share capital, rule them as if they are their personnel freedom; a kind of self regulation. Sometimes non-voting preferential shares had been used by promoters to channel funds and expropriate minority shareholders. There were cases in which the rights of minority shareholders had been compromised by management's private deals in the relatively infrequent event of corporate takeovers.

Company Boards had often been largely ineffective in their monitoring role, and their independence had been perceived as highly questionable.<sup>29</sup>

In Indian context, the need for good corporate governance has been highlighted because of the series of scams that had become an annual feature ever since the government liberalized the economy in 1991. The series of important scams which includes Harshad Mehta scam, Ketan Parikh scam, the UTI scam, Vanishing companies scam, Bhansali scam and so on shook investor confidence. The real history of Indian corporate governance started in the year 1992 following efforts made in many countries of the world to put in place a system suggested by the Cadbury Committee, United Kingdom<sup>30</sup>. Thus important developments have shown in the field of corporate governance and investor protection in India through the establishment of Securities and Exchange Board of India (SEBI) in 1992. Also, the existence of voluntary code framed by the Confederation of Indian Industry (CII) in 1997 had a great impact on Indian corporate governance. In the next three years, almost 30 large listed companies accounting for over 25 percent of India's market capitalization voluntarily adopted the CII code. By 1999 the SEBI set up a committee headed by Kumar Mangalam Birla to mandate international standards of corporate governance for listed companies. Three years later the Naresh Chandra committee gave governance more thought. From 2001 over 140 listed companies accounting for almost 80 per cent of market capitalization started following the mandatory international standards and from 2003 each and every listed companies joined the SEBI code. The SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 of the Listing Agreements. In 2004, the Narayana Murthy<sup>31</sup> committee affected changes to clause 49 of the listing agreement. Clause 49 may well be viewed as a milestone in the evolution of corporate governance practices in India. It is similar in spirit and in scope to the Sarbanes-Oxley<sup>32</sup> measures in the United States. The key mandatory features of Clause 49 regulations

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<sup>29</sup> Omkar Goswami, "Corporate Governance in India," 2002.

<sup>30</sup> Cadbury Report, titled Financial Aspects of Corporate Governance, is a report of a committee chaired by Adrian Cadbury that sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures.

<sup>31</sup> Narayan Murthy has been the Chairman of Infosys, a company that built its success on a widely held ownership structure rather than the traditional family-controlled Indian model; and he has led key corporate governance initiatives in India

<sup>32</sup> United States federal law that set new or enhanced standards for all U.S public company boards, management and public accounting firms.

deal with the following:<sup>33</sup> (i) composition of the board of directors; (ii) the composition and functioning of the audit committee; (iii) governance and disclosures regarding subsidiary companies; (iv) disclosures by the company; (v) CEO/CFO certification of financial results; (vi) reporting on corporate governance as part of the annual report; and (vii) certification of compliance of a company with the provisions of Clause 49. The composition and proper functioning of the board of directors emerges as the key area of focus for Clause 49. It stipulates that the board of a company must have an optimum combination of executive and non-executive directors with not less than fifty percent of the board comprising the non-executive directors. The number of independent directors would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise of independent directors and in case a company has an executive chairman, at least half of board should be independent. The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a Management Discussion and Analysis section in the annual report discussing general business conditions and outlook; and (vii) background and committee memberships of new directors as well as presentations to analysts. In addition, a board committee with a non-executive chair is required to address shareholder or investor grievances. Finally, it is mandated that the process of share transfer (that had been a long-standing problem in India be expedited by delegating authority to an officer or committee or to the registrar and share transfer agents.<sup>34</sup>

Although Clause 49 mandates many of these improvements, Indian companies were voluntarily improving corporate governance, through the emergence of globalization which served as the impetus for adoption of corporate governance best practices. The motivation behind this is that every Indian company is in, a) need to access foreign capital either through listing on a foreign stock exchange such as the LSE, NYSE or NASDAQ or by attracting private equity, foreign institutional investors or joint venture partnerships, b)

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<sup>33</sup> A C Fernando, corporate governance-principles, policies and practices

<sup>34</sup> Corporate Governance in India by R. Chakrabarti , W. Megginson, P. Yadav.

need to become a reputable company to export globally, and c) desire to become multinational companies.<sup>35</sup>

### **Ownership and financial Structure of Indian corporate enterprises**

Indian corporate sector is characterized by the co-existence of state owned, private and multinational enterprises. The shares of these enterprises are held by institutional as well as small investors. But this is not the case in public sector enterprises where the government is the promoter and owner of such enterprises. The findings indicate the presence of highly concentrated ownership structure in the Indian corporate firms. Family-run business groups clearly play a crucial role in the Indian corporate sector. About 60% of these companies (comprising about 65% of the total market capitalization of the Exchange), are part of these business groups. The actual ownership within these companies is far from being completely transparent with widespread pyramiding, crossholding, and the use of non-public trusts and private companies for owning shares in group companies. About 11% of companies comprising about 22% of the market capitalization are companies wholly or significantly owned by the Central (Federal) or State Governments; about 20% of companies comprising about 8% of the market capitalization are non-Group companies controlled by Indian promoters; and about 9% of companies comprising about 5% of the market capitalization are non-Group companies controlled by foreign promoters. Even in 2002, the average shareholding of promoters in Indian companies was as high as 48.1% and for the 500 largest Indian companies, based on data from Prowess which is a database of the financial performance of Indian companies, promoters own about 53% of the shareholding. Evidence from BSE-200 Index companies shows relatively few companies in India are widely held with no significant single-promoter control.<sup>36</sup> Thus it clearly confirms the belief that the Indian companies are dominated by families and promoter's stakes though the situation is slightly changing.

Also the financial structure of the company, that is, proportion between debt and equity, has implications for the quality of governance. Recent research has shown contrary to the

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<sup>35</sup> Corporate Governance in India- IIF equity advisory group, 2006

<sup>36</sup> Petia Topalova, 2004. "Overview of the Indian Corporate Sector: 1989-2002."

Modigliani-Miller hypothesis that the financial structure of the firm has no relationship to the value of a firm, that the financial structure does matter, it is no secret that the lenders exercise significant influence on the way a company is managed and controlled. Banks can perform the important function of screening and monitoring companies as the banks are better informed than other investors. Further, banks can diminish short-term biases in managerial decision-making by favoring investments that would generate higher benefits in the long run. Banks play a more favorable role than other investors in reducing the costs of financial distress.<sup>37</sup>

### **Reformation in Indian Corporate Governance:**

If we consider why the corporate governance has become a popular subject of debate in developing countries, we could realize that it is the impact of globalization. Corporate governance represents the value framework, the ethical frame work and the moral frame work under which business decisions are taken. The investors want to be sure that not only their capital handles effectively, but also the business decisions are to be taken in a manner which is not illegal or involving moral hazard.

India's corporate reform efforts were initiated by corporate industry groups, many of which were instrumental in advocating for and drafting corporate governance guidelines. The first phase of India's corporate governance reforms were aimed at —making boards and audit committees more independent, powerful and focused monitors of management as well as aiding shareholders, including institutional and foreign investors, in monitoring management. These reforms were proceeded through the great effort of Securities and Exchange Board of India (SEBI). SEBI constituted two committees to revise the Clause 49 listing agreements and to review the progress of the corporate sector and to determine the role of present companies. Moreover SEBI encouraged the credit rating agencies -CRISIL<sup>38</sup> and ICRA<sup>39</sup> - to evolve a suitable corporate governance index as a measure of wealth creation by the corporates. Some of the companies have been rated against the index. The

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<sup>37</sup> Hema Latha, Corporate governance in Indian Scenario ,2010

<sup>38</sup> Crisil is India's first and largest credit rating agency in the country's debt rating services market and was established in 1987.

<sup>39</sup> Incorporated in 1991 by a consortium of financial institutions and commercial banks, ICRA is the second largest credit rating agency in India after CRISIL

revised listing agreement provided for the following major aspects of corporate governance.<sup>40</sup>

- Changes have been made to the definition of 'independent directors'; strengthening the responsibilities of audit committee; improving the quality of financial disclosures and finally; the board as a whole has been tasked with the adoption of a formal code of conduct for senior management and the certification of financial statements issued by the CEO. Accordingly companies are now required to constitute various committees like a 'nomination committee', 'compensation committee', 'governance committee' and other committees to adhere to corporate governance.
- The Indian law requires the nomination committee of the board to be composed entirely of independent directors, who will be responsible for the evaluation and nomination of board members. In India, the responsibilities of 'audit committee' include scrutiny of the company's annual audited financial statements, appointment of external auditors, interacting with internal auditors and issues relating to internal controls existing in the company.
- The committee also recommended to improve the role of the chairman of the board. The role of Chairman is to ensure that the board meetings are conducted in a manner which secures the effective participation of all directors, executive and non-executive alike, and encourages all to make an effective contribution, maintain a balance of power in the board, make certain that all directors receive adequate information, well in time and that the executive directors look beyond their executive duties and accept full share of the responsibilities of governance.
- The board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment. All remuneration package of all the directors i.e. salary, benefits, bonuses, stock options, pension etc. has to be disclosed to shareholders.
- With regard to the shareholder rights, half-yearly declaration of financial performance including summary of the significant events in last six-months, should

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<sup>40</sup> Dr.R.Maria Inigo, CORPORATE GOVERNANCE IN LISTED COMPANIES IN INDIA, 2010

be sent to each household of shareholders. A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. The Committee believes that the formation of such a committee will help focus the attention of the company on shareholders' grievances and sensitise the management to redressal of their grievances. To expedite the process of share transfers the board of the company should delegate the power of share transfer to an officer, or a committee or to the registrar and share transfer agents. The delegated authority should attend to share transfer formalities at least once in a fortnight.

- The institutional shareholders has to take active interest in the composition of the Board of Directors, be vigilant, maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of management, ensure that voting intentions are translated into practice and evaluate the corporate governance performance of the company.

#### **Corporate Governance reformation after Satyam scam:**

Satyam Computers services limited was a consulting and an Information Technology (IT) services company founded by Mr. Ramalingam Raju in 1988. It was India's fourth largest company in India's IT industry, offering a variety of IT services to many types of businesses. Its networks spanned from 46 countries, across 6 continents and employing over 20,000 IT professionals. On 7<sup>th</sup> January 2009, Satyam scandal was publicly announced & Mr. Ramalingam confessed and notified SEBI of having falsified the account.<sup>41</sup> India's corporate community experienced a significant shock with the damaging revelations about the board failure and colossal fraud in the financials of Satyam. It is to be considered that, the period after Satyam Scandal is the second phase of reform in Indian Corporate Governance.

In September 2008 the World Council for Corporate Governance honored the now-beleaguered Indian outsourcer Satyam with a "Golden Peacock Award" for global excellence in corporate governance. With its honoree now engulfed in scandal, the Council rushed to

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<sup>41</sup> Satyam case study by Sanket Mistry, <http://www.scribd.com/doc/50938044/satyam-case-study>

distance itself from the troubled company by rescinding the award, issuing a press release through the India-based Institute of Directors stating “the award was obtained as a result of non-disclosure of material facts.” In the historic confession letter of former chairman of Satyam, B. Ramalinga Raju, admitted a fraud of Rs 78 billion (USD 1.6 billion) that has caused the regulators and the investors everywhere to re-examine the corporate governance standards. Raju confessed that Satyam’s balance sheet of 30 September 2008 contained:

- Inflated figures for cash and bank balances of Rs 5,040 crores (US\$ 1.04 billion) [as against Rs 5,361 crores (US\$ 1.1 billion) reflected in the books].
- An accrued interest of Rs. 376 crores (US\$ 77.46 million) which was non-existent.
- An understated liability of Rs. 1,230 crores (US\$ 253.38 million) on account of funds which were arranged by himself.
- An overstated debtors’ position of Rs. 490 crores (US\$ 100.94 million) [as against Rs. 2,651 crores (US\$ 546.11 million) in the books].<sup>42</sup>

The scandal all came to light with a successful effort on the part of investor’s to prevent an attempt by the company promoters to use the firm’s cash reserves to buy two companies owned by them i.e. Maytas Properties and Maytas Infra. As a result, this aborted an attempt of expansion on Satyam’s part, which in turn led to a collapse in price of company’s stock following with a shocking confession by Raju. The truth was its’ promoters had decided to inflate the revenue and profit figures of Satyam thereby manipulating their balance sheet consisting non-existent assets, cash reserves and liabilities.<sup>43</sup>

Thus the Satyam scandal served as a catalyst for the Indian government to rethink the corporate governance, disclosure, accountability and enforcement mechanisms in place and also has reiterated the importance of checks on related party transactions. As described below, Indian regulators and industry groups have advocated for a number of corporate governance reforms to address some of the concerns raised by the Satyam scandal. Shortly after news about the scandal broke out, the CII (Confederation of Indian Industry) began examining the corporate governance issues arising out of the Satyam scandal. Other industry groups also formed corporate governance and ethics committees to study the

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<sup>42</sup> <http://www.scribd.com/doc/50938044/satyam-case-study>

<sup>43</sup> <http://www.scribd.com/doc/50938044/satyam-case-study>

impact and lessons of the scandal. In late 2009, a CII task force put forth corporate governance reform recommendations. In its report, the CII emphasized the unique nature of the Satyam scandal, noting that —Satyam is a one-off incident. In addition to the CII, the National Association of Software and Services Companies (NASSCOM, self-described as —the premier trade body and the chamber of commerce of the IT-BPO industries in India) also formed a Corporate Governance and Ethics Committee, chaired by N. R. Narayana Murthy, one of the founders of Infosys Limited and a leading figure in Indian corporate governance reforms. The Committee issued its recommendations in mid-2010, focusing on stakeholders in the company. The report emphasizes recommendations related to the audit committee and a whistleblower policy. The report also addresses improving shareholder rights. The Institute of Company Secretaries of India (ICSI) has also put forth a series of corporate governance recommendations.<sup>44</sup>

Satyam prompted quick action by both SEBI and the MCA (Ministry Company Affairs). In September 2009 the SEBI Committee on Disclosure and Accounting Standards issued a discussion paper that considered proposals for:<sup>45</sup>

- Appointment of the chief financial officer (CFO) by the audit committee after assessing the qualifications, experience and background of the candidate;
- Rotation of audit partners every five years;
- Voluntary adoption of International Financial Reporting Standards (IFRS);
- Interim disclosure of balance sheets (audited figures of major heads) on a half-yearly basis;
- Streamlining of timelines for submission of various financial statements by listed entities as required under the Listing Agreement.

In early 2010, SEBI amended the Listing Agreement to add provisions related to the appointment of the CFO by the audit committee and other matters related to financial disclosures. However, other proposals such as rotation of audit partners were not included in the amendment of the Listing Agreement. Inspired by industry recommendations,

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<sup>44</sup> APARNA SHARMA, *Legal Framework and Corporate Governance: An Indian Perspective*, 2012

<sup>45</sup> *The Economic times*, 2010

including the influential CII recommendations, in late 2009, the MCA released a set of voluntary guidelines for corporate governance. The Voluntary Guidelines address a myriad of corporate governance matters including independence of the boards of directors; responsibilities of the board, the audit committee, auditors, secretarial audits; and mechanisms to encourage and protect whistle blowing. Important provisions include:

- Issuance of a formal appointment letter to directors
- Separation of the office of chairman and the CEO
- Limiting the number of companies in which an individual can become a director simultaneously
- Tenure and remuneration of directors
- Training of directors
- Performance evaluation of directors
- Additional provisions for statutory auditors
- Institution of a nomination committee for selection of directors

With the clear evidence from Satyam scandal, it cannot be denied that the Satyam episode was a stark failure of the code of Corporate Governance in India. Just as the United States needed the Enron Scandal to clean up its act, perhaps India needed the Satyam fiasco to introduce sweeping changes in its own corporate governance including financial reporting system and to strengthen shareholder activism.

### **Evolution of Institutional Investors**

India's financial market began its transformation path in the early 1990s. The Securities and Exchange Board of India (SEBI) was established in 1992 with a mandate to protect investors and usher improvements into the microstructure of capital markets. Competition in the financial market increased with establishment of the National Stock Exchange (NSE) in 1994 leading to a significant rise in the volume of transactions and to the emergence of new important instrument in financial intermediation. In Indian capital market Institutional investment comprises government sponsored mutual funds, insurance companies, banks and development financial institutions (DFIs) that are long-term creditors, and foreign institutional investors (FII). Indian investors have been able to invest through mutual funds

since 1964. Between 1987 and 1992 public sector banks and insurance companies set up mutual funds. Since 1993, private mutual funds have been allowed which brought competition to the mutual fund industry. The notification of the SEBI in Mutual Fund Regulation of 1993 brought about a restructuring of the mutual fund history. The regulation prescribed disclosure and advertisement norms for mutual fund and it permitted the entry of private sector mutual funds. Again the 1993 regulations have been revised on the basis of the recommendations of the Mutual Funds 2000 report prepared by SEBI. The mutual funds are now required to obtain the consent of investors for any change in the fundamental attributes of a scheme on the basis of which unit holder have invested.

India opened its stock markets to foreign investors in 1992, has since 1993 received a considerable amount of portfolio investment from foreigners in the form of Foreign Institutional Investment (FII) in equities. SEBI's definition of FII presently includes foreign pension Fund, mutual fund, charitable/endowment/university funds etc. as well as asset management companies and other money managers operating on their behalf. The sources of these FII flows are varied. The FIIs registered with SEBI come from as many as 28 countries including money management companies operating in India on behalf of foreign investors. U.S. based institutions accounted for slightly over 41%, those from the U.K constitute about 20% with other Western European countries hosting another 17% of the FIIs. A significant part of these portfolio flows to India comes in the form of FII's investments, mostly in equities. Ever since the opening of the Indian equity markets to foreigners, FII investments have steadily grown from about USD 520 million in 1993 to over USD 54.4 billion till the end of Feb 2008.<sup>46</sup> Thus we could realize that institutional Investment including FII has a great impact in the corporate enterprises.

### **Shareholder activism in Indian corporate governance:**

The current corporate governance assessment for India has found that over the last few years, a series of legal and regulatory reforms have transformed the Indian Corporate Governance frame work and improved the level of responsibility of insider's fairness in the treatment of minority shareholders, board practices and transparency. The Companies Act

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<sup>46</sup> Rohan j. Meshram - role of financial institution in capitalmarket in india, 2010

1956 is the basic and fundamental statutory work for the regulation of investor protection. The SEBI set up a statutory authority in 1992, and has taken the number of initiative in the area of investor protection. The Birla committee, to promote and raise standard of corporate governance, in its report observed that the “strong corporate governance and the vibrant capital market is the important instrument for investor protection”.

However, despite the various provision in the Companies Act 1956 and the regulations issued by the SEBI regarding the protection of shareholder rights, there was various case filed by investors complaining of malpractices. This is because shareholder rights remain in paper and are not really executed. The main reason for this, shareholders are not involved in the meeting of the company and do not execute their voting rights. It is also noted that minority shareholder are often deprived of their rights because of most companies are run by families and promoters and they take active participation in the company matters as a controlling shareholders. Sometimes non-voting preferential shares had been used by promoters to channel funds and expropriate minority shareholders.

Institutional investor participation in India is hardly prevalent. They do not exercise their voting rights meaningfully. They usually evaluate the associated cost with exercising their voting rights and find the cost as being too high as compared to the advantage which they would accrue. So in most Indian companies institutional investors including Foreign Institutional Investor (FII) to play a monitoring role are either missing or are only marginally visible.

We could categorize the main reasons for the lack of shareholder activism as follows:<sup>47</sup>

- **Lack of active long term investors:** Most investors in India are focused on short term gains; long term investors such as pension funds and hedge funds takes 5-7 years call on companies
- **Large number of tightly controlled companies:** Promoters typically retain control of companies by owning a significant ownership stake in companies. Shares not owned or controlled by the promoter and his family and friends are widely dispersed, making it difficult for minority shareholders to voice their concerns.

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<sup>47</sup> Equity advisory Group, Corporate Governance in India: an investor perspective, 2006

- **Lack of institutional share ownership:** Although FII's increasingly own a large number of shares in Indian companies, in general, no single minority shareholder owns enough shares to significantly influence change. Although there are some government companies like LIC and UTI have significant stakes in Indian companies, they are not activist shareholders. Therefore even though there are laws that empower shareholders controlling 10 percent of equity, the dispersed nature of ownership of shares makes it difficult for minority shareholders to benefit from the low threshold levels that allow for taking a more active role in the management of the company.
- **Limited investment scope for pension/insurance companies:** Pension and insurance companies are owned by the government and constitute a large part of the Public Sector Unit (PSU) sector. The Indian government has only recently begun allowing private sector companies to engage in these activities. Moreover, the government strictly regulates the instruments in which pension funds can invest that limits the scope of investment for these potential institutional investors.
- **Weak Court System:** Courts are the ultimate justice delivery providers for minority shareholders in India. Although the laws are generally comparable to those in the United Kingdom, the court system is seen as inadequate to handle the volume of cases being brought to trial. This results in delays in the delivery of justice. Verdicts are sometimes given 10 to 20 years after the incidents occur. This is one of the main reasons that shareholder activism has not taken hold in India, as minority investors are not willing to wait decades for redress. To prevent such thing, Indian authority has to take an action to the amended Companies Act 2006 requiring the establishment of special courts to handle securities and finance related crimes.
- Also, India suffers from a **problem of too many regulations**. Investors are having little faith in the system as high cost is involved, manipulative ways are adopted by the promoters sometimes, which makes it tough for activist shareholders to survive;
- **Lack of minority Shareholder protection:** Although the legal structure for corporate governance in India provides for strong minority shareholder protection compared with other emerging markets, in practice minority share holder cannot always exercise their rights. The Companies Act together with SEBI's listing agreement

account for most of the key minority shareholder protection that are found in the IIF code. Usually the threshold for the minority shareholder can participate by calling special meeting and exercising their right is 10 percentage. Though this threshold suggested by FII Code is below than 10 per cent, in practice this threshold cannot be reached due to founder promoters' control in many companies and highly dispersed share distribution of minority shareholders.

- **Corruption:** Corruption in the lower levels of Indian bureaucracy makes the overall business environment less than attractive to investors, particularly foreign investors. It is common in India that, large shareholder, mainly the family promoters, has a great influence on Indian Government authority and they will take this advantage to establish their priorities.

But it is very important to have a look to some of the recent activities in the Indian Corporate Governance which shows that the shareholder activism has improved considerably. The need for widening the scope of shareholder democracy and rights, investor protection and information disclosure has been rightly emphasized through the enactment of New Companies Bill 2009.<sup>48</sup>

Some of the recent news shows that, Indian corporations can no longer expect shareholders to remain calm if their rights are trampled upon. Not just big institutional investors, but even minority shareholders are now turning increasingly assertive to influence corporate decision- making. Recent developments in the financial markets and in business practices suggest a growing trend in shareholder activism, wherein investors attempt to influence management and corporate practices by raising uncomfortable questions to the top management of the company. For example, the lead Indian companies like Infosys Limited, Coal India Ltd, Akzo Nobel India<sup>49</sup> and Vedanta Resources plc have run up against shareholders who are not afraid to raise their voices, even if they happen to be minority shareholders. Also, when Satyam Computer Services had decided to acquire Maytas-Infra and Maytas-Infrastructures properties for \$1.6 billion, institutional investors, though they belong to the minority shareholder category, protested against the deal and succeeded in

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<sup>48</sup> MUKUL SHARMA, Working of shareholder democracy, The Hindu .com

<sup>49</sup> Economic Times, a leading news paper of India, 2012

reversing the proposal.

The Children's Investment Fund Management (Foreign Institutional Investor, UK) has threatened to sue the company, its independent directors and the government of India unless they agree to make decisions with the interests of minority shareholders in mind, as the central government pushed the company to sign a deal with power producers, inflicting a serious threat to its financial stability. Chief among its demands is that Coal India be allowed to sell fuel at market prices, not government-set rates, which are about 70 percent to 80 percent lower than prices the company has been able to get in limited auctions. The fund also wants the company, which has 549 billion rupees (about \$10.5 billion) in cash, to substantially increase its dividend. Coal India being a public sector undertaking, this incident shows shareholder activism has been on the rise even in the public sector as well. As another case, a large chunk of minority shareholders of Akzo Nobel India (formerly known as Imperial Chemical Industries (India) Ltd.) have raised their voice either by voting against or abstained from voting as a protest to the amalgamation of three unlisted entities - Akzo Nobel Car Refinishes India Pvt Ltd, Akzo Nobel Coatings India Pvt Ltd, and Akzo Nobel Chemicals (India) Ltd. Even though Akzo Nobel managed to receive shareholder approval for the merger proposal in February 2012, 23.15 percentage of the 28.99 million valid votes polled at a court-convened shareholder meeting, were against the merger proposal.<sup>50</sup>

Also now the current issues making headlines in investor protection that, as a number of foreign firms are threatening to take the government of India to arbitration for its failure to protect their rights under Bilateral Investment Promotion and Protection Agreements (BIPPAs) and Comprehensive Economic Partnership Agreements (CEPAs). According to information posted by the finance ministry, India has signed 82 BIPPAs, of which 72 are in operation. Besides, India has signed agreements with its partners to protect foreign investment in their respective jurisdictions that are part of CEPAs. The provisions allow foreign investors to initiate dispute-settlement proceedings directly against the host state.

In conclusion, the shareholder activism will need to be seen more in India, from foreign

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<sup>50</sup> K. S Badri Narayanan, shareholder activism, 2012

investors as well as from domestic investors in the coming days if shareholders interests are not valued and good corporate governance are not practiced.

#### **4. The major areas of interest to shareholder empowerment**

In this chapter, I would like to discuss the major areas in corporate governance where shareholders need to be empowered. Shareholders are assigned many rights in corporate governance, but they are unable to exercise their rights in most real scenarios. Even though there are recent legal developments in empowering shareholders, the current law indirectly eviscerates explicit shareholder rights in most situations. Various statutory provisions and judicial decisions have the effect of blocking meaningful exercise of legitimate shareholder rights. I believe that many of these legal rules were never intended to have such a negative effect on the exercise of shareholder rights and deserve reconsideration.

Corporate governance law in many countries provides that shareholders vote to elect directors, and that they must approve certain fundamental matters, such as mergers and charter amendments. Yet shareholder rights are far more limited than this cursory description suggests. In the first place, these rights represent only default rules. They are subject to change by contractual arrangement, either in the corporate charter or otherwise. Moreover, even the default rules are subject to legal restriction in various respects. In the following paragraphs, we discuss the major real corporate scenarios and the difficulties that shareholders face to execute their rights and the implications.

## 1. Directors' election

Directors' elections are at the core of corporate governance. And while the primary powers of shareowners—aside from buying and selling their shares—are to elect and remove directors, shareowners in most countries have few tools to exercise these critical and most basic rights.<sup>51</sup> Several statutory, regulatory and contractual provisions grant sitting directors effective control over the election of new directors and indeed obstruct shareowners to exercise their voting rights effectively. As a consequence, the board of directors can become a largely self-perpetrating body and the shareholders become powerless spectators. This emasculation of the most fundamental right of shareholders would cripple the very base on which the corporate law system is founded.

CoPERA<sup>52</sup> believe that the accountability of directors is weakened at most companies where shareowners do not have a meaningful vote in director elections.<sup>53</sup> Until a recent amendment of NYSE regulation in 2009 in the U.S., effective for meetings held on or after January 1, 2010,<sup>54</sup> in uncontested directors' elections, brokers could vote uninstructed shares. Uncontested elections were considered as "routine" matters, and brokers had the discretion to vote the shares in the absence of specific instructions from the beneficial holders of the securities. In these instances, brokers would usually cast their votes according to managers' proposals. As mentioned, however, NYSE Rule 452 has been amended in 2009. Brokers' discretionary voting had two important and powerful effects on directors' elections. On the one hand, it ensured the presence of the required quorum. On the other hand, it made it easier for boards' nominees to receive a majority or a plurality of the votes, and be elected. According to the new provision, directors' elections will no longer be considered "routine" matters, even when uncontested. Consequently, from January 2010, brokers will no longer be permitted to vote in the absence of specific instructions from the stockholders. The scope of the rule is broad because it applies to all NYSE-registered brokers, independently from the market on which the corporation holding the election is

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<sup>51</sup> Marco Ventoruzzo, "Empowering Shareholders in Directors' Elections: A Revolution in the Making", February 24, 2010

<sup>52</sup> Colorado Public Employees' Retirement Association, U.S.

<sup>53</sup> Gregory W. Smith, COLORADO PERA, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>54</sup> Eric Knox, Frank Pellegrino, CORPORATE AND SECURITY LAW Alert, "Proxy Access and Shareholder Activism: What to Do Now?", July 2009

listed. This innovation will clearly make it somehow more difficult for directors to attract votes under either a plurality or a majority voting system. While institutional investors' campaigns against board nominees are likely to have more chances of success, the concrete effect of new NYSE Rule 452 is not completely clear, especially when plurality vote still applies.

As stated in the testimony From Tom Gardner, CEO of the Motley Fool Holdings, Inc., before the U.S. House Financial Services Subcommittee, one of the prevalent corporate governance practices that have failed to serve the long-term individual investor is that too many CEOs nominate directors whom they know will be unconditionally gracious in return for the social and monetary benefits of boardmanship. Despite the reforms of the Sarbanes-Oxley Act of 2002, the world of corporate boards, quite frankly, remains a clubby alliance of mutual back-scratching and groupthink, rather than serving its intended goal of democratic shareholder representation. The lack of a mandated majority voting structure in uncontested elections is largely to blame for this.<sup>55</sup> Under so-called plurality systems, uncontested directors can keep their seats so long as they receive one vote. The vast majority of director elections are uncontested, and most often the candidates are incumbent directors seeking reelection. Under plurality voting, shareholders have no easy means to reject such candidates. Plurality voting is still the standard at a little less than a third of the companies in the S&P 500.<sup>56</sup> Also, plurality voting is still very common among the smaller companies in the U.S. included in the Russell 1000 and 3000 indices. Over half (54.5 percent) of the companies in the Russell 1000, and nearly three-quarters (74.9 percent) of the companies in the Russell 3000, still use a straight plurality voting standard for director elections.<sup>57</sup>

As Notre Dame Law School professor Julian Velasco put it, "Incumbent directors are virtually immune to the effects of a shareholder vote. In most cases, it seems misleading to claim

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<sup>55</sup> The Motley Fool's Testimony on Corporate Governance and Shareholder Empowerment, April 21, 2010

<sup>56</sup> Gregory W. Smith, COLORADO PERA, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>57</sup> Testimony of Ann Yerger Executive Director Council of Institutional Investors before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs July 29, 2009

that there is any election or right to vote at all." As of late 2009, a record 93 board members failed to receive 50% of votes cast by shareholders during that fiscal year. Yet even in the face of broad shareholder opposition, not one of those 93 directors tendered his or her resignation. And let's not forget that 93 is a very small number which indicates that the balance of power is skewed so far in management's favor that shareholders are obstructed from electing their own representatives. This practice of suppressing shareholders' voices must end, which is why it should be of high priority that all uncontested directors receive majority votes to retain their board seats.

Majority voting for directors is standard practice in the United Kingdom, France, Germany and other European nations, and it is also in place at some U.S. companies. Since 2006 some companies have volunteered to adopt majority voting standards, but in many cases they have only done so when pressured by shareowners forced to spend tremendous amounts of time and money on company-by-company campaigns to advance majority voting.<sup>58</sup> Gregory W. Smith, COLORADO PERA in his testimony on April 21, 2010 states that "The international and U.S. experience indicates that majority voting is not harmful to the markets and does not result in dramatic and frequent changes to corporate boards. Plurality voting is a fundamental flaw in any corporate governance system. It is time to move the default standard to majority voting and this enable shareholders to exercise their voting rights more effectively."

## **2. Staggered Boards**

Staggered boards are particularly offensive to shareholder rights activism because of its nature itself. With a staggered board, board members are grouped into classes. Usually, there are three classes, with each class serving for a different term length than the other. Only one class comes up for election in a given year, thus assuring that it will take more than one costly proxy fight to gain a majority of the board seats. The terms of service for elected directors vary, but one-, three- and five-year terms are common.<sup>59</sup> Thus, when a company

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<sup>58</sup> Gregory W. Smith, COLORADO PERA, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>59</sup> Carl Icahn, The ICAHN report, "Absurdity of the Staggered Board", June 15, 2008

has a staggered board, only a minority of directors faces election in a given year, and it takes not only longer but harder and costlier to replace a majority of board members.

When staggered boards are in place, a majority of shareholders attempting to effect change at a company has to mount, finance and win at least two very costly proxy contests over a period of at least two years to gain a majority of the board seats. Removing a set of poorly performing directors may take multiple elections and several years, assuming it can be done at all. In a staggered board, roughly a third of directors are up for election in any given year. It therefore takes at least two years to replace a majority of the board. In cases of incompetent or corrupt leadership, staggered boards ingrain the status quo.

Staggered boards used to be common mainly because of board continuity and anti-takeover provisions - hostile acquirers have a difficult time gaining control of companies with staggered boards. Yet if majority votes are required in director elections, as mentioned above, we should question whether the deal is truly hostile. By far the most significant implication of staggered boards is prolonged tenures for directors of whom a majority of shareholders may disapprove. To this point, there are verified economic drawbacks of the staggered-board system. A Harvard University study found that "staggered boards are associated with a lower firm value" that is "economically meaningful." Yet roughly half of companies traded on major U.S. stock exchanges have staggered boards.

Companies that are already public are rushing headlong to ditch their staggered boards. According to the data provider FactSet SharkRepellent, 302 S&P 500 companies had staggered boards in 2002. Ten years later, the figure has fallen to 126<sup>60</sup>. More evidence of this comes from the Harvard Law School Shareholder Rights Project. At the same time, however, companies undertaking initial public offerings, like Angies' List and LinkedIn, are increasingly choosing to go public with staggered boards. Companies going public may believe that the staggered board is important because it creates value by insulating directors from shareholder pressure so that they can make long-term decisions. More cynically, they adopt these provisions because it prevents shareholders from having undue influence that may affect their ability to keep their management positions or pay themselves compensation.

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<sup>60</sup> STEVEN M. DAVIDOFF "The Case Against Staggered Boards" 2012.

Thus we see above see that if a company has a staggered board it is nearly impossible to change control of that company in less than two years. But as we all know, two years in the life of a poorly managed company is an eternity. To make matters worse, under Delaware's General Corporation Law which governs the majority of public companies in the U.S., directors on a staggered board can only be removed for cause unless the certificate of incorporation provides otherwise, which it never does. This is true even if a majority of the shareholders want to replace the existing board.

In many countries, for example India, the rights of shareholders to call a meeting and remove and replace directors is enclosed in the local law of the jurisdiction. This prevents the stagnation and abuse of shareholders that a staggered board can promote. In the Indian context, Sections 255 and 256 of the Companies Act, 1956 provide for an element of staggering of the board, in as much as they provide that at least two-thirds of the board should consist of directors who retire by rotation. The remaining one-third is appointed in the manner permitted by the articles of association.<sup>61</sup> Despite some shades of similarity between the Indian and U.S. position, there is one stark difference. And that is that Indian directors (whether appointed by general meeting through rotation or in the manner permitted by the articles) are all liable to be removed by the shareholders through an ordinary resolution (simple majority) at a shareholders meeting (Section 284, Companies Act, 1956). This is a significant power in the hands of Indian shareholders<sup>62</sup> that makes staggered boards an entirely ineffective defense in the context of takeovers. In the U.S. and other countries, it is time for public companies to either abandon their staggered boards or to empower shareholders to call a meeting at which the entire board can be removed and replaced by the vote of a majority of the quorum.

### **3. Voting rights on Fundamental Transactions**

As mentioned by Lucian Arye Bebchuk in his paper "The Case for Increasing Shareholder Power", the major corporate transactions can be broadly classified as below:

- (i) merge, sell all assets, or dissolve

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<sup>61</sup> IndiaCorpLaw, "A Call for Greater Shareholder Rights under U.S. Law", Thursday, May 14, 2009

<sup>62</sup> IndiaCorpLaw, "A Call for Greater Shareholder Rights under U.S. Law", Thursday, May 14, 2009

- (ii) contract the size of the company's assets by ordering a cash or in kind distribution<sup>63</sup>
- (iii) Corporate charter amendments or change the company's jurisdiction of incorporation.

With respect to fundamental transactions, such as mergers and charter amendments, shareholder voting rights are severely limited by the fact that directors largely control the voting agenda. Shareholders vote only on such matters as are submitted to them. Generally, fundamental matters must be proposed by directors first. This control allows directors to prevent shareholders from deciding on many matters that directors would rather avoid.

Shareholders may be able to get their own proposals before other shareholders, but often only in the form of a nonbinding recommendation. Shareholders may vote in favor of the directors' proposal or against it, but neither on a modified version of the proposal nor on any alternative.<sup>64</sup> Thus, directors do not need to ensure that proposals are optimal from the shareholders' perspective, but only that they are adequate to obtain majority approval.

It might seem that the shareholder right to vote on fundamental matters amounts to a veto power over objectionable transactions. In practice, however, the right does not extend so far. Shareholders generally have the right to vote on certain fundamental matters, but not others. As a result, directors often can restructure a transaction that should require shareholder approval into one that does not. Long ago, courts of equity would police such behavior for abuse by looking beyond the form of a transaction to its substance; but it is clear that they no longer will do so.<sup>65</sup> Thus, shareholders often cannot veto even fundamental transactions desired by directors.

Shareholders generally do have the right to amend the bylaws of the corporation without director approval. This is a substantial power, but there are limits to what shareholders can do in the bylaws. Bylaws are "self-imposed rules and regulations deemed expedient for convenient functioning of a corporation"; they are not a collection of substantive business decisions. In addition, the bylaws cannot be inconsistent with the law or the charter. Some

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<sup>63</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>64</sup> Julian Velasco "Taking Shareholder Rights Seriously " 2007

<sup>65</sup> Julian Velasco "Taking Shareholder Rights Seriously " 2007

insist that this means that shareholder bylaws cannot interfere with the directors' authority to manage the business and affairs of the corporation. I disagree. Nevertheless, it is difficult for shareholders to coordinate their efforts to get bylaws adopted. Even if they manage to do so, directors generally can amend the bylaws as well, and may be able to use this power to undermine or even undo any action shareholders may take. Thus, the shareholder right to amend the bylaws is not quite as significant as it may seem.

#### **4. Proxy Rules**

Recognizing the importance of the shareholder vote and the potential for abuse by directors, SEC published new regulations, commonly known as the proxy rules. These rules follow the general approach of the federal securities laws of mandating disclosure. This makes sense in the context of a contested election of directors or a transaction requiring shareholder approval because, in such circumstances, shareholders can use the information in making decisions.<sup>66</sup> However, given the uncontested nature of most elections and the plurality vote requirement, shareholders often do not have the opportunity to make any decision at all on electing directors or on fundamental transactions. Thus, disclosure is of limited value.

SEC has promulgated rules that not only regulate the procedures of proxy solicitations, but also impose certain requirements. However, despite the goal of promoting "fair corporate suffrage," the proxy rules do little to facilitate shareholder voting in uncontested elections. They provide that the company's proxy materials only must allow shareholders to vote for a candidate or to withhold their votes, but not necessarily to vote against a candidate. Moreover, the demanding requirements for proxy solicitation, which were intended to benefit shareholders, also have certain drawbacks. If anyone would like to run a proxy contest in order to replace one or more incumbent directors (or for any other reason), they would be subject to the same strict requirements. Preparing the necessary proxy materials is difficult and expensive, even before factoring in the additional costs necessary to persuade "rationally apathetic" shareholders. While directors are able to use the company's resources for a proxy solicitation, an insurgent would be required to bear the cost

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<sup>66</sup> Julian Velasco "Taking Shareholder Rights Seriously " 2007

himself/herself. The expense of a proxy contest is likely to discourage many who otherwise might consider the possibility.

In reality, overly strict requirements in proxy rules not only deter proxy contests, but they also can prevent shareholders from acting together to influence elections. In short, the proxy rules arguably have done more to exclude insurgents than they have to empower shareholders. Recognizing this problem, the SEC has been easing the restrictions on shareholder communications for some time. These reforms have improved shareholders' ability to exercise their right to vote in a meaningful manner, but formidable obstacles to shareholder cooperation remain.

Lastly, the issue of proxy access in director nominations must be addressed. When management handpicks board nominees, even through the apparent veil of an "independent" nominating committee, it muddies the intended role of corporate directors. A determined CEO can simply repeatedly re-nominate the same gracious director<sup>67</sup>. Moreover, as Warren Buffett said at last year's Berkshire Hathaway press conference, a lot of directors love the job for the money and sociability, so they aren't going to do anything that gets them kicked off that board or not invited to another board. The average "independent" Lehman director was paid more than \$360,000 in 2007 -- a sum that would ingratiate any director to those with the power to hire and fire. Without the ability to nominate their own candidates to company proxies, shareholders don't have a reasonable alternative to the CEO's personal priorities. That's why I strongly argue that shareholders must be given a legitimate and practical chance to nominate directors.

## **5. Executive pay**

Over the last decade, executive pay in the UK's largest listed companies has quadrupled, with little evidence that this is a result of improved performance or in any way connected to shareholder returns. Pay policies which do not appropriately link executive pay to company strategy and performance have an economic cost through diminished shareholder returns, weakened corporate governance and reduced confidence in the corporate sector. This calls into question whether the 'principals' (i.e. shareholders, the owners of companies) have the

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<sup>67</sup> Julian Velasco "Taking Shareholder Rights Seriously " 2007

right mechanisms and sufficient information to influence and control the ‘agents’ (directors) appointed to run the company on their behalf. Shareholders have told us that companies’ remuneration reports are complex and opaque and the existing advisory vote on executive pay does not incentivize companies to act on shareholder views.<sup>68</sup>

Government has a role to address these regulatory failures in the corporate governance framework around executive pay. This again calls for particular focus on the effectiveness of shareholder voting mechanisms. Increased voting rights will enable shareholders to approve the remuneration framework and should promote better quality engagement between the company and shareholders. There is some concern that, with emerging overseas markets, excessively strict controls on the levels of pay and bonuses could lead to the loss of talented individuals to other jurisdictions. However, there is clearly a balance to be struck between the need to address the absence of a link between pay and performance and the need to offer competitive remuneration packages to recruit and retain high quality executives in the company board.<sup>69</sup>

Corporate governance has largely been a matter for state corporation law, which has viewed the matter of executive compensation as one for the discretion of boards of directors who are supposed to exercise that discretion in light of their fiduciary duty to investors.<sup>70</sup> The person in the street sees salaries of corporate decision makers constantly increasing to a level viewed as obscene, while at the same time the corporations being managed are decreasing in value, losing money, failing in competition and eliminating productive jobs. It is not an easy piece of the economic puzzle to understand or to apologize for.<sup>71</sup>

Executive compensation should provide incentive for corporate success. That does not mean success defined by manipulation of accounting concepts to provide a short-term picture of success that lacks long-term substance. Compensation standards should also recognize that the ultimate source of funds to pay managers is the owners of the corporation, the shareholders. A dollar paid to the manager is a dollar decrease in the value

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<sup>68</sup> BIS "Shareholder votes on executive remuneration", 2012

<sup>69</sup> Executive pay: Government consults on empowering shareholders, @shoosmiths, 2012

<sup>70</sup> Testimony of Steven D. Irwin, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>71</sup> NASAA , Urges Congress to Restore Investor Confidence, 2010

of corporate assets and the balance sheet should reflect a dollar or more of corporate value added in return for the payment.

The standards have evolved through decisions rendered in cases where management simply went too far in treating the assets of shareholders, particularly public shareholders, as their own piggy banks. These had little effect on the day to day practices of corporate management which diverted substantial assets from investors to themselves by means of compensation packages that included stock options that would significantly dilute shareholder ownership.<sup>72</sup>

Although individual small shareholders have little power to influence executive compensation, except by selling their shares, institutional investors acting in concert, have the potential to provide a significant counterbalance to the compensation demands of management. Clearly, in order to affect such a counterbalance, shareholders must and should have access to full and accurate information concerning management compensation.<sup>73</sup> Steven D. Irwin also finds that far too many boards structured and approved executive compensation programs that motivated excessive risk taking and yielded outsized rewards for short term results with no attention to downside risk.

It could be that if a fair vote by shareholders on executive pay were ever allowed, a number of CEO pay proposals would be voted down.<sup>74</sup> Last year, the Dodd-Frank Wall Street Reform Act made such votes mandatory for publicly traded corporations. When Dodd-Frank was passed, many who opposed real shareholder involvement in corporate governance were not worried. They made sure that the mandatory shareholder votes on executive pay would not be binding. Even if shareholders worked their way through the complex labyrinth of corporate proxy voting and voted no, the corporate board could disregard their vote and give the CEO the pay increase anyway.<sup>75</sup>

Recently, Citigroup shareholders voted against the board proposal for a \$15 million pay package for their CEO. The vote is not binding, but you could feel the tremors throughout the executive suites on Wall Street. The Citigroup vote may be the first step in a long-

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<sup>72</sup> Testimony of Steven D. Irwin, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>73</sup> Testimony of Steven D. Irwin, "Corporate Governance and Shareholder Empowerment", April 21, 2010

<sup>74</sup> Ted Kaufman, Fmr. U.S. Senator from Delaware, "U.S. Needs Shareholders' Rights", April 2012

<sup>75</sup> Ted Kaufman, "Citigroup Should Heed Say On Pay Vote", May 2012

overdue reversal of the erosion of shareholder rights that has been going on for the past few decades.

In short, shareholders rights should be enhanced effectively to ensure that their company executives' remuneration is in alignment with the company performance.

## 5. Potential benefits of shareholders empowerment

For the system to work effectively shareholders need to have appropriate and relevant information to enable them to make a judgement on the governance practices of the companies in which they invest. They also need the rights to enable them to influence the behaviour of the board when they are not content. 'Comply or explain' therefore needs to be underpinned by an appropriate regulatory framework.<sup>76</sup>

A regime of shareholder intervention could permit shareholders to initiate and bring to a shareholder vote a proposal to (i) have a merger or consolidation with another company, (ii) sell all of the assets to a certain buyer, or (iii) dissolve the company. The initiative for a shareholder vote would not have to come from the board as is required by existing rules.<sup>77</sup> Without intervention power, shareholders are only able to get an acquisition offer accepted over the objection of management by accepting a tender offer.

Establishing shareholder power to initiate a vote to approve an acquisition offer would be a simple and clean way to accomplish a similar result. The initiated vote would express shareholders' undistorted choice on whether acceptance of the offer is in their collective interest. Thus, providing shareholders with the power to initiate proposals to accept acquisition offers would be a good way to resolve the long-standing debate on defensive tactics. Note that the ability to vote on an acquisition proposal would offer some flexibility that tender offers do not currently offer. In particular, the unsolicited tender offers that now provide the only way to accomplish a transaction without management support do not always allow full realization of the potential savings to shareholders from having the transaction structured as a tax-free reorganization. Permitting shareholders to bring acquisition offers to a shareholder vote would enable the full realization of tax benefits that are now possible only with merger agreements supported by management.<sup>78</sup>

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<sup>76</sup> The "Comply or Explain" Approach to Improving Standards of Corporate Governance by Sir Christopher Hogg, QFINANCE

<sup>77</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>78</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

One question worth considering is whether shareholders should have not only the power to sell the company to a particular buyer, but also the possibility to direct that the company be sold through a specified auction procedure. Whether or not a particular buyer has already expressed interest in the company, shareholders might wish to have an auction that would sell the company to the highest bidder. Under current rules, only management can start such a process. In a regime of shareholder intervention, however, it might be worth permitting shareholders to begin such a process as well.<sup>79</sup>

One of the problems that has long occupied legal scholars and financial economists concerns the bias of management in favor of continuing the existence of their firm.<sup>80</sup> The empirical evidence on acquisition offers indicates that management decisions in this area produce significant agency costs. For example, studies indicate that, when directors of target companies use their veto power to defeat offers, shareholders on average experience a significant stock market loss.<sup>81</sup> Cotter and Zenner found that managers are more likely to resist offers when they have smaller holdings and their interests thus overlap less with shareholder interests. A recent study by Hartzell, Ofek, and Yermack found that target CEO's are willing to accept lower acquisition premia in transactions that involve extraordinary personal treatment such as special payments to the CEO at the time of the acquisition or a high-ranking managerial post in the acquirer. Another study indicates that, in merger negotiations, CEO's are willing to trade higher acquisition premia in exchange for better managerial positions in the merged firm.<sup>82</sup> As Warren Buffett said at Berkshire Hathaway press conference, a lot of directors love the job for the money and sociability, so they aren't going to do anything that gets them kicked off that board or not invited to another board. The average "independent" Lehman director was paid more than \$360,000 in 2007 -- a sum that would ingratiate any director to those with the power to hire and fire.<sup>83</sup> Without the power to initiate corporate transactions or to nominate their own candidates to company proxies, shareholders don't have a reasonable alternative to the CEO's personal priorities.

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<sup>79</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>80</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>81</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>82</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>83</sup> The Motley Fool's Testimony on Corporate Governance and Shareholder Empowerment, April 21, 2010

Under a regime of shareholder intervention, management would always act against the background possibility that shareholders might decide to accept an acquisition offer or even dissolve the company if they prefer termination to continued independent existence of the company.<sup>84</sup> This possibility would provide management with incentives to serve shareholders. Better performance by management would make it less likely that shareholders would intervene to make a termination decision. Permitting shareholder intervention would thus eliminate or reduce the agency costs that now exist in the majority of publicly traded companies whose management is protected in one way or another from the discipline of a takeover threat.<sup>85</sup> Studies by Bertrand and Mullinathan and by Garvey and Hanka found that stronger protection from antitakeover statutes causes increases in managerial slack. Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are associated with poorer operating performance—including lower profit margins, return on equity, and sales growth. There is also evidence that insulation from takeover threats results in greater consumption of private benefits by managers. Borokhovich, Brunarski, and Parrino found that managers with stronger antitakeover defenses enjoy higher compensation levels. Bertrand and Mullinathan obtained similar findings for managers that are more protected due to antitakeover statutes. Finally, Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire building.<sup>86</sup>

At present, all decisions concerning distributions are in management's hands.<sup>87</sup> Management may decide to distribute to shareholders a cash dividend or an in-kind dividend (say, in shares of a subsidiary). Such decisions transfer assets from company control into shareholder hands, in effect reducing the size of the empire under management's control. Under an intervention regime, shareholders would also be able to order in-kind distributions, forcing the company to distribute, for example, its shares in a subsidiary. These decisions, too, would reduce the scale of the enterprise governed by management and would remove some shareholder value from management control.<sup>88</sup> It should be clear that an intervention regime would not weaken the protection currently

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<sup>84</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>85</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>86</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>87</sup> The Role of institutional Investors in the Corporate Governance, by Moshe Pinto, 2004-2005 ERASMUS

<sup>88</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

accorded to creditors. Creditors have statutory protection – and often also contractual protections – limiting the amounts that the company may distribute to its shareholders.<sup>89</sup>

One of the agency problems that has received a great deal of attention from financial economists and corporate law scholars concerns the tendency of managers to avoid distributing cash or assets to shareholders. A company might have cash reserves whose distribution to shareholders would be value-maximizing because the company currently has poor internal investment opportunities. A company might also have assets that would be better managed separately, and it thus would be value-maximizing to spin off these assets or sell them to a third party and then distribute the cash proceeds to shareholders. In such circumstances, management might, for self-serving reasons, refrain from taking actions that would reduce the size of the empire under its control.<sup>90</sup>

Corporations live in a dynamic environment. They need to adapt to changing conditions. Thus, the optimal set of corporate governance arrangements is likely to change over time. Accordingly, from time to time, shareholders may well be served by appropriate adjustments in the corporate charters. Management's current control over charter amendments agenda distorts the evolution of charter provisions in favor of management. Changes that could increase shareholder value can be expected to be adopted if and only if they management also favors them.<sup>91</sup> Lucian Arye Bebchuk suggests that when shareholders view the incumbent team as generally doing a good job, it is unlikely that they would vote for a challenger team solely because of its promise to initiate some given charter amendment or reincorporation. For this reason, shareholder power to intervene in those decisions can significantly improve corporate arrangements. When shareholders are able to initiate charter amendments, they will be able to effect value-increasing changes that management does not favor for its own, private reasons. They will no longer find themselves stuck with arrangements that they view as inferior but which they are powerless to change without management initiation. Plus, against this background, management will be more likely to initiate value-increasing amendments itself.<sup>92</sup>

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<sup>89</sup> Lucian Arye Bebchuk, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>90</sup> Lucian Arye Bebchuk, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>91</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>92</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

Another argument could be that shareholders would not have sufficient incentives to initiate proposals. Without a willingness to initiate proposals, the shareholder power to intervene would not have substantial impact.<sup>93</sup> Bebchuk suggests that once intervention power is introduced, it would be possible and indeed desirable to strengthen incentives to bring good proposals with meaningful chances of adoption by installing appropriate reimbursement rules. Specifically, when a proposal is adopted in a vote, or perhaps even when it passes a specified threshold of support (e.g., 10% of the vote), it would be desirable to reimburse the costs of the shareholders initiating the proposal. Indeed, if further strengthening of incentives to bring proposals with potential significant support is viewed as desirable, the proponents of successful proposals might be granted some multiple of their costs. Such financing rules would encourage the bringing of exactly those proposals, and only those proposals, which enjoy substantial shareholder support and thus are worth encouraging.

It might be argued that shareholder intervention power would have little effect for a second reason. Even if proposals are initiated, the argument goes, they will not be adopted because shareholders will not have sufficient incentives to participate in the vote or, even if they participate, they can be expected to defer to management rather than vote against it.<sup>94</sup> The tendency of institutional investors to vote with management might result from rational deference to a party that institutions believe is better informed on the question at hand. It might also be reinforced by the desire of institutional investors to be on good terms with management in order to receive information and in some cases also to obtain business. For this reason, voting can be expected to be somewhat tilted in favor of management's position. But there is no reason to assume that shareholders will always vote with management.<sup>95</sup> Institutional investors' bias in favor of voting with management does not at all indicate that shareholders should be denied the power to intervene. When a majority of shareholders will in fact be prepared to vote for a shareholder-initiated proposal, there will be no reason to block them from doing so.<sup>96</sup> To the contrary, if shareholders actually choose

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<sup>93</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>94</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>95</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>96</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

to intervene, despite their tendency not to vote against management, such a vote would suggest that the proposal is strongly in the shareholder interest.

Finally, and perhaps most importantly, it should be emphasized that the benefits of a regime of intervention should not be measured by the number of times that shareholders would in fact intervene and adopt shareholder-initiated proposals. Rather, the primary benefits would be indirect ones. Introducing the power to intervene would induce management to act differently in order to avoid the power to intervene. Thus, if a regime of intervention does not produce many adoptions of proposals, this would not imply that the power is not working as hoped; rather, it might well mean that the power is working better than expected.<sup>97</sup>

To sum up, empowering shareholders by enabling them with initiation power and power to approve their proposals and important corporate transactions by majority votes would solve important long standing agency problems. It would also contribute to good corporate governance. Indeed, shareholders' empowerment would encourage management to be more vigilant in daily operation of corporation and while making important decisions.

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<sup>97</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

## 6. Arguments against empowering shareholders

In this section, I would like to discuss about some significant arguments that are raised against shareholder empowerment and logical reasoning against those arguments.

1. One might be concerned that shareholders would bring nuisance proposals. One shareholder, who has an idea that is far-fetched or motivated by considerations other than shareholder wealth, would be able to impose a cost on the system. The bringing of nuisance proposals, the argument goes, would burden shareholders with the need to vote against them, and management with the need to lobby against them. An appropriate design of the intervention regime, however, could keep the costs of such nuisance proposals to an acceptable minimum.

First of all, some threshold requirements for submitting a proposal could screen out the proposals that are completely frivolous or have no meaningful support among shareholders. For example, submission of proposals might be conditioned on their being co-sponsored by shareholders having together more than a threshold fraction (say, 5% or 10%) of the company's shares. Such threshold requirements are already used in state law rules and charter provisions that allow shareholders to call a special meeting.<sup>98</sup> For a proposal to be adopted, it would need such strong support that holders of a majority of outstanding shares would affirmatively support it. Given that getting support from a majority of outstanding shares is somewhat demanding, management would have to pay attention only to proposals that appear to have support among a significant fraction of the shares.<sup>99</sup> Thus, management would not have to pay costly attention to proposals other than those with significant shareholder support, which is precisely the desirable state of affairs.

2. Concerns might also be expressed that allowing shareholder intervention would enable some large shareholders to try to initiate proposals in order to extract benefits from management.<sup>100</sup> The ability to initiate and push for proposals, it might be feared, will lead

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<sup>98</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>99</sup> Lucian Arye Bebchuk, School of Law, Harvard University "The Case for Empowering Shareholders" (2003)

<sup>100</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

such large shareholders to threaten to initiate value-decreasing proposals unless they are paid off by management.<sup>101</sup>

Large shareholders can already threaten to vote against management in the annual election of directors and in votes on fundamental changes (such as charter amendments) proposed by management. Bebchuk perceives that there is no substantial evidence that large outside shareholders are able to extract significant benefits from management as a result.<sup>102</sup> Large shareholders are unlikely to bring any value diminishing proposals. Gaining support from majority of the outstanding shareholders would be quite a difficult task when a proposal would not benefit shareholders but instead considerably harm them. Furthermore, there is credibility problems with a threat to bring a value-decreasing proposal, as carrying out the threat would not be in the interest of the large shareholder. It is worth noting that, when a proposal is initiated, it would be possible to make counter-proposals. Such proposals could be made either by other shareholder groups or by management. A counter-proposal, by management or another shareholder group, might thus lead to an outcome that is superior to the one that an initial proposal would produce. A counter-proposal that would make matters worse off as compared with an initial proposal would be unlikely win majority support. For this reason, it would be perfectly acceptable, and even desirable, to facilitate the submission of counter-proposals to the same meeting at which an initial proposal will be considered.<sup>103</sup>

3. Another common argument is that non-shareholder constituencies' interest will be affected badly when shareholders are interests given highest preference. Even assuming that stakeholders should get some protection beyond what is accorded by their contracts, support for board control does not follow. Insulating the board from shareholder intervention would not be a good way to protect stakeholders. The overlap between the interests of management and those of stakeholders is hardly such that management can be relied upon to use its powers to protect stakeholders. Management is unlikely to use its power to protect stakeholders. Therefore, those interested in stakeholder protection should seek arrangements tailored specifically to address this concern.<sup>104</sup>

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<sup>101</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>102</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>103</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

<sup>104</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

4. The most commonly used argument against expansions in shareholder voting rights is based on the informational disadvantage that they are likely to have vis-à-vis management. Management is better informed about the company and is thus in a better position to evaluate which decision would most enhance shareholder value. Having decisions made by management or at least initiated by management prevents shareholders from making some poor, erroneous decisions.<sup>105</sup>

Management might use its power over corporate decision-making not (or not only) for the intended purpose of stopping shareholders from making erroneous decisions but also to avoid some decisions – to terminate, scale back, or change game rules -- that would be beneficial to shareholders. This concern is real and significant because the claim that management has superior information is one that management can always raise and that would be hard to falsify, whenever management prefers the status quo. In contrast, if shareholders had intervention power and used it in some cases, their decisions might sometimes be less informed but would generally be based on their judgment of what would best serve their interests. Importantly, granting shareholders the power to intervene hardly implies that management's superior information will go unused. It can be expected that, most of the time, shareholders will defer to management's judgment. Even when a shareholder initiative offers up a decision for shareholder vote, management's superior information would not necessarily be wasted. Management would be prevented from blocking the proposal, but management would be able to use the information as a basis for its communications and recommendations to shareholders.<sup>106</sup> So, stockholders should be given authority to decide if they want or not to engage management to make a decision when required by a situation. With the presence of an efficient management, stockholders would even mind to defer a decision to management.

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<sup>105</sup> The Case for Increasing Shareholder Power, Lucian Arye Bebchuk, Harvard Law School, December 2004

<sup>106</sup> Empowering Shareholders by Lucian Arye Bebchuk, Harvard Law School, March 2003

## 7. CONCLUSION

Enhancing the role of shareholders in corporate governance by facilitating them with required rights and enabling them to execute their rights efficiently and effectively contribute to good corporate governance. Being the ultimate owner of publicly traded companies, their interests should be served with priority along with company objectives and principles. Also, we have seen that shareholder empowerment is a necessary mean to hold the company owners' interests over the management interests.

We have categorized public held companies into three as (i) corporations with empowered shareholders where shareholders with much power to intervene and make their own proposals and decisions (ii) corporations with empowering shareholders where shareholders lack power to effectively put forward their own resolutions or their rights are not well exercised and thus needs empowerment (iii) corporations with little shareholder activism. We took more consideration into categories 2 and 3 and did a study about shareholder rights and activism in the U.S. and Indian companies.

In India, despite the fact that shareholders are granted with more rights by law as compared to U.S., there is little shareholders activism. We have seen with real corporate incidents that the situation is improving of late. The major task for the Indian corporate sector is that to discipline the dominant shareholder & promoters and protecting the minority shareholders. Since the last decade, shareholders' protection has steeply increased in India mainly because of the strengthening of corporate governance norms with the introduction of Clause 49 of the Listing Agreement by Securities and Exchange Board of India (SEBI). Major corporate governance reforms by SEBI, before and after the Satyam corporate scandal would help the shareholders to increase their values. Still, there need to be more rules and regulations in order to empower minority shareholders.

We realized that various long existing statutory provisions and judicial decisions have the effect of blocking meaningful exercise of legitimate shareholder rights. Stockholders' power in U.S. companies is much restricted under the traditional U.S. regulatory framework and they often lack the power to put forward their resolutions. Still with a significant existence of staggered boards, U.S. shareholders need to be provided with a way to replace the entire board of their company if a situation demands so. Long standing plurality voting system need to be replaced with majority voting in major corporate matters. Studies about company failures in U.S. reinforces that shareholder empowerment is a necessary mean to improve corporate governance. The current state of shareholder rights is the result of an unfortunate blend of competing regulations that undermine more fundamental aspects of corporate law and therefore would benefit from reform.

Enron taught investors that they could not trust the numbers contained in financial reports. Investors lost confidence & faith in company governance and no single solution can easily restore it. The average shareholding period in companies has fallen drastically over the last years. Provided with required rights and responsibilities, shareholders can really monitor and direct the management when mandated by a situation towards the growth of their company & values, which would in turn encourage the shareholders to invest for long term. Empowering long-term shareholders will lead to healthy business practices that are beneficial to all stakeholders, including employees, customers, and even the wider economy.

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