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STRENGTHENING CORPORATE GOVERNANCE: A FOCUS ON SHAREHOLDER RIGHTS AND ACTIVISM IN INDIA[1]

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ABSTRACT

Corporate governance plays a crucial role in shaping the framework of accountability, transparency, and ethical conduct within companies. The enactment of the Indian Companies Act 2013 introduced significant reforms aimed at enhancing corporate governance practices in India. This paper explores the implications of corporate governance on Indian companies under the Companies Act 2013, with a special focus on shareholder democracy and shareholder activism. The Companies Act 2013 introduced several provisions aimed at promoting shareholder democracy by empowering shareholders and ensuring their active participation in corporate decision-making processes. Provisions such as e-voting, postal ballots, and the appointment of independent directors aim to enhance transparency and accountability, thereby strengthening shareholder rights and promoting democratic principles within corporate governance structures.

Furthermore, the Companies Act 2013 also addresses the growing phenomenon of shareholder activism in India. Shareholder activism refers to the proactive efforts undertaken by shareholders to influence corporate behavior and governance practices. The Act provides avenues for shareholders to voice their concerns and hold management accountable through mechanisms such as class action suits, proxy advisory firms, and stringent regulations on related party transactions.

This paper examines the impact of shareholder democracy and activism on corporate governance practices in Indian companies under the Companies Act 2013. It analyzes the challenges and opportunities presented by these concepts and discusses their implications for corporate governance standards, investor protection, and overall market dynamics in India. Additionally, the paper highlights the evolving regulatory landscape and the role of stakeholders in shaping the future trajectory of corporate governance in India.

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INTRODUCTION

"Corporate Governance is beyond the realm of law. It stems from the culture and mindset of the management and cannot be regulated by legislations by alone. Corporate governance means the conducting the affairs of a company in such a way that there is fairness to all shareholders and its actions benefits and the greatest number of stakeholders.. It is all about openness, integrity and accountability. Corporate Governance is the key element in improving the economic efficiency of a company and makes the Board accountable to shareholders. Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of the company. The failure to implement corporate governance can have a heavy cost beyond regulatory problems. Companies that do not employ good governance can pay a significant risk premium when competing with scarce capital in public markets. The credibility offered by corporate governance also helps to maintain the confidence of both the foreign and domestic investors, which helps in attracting more patient long term capital and also will reduce the cost of capital…" Shri. Narayana Murty Committee Report.

Enterprises gather funds from a diverse investor pool, spanning both domestic and international capital markets. Within this framework, investment essentially entails placing trust in the competence of a corporation's leadership. When an investor commits funds to a corporation, they anticipate the board and management to function as custodians, safeguarding capital while generating returns surpassing the cost of capital. Consequently, investors expect management to consistently prioritize their interests and uphold sound corporate governance standards. The needs of India's expanding economy, including access to foreign direct investment, the increased presence of institutional investors (both domestic and foreign), and the growing desire of Indian companies to access global capital markets by being listed on stock exchanges outside of India, have spurred corporate governance laws.[2] Corporate governance encompasses the mechanisms by which a corporation is managed and overseen. It encompasses various stakeholders, with primary participants including shareholders, company executives, and the board of directors. Additional stakeholders may encompass employees, suppliers, partners, customers, governmental and professional regulatory bodies, as well as the broader community where the corporation operates. India's corporate governance reforms were initially spearheaded by corporate India and quickly became an important component of the work of the country's primary capital markets regulatory authority, the Securities Exchange Board

[2] Bernard S. Black & Vikramaditya S. Khanna, *"Can Corporate Governance Reforms Increase Firms' Market Value: Evidence from India,"* University of Michigan Law School, Olin Working Paper No. 07-002, Oct. 2007, available at www.ssrn.com/abstract=914440.

of India (SEBI), and the Ministry of Corporate Affairs (MCA). Beginning in the late 1990s, the Indian government began to undertake a significant overhaul of the country's corporate governance system.[3]

Corporate governance acts as a concept designed to assign resources in a manner that optimizes stakeholder's value, ensuring transparency, inclusivity, fairness, and accountability in decision-making. Recent concerns regarding Corporate Governance in India stem from the imperative to maintain a clear separation between ownership and managerial control within contemporary corporations. Within this context, corporate governance emerges as a framework through which shareholders and stakeholders can legitimately exert influence and exercise effective control over managerial decisions and actions.

CORPORATE GOVERNANCE - BENEFITS

The preceding discussion underscores the pivotal role of corporate governance in fostering long-term value creation for entities. Hereafter, we delve into some of the key benefits associated with sound corporate governance:

1. Enhanced Access to Capital: Firms that embrace openness and transparency, thereby adhering to robust governance standards, are better positioned to attract capital. Investors, armed with essential information and confidence, are more inclined to lend funds to such firms. Additionally, well-governed entities typically secure capital at lower costs compared to those with deficient governance practices, as investors demand reduced risk premiums.

2. Efficient Resource Allocation: Sound corporate governance practices empower management to allocate resources efficiently, enhancing the prospects of higher returns for investors. In an efficient capital market, investors gravitate towards firms with robust governance frameworks, enticed by lower risk and the promise of superior returns.

3. Mitigation of Financial Crises: Effective corporate governance contributes to reducing the likelihood and severity of domestic financial crises. By fostering a conducive environment for funds, governments in developing countries can mitigate the risk of crises. A sound governance framework plays a pivotal role in creating such an environment.

4. Combatting Wasteful Practices: Strong corporate governance extends its benefits even to countries prioritizing a development strategy independent of foreign investments. In many developing nations, entrenched distribution cartels squander precious resources. However, good governance practices can curtail such wasteful behavior, paving the way for productivity growth. Furthermore, by addressing corruption, corporate governance significantly enhances a country's development prospects.

[3]For a detailed history of developments in Indian corporate governance, *see* Afra Afsharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, North Western Journal of International Law & Business 335 (2009); Rajesh Chakrabarti, *Corporate Governance in India—Evolution and Challenges*20 (Jan. 17, 2005) (unnumbered working paper), *available at* http://ssrn.com/abstract=649857.

The enactment of the 2013 Act in India has laid a solid foundation for advancing corporate governance standards. Embracing the ethos of the Act, various aspects, including entrenchment provisions, Proxy System participation, Voting Mechanisms, Independent directors, Women Directors, Small Shareholders Director, time bound grievance redressal mechanism, Class Action suits and Corporate Social Responsibility and many more, underscore a holistic approach by Indian legislators to safeguard investor rights and foster trade and investments in the country. For all the above possibilities to be efficiently executed one thing which should matter most is the participation of various stakeholders in the corporate set up. Some stakeholders are too prominent and they need to make their presence felt in order to keep a check on various corporate transactions.

Professor Gower, in his discussions on company law, drew parallels between a company and a democratic society. He articulated that within a company, akin to a democratic society, there exists a system of checks and balances to ensure fairness and accountability. Just as citizens in a democratic society elect representatives to govern them, shareholders in a company appoint directors to manage the company's affairs on their behalf. Moreover, Gower highlighted the importance of transparency and accountability within both entities. In a democratic society, transparency ensures that citizens are aware of governmental actions and decisions. Similarly, in a company, transparency is essential to keep shareholders informed about the company's operations and performance. Furthermore, Gower emphasized the significance of the rule of law in both contexts. Just as laws govern the conduct of individuals in a democratic society, company law sets out the rules and regulations that govern the behavior of companies and their directors. Overall, Gower's comparison underscores the notion that principles of democracy, including representation, transparency, and the rule of law, are fundamental to the functioning of companies and the protection of shareholder interests.

SHAREHOLDERS DEMOCRACY

For the purpose of this article the researcher delves into the concept of Shareholders democracy or shareholders activism in the corporate set up and its relationship with Class Action Suits in under the 2013 Act. In the corporate realm, shareholders hold a position of paramount importance. They possess the theoretical authority to impact and shape significant corporate decisions, effectively functioning as stewards of their respective companies. It is the responsibility of the company's management to facilitate shareholder participation in the decision-making process, thereby establishing a system of checks and balances. This fosters transparency in all company actions and shareholder engagements. Within the framework of shareholder democracy, every individual has an equal opportunity to elect and establish a board to oversee and direct the company's operations, determining its future trajectory.

Shareholder activism encompasses the efforts made by shareholders to influence the management and operations of companies in order to safeguard their interests. This activism manifests in various ways, including direct engagement with management, the submission of shareholder proposals, participation in proxy contests, and resorting to

litigation. Activist shareholders often call for changes in company policies, board structure, executive compensation, or financial performance. In recent years, shareholder activism has gained traction in India, particularly within publicly listed companies, with activists advocating for increased transparency, accountability, and enhanced governance practices. The board of directors plays a pivotal role in shareholder activism, being responsible for ensuring that the company adheres to best practices and protects the interests of all stakeholders. Activist investors are often viewed as investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control.[4] Shareholder activism acts as a crucial mechanism for providing checks and balances against the management of a company. Activist shareholders aim to influence the decision-making processes of the company by questioning management actions, proposing alterations to corporate strategy, and advocating for optimal corporate governance practices. This serves as an additional layer of oversight, ensuring that management remains accountable and aligned with the interests of stakeholders.

Shareholder activism can yield several positive effects on the functioning of the company. Firstly, it can contribute to the improvement of corporate governance practices, fostering greater transparency and accountability in company operations, thereby enhancing trust and confidence in management. Secondly, activist shareholders can drive enhancements in the company's financial performance by advocating for superior corporate strategies, cost reductions, or changes to the management team. Lastly, shareholder activism can help prevent or mitigate significant losses for shareholders by addressing risks and issues that might otherwise have been overlooked.

Within developed economies like the United States (U.S.), shareholders hold significant sway over corporate boards, pushing for the adoption of robust corporate governance standards to protect their interests. Moreover, they actively involve themselves in corporate affairs, frequently forming shareholder associations to assert their rights during meetings. In cases of managerial misconduct resulting in investor fraud, shareholders may opt to pursue legal action through class action lawsuits to recover damages.

Though as a separate concept, shareholder activism is almost non-existent in India, yet in recent times, the Ministry of Corporate Affairs ("MCA") and the Securities and Exchange Board of India ("SEBI") are trying to boost shareholders activism to improve confidence and awareness among investors.

COLLECTIVE ACTION PROBLEMS

Mostly publicly listed corporations, non-promoter shareholders typically hold relatively small ownership stakes, which often lack the incentive for collective action and meaningful participation in decision-making processes. Although these shareholders technically own part of the company, challenges arise from collective action problems that hinder their ability to engage effectively in decision-making. Companies that are controlled are prevalent in

[4] Stuart Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in theUnited States* (2007), *available at* http://ssrn.com/abstract=959670.

India, minority shareholders encounter difficulties in organizing and aligning their interests, thus limiting their ability to exert influence through voting rights. Consequently, the lack of active participation from minority shareholders tends to favor controlling shareholders and the management appointed with their approval. A related issue is shareholder apathy, where the costs associated with coordinating actions among minority shareholders are prohibitive. As a result, many minority shareholders either abstain from voting altogether or simply follow management's recommendations. Historically, both retail and institutional investors have tended to adopt a passive approach due to collective action challenges and shareholder apathy. However, the emergence of more active shareholders is a relatively recent phenomenon, with institutional investors such as pension funds playing a key role, particularly since the 1980s. Recent regulatory reforms in India, including provisions for postal ballots and e-voting, present opportunities for greater shareholder participation in corporate decision-making. However, despite these advancements, shareholder activism faces significant structural and institutional barriers within Indian markets. While there is a growing presence of shareholder activism, its effectiveness as a tool for enhancing corporate governance remains somewhat limited.

The notion of shareholder democracy refers to the principle of granting shareholders primary authority in governing the business and affairs of their respective companies, either directly or through elected representatives. Its primary objectives include:

i. Facilitating dialogue between shareholders and management regarding pertinent issues

ii. Enhancing awareness of economic, environmental, social, and human concerns relevant to the organization (known as shareholder activism).

iii. Influencing the corporate ethos and culture.

Some activism on the part of shareholder is considered to be a set of "proactive efforts on the part of shareholders to change firm behavior or governance rules."[5] It represents investors' efforts to influence management practices within the company. Activist investors are commonly seen as investors who, when discontented with certain facets of a company's management or operations, seek to instigate changes within the company without necessarily aiming to take control.[6]

Shareholder activism, as commonly understood today, finds its origins in the 1930s. After the Great Depression, shareholders found that the resulting new laws aimed at reforming businesses were not enough. The early shareholder activists in the 1930s and 1940s were rarely effective, as the activist shareholders often could not garner enough support to actually effect change. Most shareholders would, instead of trying to reform the company via

[5] Roberta Romano, *Less is More: MakingInstitutional Investor Activism a Valuable Mechanism of Corporate Governance*,18 YALE J. ON REG. 174 (2001).

[6] Stuart Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in theUnited States* (2007), *available at* http://ssrn.com/abstract=959670.

shareholder activism, divest themselves through the selling of their shares to express their dissatisfaction with the company's governance practices or activities. This was called the "Wall Street Walk," wherein shareholders unhappy with the company would simply "vote" with their feet.
Activist investors stand in contrast to passive investors, who typically refrain from involvement in corporate decision-making. Passive investors commonly opt for a more hands-off approach and may choose to divest from a company if they are dissatisfied with management or controlling shareholders' decisions.[7]

Shareholder activism, also referred to as "relationship investing," aims to enhance corporate governance to protect stakeholder interests and enhance shareholder wealth. Through intervention and oversight, particularly by institutional shareholders wielding considerable bargaining power and expertise, companies may be compelled to operate within the bounds of their authority and consider the concerns of all stakeholders. It is imperative for all shareholders to take responsibility for their investments by actively engaging with the company. Shareholder activism encompasses a wide array of actions aimed at altering a company's conduct, rectifying any unfavorable practices, or offering recommendations on various matters.

BACKGROUND TO SHAREHOLDER DEMOCRACY AND ACTIVISM IN INDIA

Conceptual Background: Shareholders' Rights as Basis of Democracy

The articles of association will invariably vest the management in the hands of Board of Directors ("BOD"). However, the equity holders are the owners of the company and thus they have the ultimate control. Regarding rights of shareholders, the Supreme Court, in a very important case L.I.C. India v. Escorts Ltd.[8] held that, "*a shareholder has an undoubted interest in a company, an interest which is represented by his shareholding. The rights of sharehol*ders are,

(i) To elect director and thus to participate in the management through them;
(ii) To vote on the resolutions at meeting of the company;
(iii) To enjoy the benefits of the company in the shape of dividends;
(iv) To apply to the court in the case of oppression;
(v) To apply to court for winding up of the company;
(vi) To share in surplus on winding up; and
(vii) To apply to the court for relief in case of mismanagement"

[7] Umakanth Varottil, *The Advent of Shareholder Activism in India*, 1 JOURNAL ON GOVERNANCE 581, 590 (2012).
[8] AIR 1986 SC 1370.

SHAREHOLDER PASSIVITY

In the early years following India's independence, shareholder inactivity prevailed widely. The equity markets remained shallow, and individual investment in Indian listed companies was minimal. Although a few prominent Indian conglomerates had listed companies under their umbrella, retail investors lacked the influence to challenge controlling shareholders, who held substantial control over their enterprises due to their significant shareholdings. Even if retail shareholders had the opportunity to attend shareholder meetings and voice their opinions, managements and controlling shareholders might still overlook the minority viewpoint. This is because retail shareholders typically hold a small stake in the company, rendering them unable to significantly influence corporate decisions or outcomes.[9] Additionally, the legal framework governing corporate decision-making offered little support to retail shareholders. Company meetings were required to be held at specific physical locations, often in remote areas, making it challenging for retail investors to participate. These factors collectively contributed to the apathy among retail shareholders.

Conversely, on the other hand, certain institutional shareholders such as banks, development financial institutions (“DFIs”) and the then largest mutual fund, the Unit Trust of India (“UTI”), held larger stakes in companies in comparison to retail shareholders.[10] These institutions were heavily influenced by governmental and bureaucratic control. While they often appointed their representatives to the boards of investee companies and exercised their voting rights to some extent, they were not perceived as independent investors or a threat to management and controlling shareholders. The close relationship between government and industry ensured that management consistently enjoyed support from these institutional investors. Therefore, despite their higher level of engagement compared to retail shareholders, their role as activists was minimal at best. Although these influences persisted to a large extent post-liberalization in 1991, the shareholding of government-controlled banks and institutions in Indian companies has declined dramatically in recent years, leading to a significant reduction in their influence.

Another class of institutional shareholders comprises foreign portfolio investors, who inject capital into Indian listed companies through various channels, with the foreign institutional investor route being predominant among them. Despite holding significant stakes in Indian companies, foreign institutional investors ("FIIs") have rarely utilized their voting rights in these companies, except in rare instances. Additionally, another group of foreign investors opts for depository receipts ("DRs") in Indian companies rather than directly acquiring the underlying shares. Prior to the commencement of Companies Act, 2013, DR holders did have any legal right to vote. This was because under various provisions of company legislation, only members registered in the books of such a company are entitled to receive notices of meetings and to exercise voting rights.[11] Only in limited instances are depositories required to

[9] John Armour & Priya Lele, *Law, Finance, and Politics: The Case of India*, 43 LAW & SOC’Y REV. 491.
[10] Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India* (2000), *available at,*http://www1.fee.uva.nl/fm/Conference/cifra2000/sarkar.pdf.
[11]Sec. 82 &Sec.172, Companies Act, 1956.

exercise voting rights. The Companies Act, 2013 has offered a solution to this problem by widening the definition of a member[12] as to include not only a person who is registered as a member in the books of a company but also every person holding shares of the company and whose name is entered as a beneficial owner in the records of a depository and every such member shall be entitled to receive notices of meetings and to exercise voting rights.[13] Interestingly, investors in DRs have not displayed any keenness at all in the exercise of voting rights on the underlying shares.[14]

Shareholder passivity, both among retail and institutional shareholders, was the norm following liberalization as well, and continued to be so until very recently. However, this status quo seems to be changing. Not only have the regulators begun to recognize the need for greater shareholder participation in Indian listed companies, but investors themselves have sought to monitor their investments more carefully.

SHAREHOLDER DEMOCRACY AND COMPANIES ACT 2013

Acknowledging the concept of shareholder democracy, various provisions have been incorporated in the 2013 Act. These provisions can be broadly classified as under:

- **i.** Shareholder Rights or Protection
- **ii.** Special Consideration to Small Shareholders

Shareholder Rights or Protection.

Recognizing the importance of aligning with international norms, the 2013 Act has authorized shareholders associations or groups of shareholders to initiate legal proceedings in the event of fraudulent actions by a company. Additionally, they are empowered to participate in investor protection initiatives and class action lawsuits under Section 245 of the 2013 Act.

Moreover, addressing the Standing Committee's recommendation outlined in its Twenty-First Report to safeguard the interests of minority shareholders and small investors, the Ministry of Corporate Affairs (MCA) proposed that during the adjudication process of class action suits, the Tribunal would ensure the protection of shareholders' interests. Furthermore, wrongdoers, including auditors and audit firms, would be mandated by the Tribunal to compensate victims based on suitable orders.[15]

Also, as stated in the 2013 Act, the central government will have power to prescribe class or classes of companies which shall not be permitted to allow use of proxies. The 2013 Act also to have provisions to provide that a person shall have proxies for such number of members or such shares as may be prescribed.

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[12]Sec. 2(55), Companies Act, 2013.
[13]Sec. 101 & Sec.47, Companies Act, 2013.
[14]Supra 9.
[15]*Companies Act 2013: Key Highlights And Analysis- Significant Changes And Implications,* PwC India 30th November, 2013, https://www.pwc.in/en_IN/in/assets/pdfs/publications/2013/companies-act-2013-Key-highlights-and-analysis.pdf

SPECIAL CONSIDERATION TO SMALL SHAREHOLDERS

The 2013 Act acknowledges the existing rights of small shareholders:

A listed company has the option to elect one director through the representation of small shareholders, following the regulations and criteria specified. The term "small shareholders" refers to shareholders possessing shares with a nominal value not exceeding 20,000 INR or any other amount specified by regulations (as per Section 166 of the 2013 Act).

For companies with over 1,000 shareholders, debenture-holders, deposit-holders, and other security holders at any point during a financial year, the board of directors is mandated to establish a stakeholders relationship committee. This committee must include a non-executive director as chairperson and additional members as determined by the board. Additionally, Section 178 of the 2013 Act, under Sub Section 6, introduces the stakeholders relationship committee, tasked with addressing and resolving grievances raised by the company's security holders.

Furthermore, specific disclosures regarding the impact of mergers or amalgamations on minority shareholders are required under the merger scheme. Various sections of the 2013 Act, such as those concerning changes in contract terms or prospectus objectives, afford dissenting shareholders the opportunity to exit. This provision serves to safeguard the interests of small shareholders.

ISSUES AND CHALLENGES:

1. Passive Individual Investors: Many investors demonstrate a lack of proactiveness in enforcing their rights within companies. Typically, larger investors, with more significant stakes, exhibit greater vigilance in monitoring corporate affairs.

2. Regulatory Complexity and Legal Delays: India grapples with a regulatory landscape characterized by both excessive and inadequate oversight. Legal proceedings often stretch over extended periods, sometimes spanning decades. In such circumstances, robust corporate governance mechanisms become even more imperative.

3. Limited Presence of Long-Term Companies: Numerous companies have small capital bases and low trading volumes, making it challenging for investors to avoid involvement with firms they are uneasy about. Institutional investors must take an active stance on governance issues within companies they invest in, rather than refraining from investment altogether.

4. Diverse Financial Service Offerings: Several key players in the financial services sector operate across various domains such as banking, insurance, mutual funds, broking, and investment banking. This broad scope of activities raises the potential for conflicts of interest, blurred boundaries between business segments, and frequent employee mobility.

5. Voluntary versus Mandatory Activism: Enforcing activism through mandates risks reducing it to a mere checkbox exercise. It's preferable to let valuation concerns drive institutional investors' activism, incentivizing a market environment where poorly governed companies face valuation penalties. Investors should also be encouraged to favor funds that actively engage with governance issues in their invested companies.

EMERGENCE OF SHAREHOLDER DEMOCRACY AND ACTIVISM:

In the past two years, shareholder democracy and activism have gained prominence in Indian corporate governance. Regulatory reforms have facilitated increased shareholder participation in corporate decision-making. Additionally, a market ecosystem conducive to activist investors and corporate governance intermediaries has rapidly evolved. The rise of proxy advisory firms issuing recommendations for numerous listed Indian companies and instances of institutional investors challenging Indian managements exemplify this trend. However, the corporate structure and legal framework in India pose significant obstacles that impede the full realization of the benefits of shareholder activism. Controlling shareholders prevalent in most Indian companies mitigate the impact of activist investors. Moreover, the legal system is not conducive to shareholder litigation, a tool commonly employed by activist investors in other jurisdictions. There also exists some skepticism regarding the long-term impact of shareholder activism on company performance and shareholder value.

THE ROAD AHEAD:

Moving forward, there is a need for extensive empirical research on the effects of shareholder activism in India to better understand its desirability and impact. Furthermore, efforts must be made to bolster the influence of minority shareholders who often operate in the shadow of controlling shareholders. Measures such as cumulative voting for the appointment of independent directors and prohibiting controlling shareholder voting in interested party transactions could empower minority shareholders. Creating such an enabling environment would incentivize activist shareholders to enhance corporate governance norms in listed companies and elevate governance standards nationwide.