

Corporate Governance Issues with Coal India and its minority shareholders



1.0 Corporate Governance Issues with Coal India and its minority shareholders

1.1 A Summary of Actions of The Children's Investment Fund (TCI)

In January 2012, GCV based pricing mechanism which CIL had introduced in December 2011 was rolled back under the directions of MoC and CIL reverted back to the old pricing mechanism based on UHV. Following such change, TCI raised several issues with respect to the Company in relation to fairness of coal pricing, corporate governance etc. Significant among them are:

- The sale of coal at a 70% discount to international market prices despite the deregulation resulting in a loss of US\$20 billion a year.

TCI claims that sale of coal at discounted prices benefits only politically connected industrialists and not the general public. It also alleged that the government had sold shares to the Indian public and foreign investors in the IPO (in 2010) based on misrepresentation that there is an independent board and that the price of coal is deregulated according to the law that is upheld in Supreme Court rulings.

- Pressure by the Government to sign Fuel Supply Agreements (FSAs) which obligated CIL to supply at least 80% of the contracted quantity of coal (even if it has to import coal) to the power projects, failing which it would be penalized.
- Repeated failure of the Company to engage with TCI on various matters including the implementation of coal washing infrastructure and processes.
- In July 2011, TCI had opposed the Draft Mines and Minerals (Development and Regulation) Bill, 2011 stating it was not in the best interest of the Coal Industry in India. *According to TCI if the Bill is passed into law by the Indian Parliament, the undue and disproportionate adverse effects of this bill on the operation of CIL (due to increase in the tax burden) will also constitute a contravention of each of the treaties (two bilateral agreements between India and the United Kingdom in 1994 and India and Cyprus in 2002). In a letter to the Finance Minister of India Mr. Pranab Mukherjee, asking him to reconsider the proposal in the Draft Bill requiring domestic coal mining companies to share 26% profit with local governments for benefiting*

local communities affected by their operations, it had suggested alternatives. However, on September 30, 2011 the bill was approved by Cabinet.

- Breach of fiduciary duties by the CIL Board in operating CIL in a manner that was prejudicial to the public interest and oppressive to shareholders and that the management “lacked the necessary leadership”. TCI has indicated it will file a petition in the Indian courts claiming breach of fiduciary duties
- On March 27, 2012, TCI sent a written notification to the Ministry of Finance claiming it had contravened two international agreements for the “promotion and protection of investments”, one with Britain and one with Cyprus, (where the fund which holds the CIL shares is domiciled). Previously, it accused the CIL board of breaching its fiduciary duties by failing to stand up for the interests of the company

(Note: The issues raised by TCI against CIL are well chronicled in various media publications most of which have been discussed in other parts of this report. Listed above are the most significant of these issues).

- A media report dated April 3, 2012 stated that DLA Piper of the UK had offered to defend CIL against TCI. The same report noted that DLA Piper and Luthra & Luthra together had served as international counsel to Disinvestment Department and CIL for the company’s greater than Rs 15,000 crores IPO in October 2010.

The IPO document of CIL dated August 9, 2010 states that Luthra & Luthra was the Domestic Legal Counsel to the Company and the Selling Shareholder and DLA Piper Singapore Pte. Ltd. was the International Legal Counsel to the Company and the Selling Shareholder.

It may be noted that in this case there may be a conflict of interest for Luthra & Luthra.

- On 16 May 2012, TCI has again raised the dispute with the Finance Ministry of the Government of India (GoI) arising out of the treaty between India and Cyprus of 9 November 2002 relating to mutual promotion and protection of investments. TCI contends that sale of coal under FSAs at 70% discount to international prices and the directive by the government to enter into FSAs for 80% of fuel requirements with power companies among other matters contravenes the treaty and TCI requests GoI to enter into negotiations with TCI on behalf of TCI Cyprus to amicably settling the disputes under the treaty.

Issues raised by TCI

- TCI has claimed to be aggrieved as a minority shareholder due to government and BoD of CIL's actions.
- CIL has been forced by the government to sell coal or enter into FSAs (including inputs) to sell at significant discount to international prices and that lowers the profits of their investee company.
- The BoD is not independent and not acted in the best interest of minority shareholders of CIL and TCI intends to sue the BoD individually and collectively.
- TCI also intends to sue GoI under the Indo-Cyprus treaty on protection of investments, which they feel was not honoured by GoI

1.2 A summary of actions of Government of India in relation to CIL and TCI's claims

- In initial reactions to the allegations made by TCI, the then acting Chairperson and Managing Director of the Company, Ms. Zohra Chatterjee, a nominee of the Coal Ministry said such allegations "do not merit comments."
- Reacting to these accusations the Secretary to the Ministry of Coal, Mr. Alok Petri said that if TCI is unhappy, it could sell off its stake in Coal India.
- The Presidential Directive which required CIL to ink pacts with power producers to ensure it supplies at least 80% of their coal needs came after pressure from the power producers. They need a guaranteed fuel supply even if it meant that CIL needed to import coal for such purposes. This triggered TCI to make statements that they intend to sue CIL for violations of TCI's interest as a minority shareholder.

The Coal Minister Mr. Sriprakash Jaiswal rebutted TCI's charges saying the public sector undertaking was free to decide prices to protect its commercial interests, and the government played no role in this. However, in the same breath, he said that coal prices are kept on the lower side to ensure that consumers do not pay an exorbitant price for electricity, and that it "is entirely in the *public interest*".

- In an interview to The Indian Express (*dated April 16, 2012*) Mr. Jaiswal stated that the Centre in December 2011 had notified a change in the grading of coal by introducing the globally accepted

system of grading coal at its Gross Calorific Value (GCV) instead of the erstwhile Useful Heat Value mechanism. Mere switching over to a grading system should not normally lead to increase in the prices. Following the initial exercise by CIL, coal prices had risen to a certain extent, which led to the government getting numerous representations from end-user industries requesting for maintaining the earlier prices. These representations were forwarded to CIL and it took a decision on pricing on its own.

- He also countered TCI's argument that the Planning Commission has asked for moving expeditiously towards a market-driven pricing mechanism. Mr. Jaiswal pointed out that the country's planning body has desired that coal prices should move slowly towards such a mechanism and not immediately adopt international prices. He said that it is incorrect to perceive that there is an abuse of minority shareholders and that in fact, CIL's profits have gone up in the current financial year and they have also given a larger dividend.
- Denying TCI's contention that facts were misrepresented during CIL's Initial Public Offering, Mr. Jaiswal argued that:
 - *The IPO prospectus outlines the risk factors in investing in CIL;*
 - *It clearly specifies that the firm sells at prices lower than those in Indian and international markets; and*
 - *It declares that the interests of the government as its controlling shareholder may conflict with interests of other shareholders.*
- Subsequent to reports of the Independent directors opposing Coal India's fuel supply pacts Coal Ministry officials said that Shareholders of CIL have signed a MoA (memorandum of association) according to which the Government can issue directives or instructions to the board of CIL and eventually the directives will have to be accepted on account of public interest.
- In response to a question raised in the Upper House of Parliament (the Rajya Sabha) on May 7, 2012 about whether TCI has demanded that the fuel supply agreement (FSA) should be scrapped and the steps the Ministry is taking to benefit the public by acting independently, the Minister responded that:
 - *TCI has argued that the existing FSA system reduces the profits of CIL and does not pass on the benefit of low coal prices to the end consumers, and therefore, the FSA system should be abolished or FSA coal prices should be moved to the market levels.*

- *Supply of Coal at notified prices to the Power and other major sectors is essential to keep the cost of power generation and manufacturing at reasonable levels. Keeping this objective in view, the New Coal Distribution Policy of 2007 provides for supply of coal through FSAs at notified prices. Accordingly, CIL has been directed to sign FSAs with Power Plants that have entered into long-term PPAs with Distribution companies and have been commissioned/would get commissioned after 31-03-2009 and on or before 31st March, 2015 and who have already entered into long term supply agreement with the distribution companies.*
- Till date 154 companies, including IPPs have entered into FSAs with CIL with a total commitment of Rs. 332.27 million tonnes of coal.
- The largest power company, NTPC, a PSU and other 11 smaller power producing PSUs have not signed FSAs with CIL. They have written to CIL, seeking parity of prices with their existing agreements while having penal clauses for short supply. CIL is currently evaluating these demands.

GoI's actions in relation to CIL & TCI's claims

- GoI maintains that TCI was aware of the government's control over CIL and coal as a natural resource. Such risks were elaborated in the prospectus of the IPO.
- GoI can issue directives in matters of public policy and interest based on the powers vested in the public sector undertakings that they control.
- Coal Ministry has given instructions to CIL to enter into FSA with power producers that are commissioned by 31 March 2009 or will be commissioned by 31 March 2015.
- The intent of the Presidential directive has been diluted due to lowering of the penalties by CIL in case of lower supplies etc., in the FSA and the threshold of eligibility by the Coal Ministry. This protects CIL's own commercial interests.
- The government owned power companies have not yet signed FSAs with CIL for new plants having the new conditions and pricing.

Draft Red Herring Prospectus (DRHP)

According to the draft red herring prospectus, among the risk factors identified for the IPO in 2010, the following were also listed by the company:

- Our operations are extensively regulated by the GoI, State Governments and various statutory and regulatory authorities. The compliance costs, liabilities and requirements associated with existing statutory and regulatory requirements and adverse regulatory or policy developments can have a significant impact on our operations.
- We sell our coal at prices lower than the prices otherwise in the Indian and international coal markets.
- The distribution of our coal and allocation among customers is administered by the GoI in accordance with the New Coal Distribution Policy which reduces our negotiating power.
- The GoI will continue to control us post listing of our Equity Shares.
- The interests of the GoI as our controlling shareholder may conflict with your interests as a shareholder.

Memorandum and Articles of Associations (MoA) and (AoA)

The MoA of the Company identifies its main object as:

“To carry on in India and elsewhere the trade or business of coal mining including the management of coal mines either independently or for and on behalf of or under the directions of the Central Government or any State Government whether as custodian, receiver or in any other similar capacity.”

Article 37 of the Articles of Association (AoA) of CIL vests the power in the President of India to issue directives to CIL for compliance in matters of public interest.

Article 14 of the Constitution of India and public interest/public policy

Article 14 talks about equality before law.—The State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India.

The terms public policy and public interest are not defined in law. Public policy addresses the social, moral and economic values that tie a society together: values that vary in different cultures and change over time. Law regulates behaviour either to reinforce existing social expectations or to encourage constructive change, and laws are most likely to be effective when they are consistent with the most generally accepted societal norms and reflect the collective morality of the society. Public interest refers to the "common well-being" or "general welfare."

Public interest is central to policy debates, politics, democracy and the nature of government itself. While nearly everyone claims that aiding the common well-being or general welfare is positive, there is little, if any, consensus on what exactly constitutes the public interest, or whether the concept itself is a coherent one.

Therefore to better understand the meanings of these terms, definitions provided by the Supreme Court of India in their various judgments have to be relied upon. This is discussed in a subsequent section.

1.3 What is public interest / public policy in India

In the context of the issues raised by TCI, the Government and CIL responses have been based on the ground that their moves are in the public interest. Public interest and public policy are therefore discussed in this section for a better understanding of the terms based on various judgments of the Supreme Court of India

Public Interest / Policy and Equality under Article 14 of the Constitution have been extensively discussed in various judgments of the Supreme Court of India.

- ***Reliance Natural Resources Limited v Reliance Industries Limited***

This case was in relation to determining the right over pricing of natural resources under the Honourable Supreme Court of India.

The judgment puts forth the conclusions in the following manner:

Referring to Food Corporation of India vs. M/s Kamdhenu Cattle Feed Industries, the Court observed as follows: *“In contractual sphere as in all other State actions, the State and all its instrumentalities have to conform to Art. 14 of the Constitution of which non-arbitrariness is a significant facet. There is no unfettered discretion in public law: A public authority possesses powers only to use them for public good. This imposes the duty to act fairly and to adopt a procedure which is 'fairplay in action'.”*

With relation to the Public Trust Doctrine, Supreme Court in M.C. Mehta v. Kamal Nath held:

The Public Trust Doctrine primarily rests on the principle that certain resources like air, sea, waters and the forests have such a great importance to the people as a whole that it would be wholly unjustified to make them a subject of private ownership. The said resources being a gift of nature. They should be made freely available to everyone irrespective of the status in life.

The doctrine enjoins upon the Government to protect the resources for the enjoyment of the general public rather than to permit their use for private ownership or commercial purposes.

This doctrine is part of Indian law and finds application in the present case as well. It is thus the duty of the Government to provide complete protection to the natural resources as a trustee of the people at large.

The judgment draws the following broad sustainable conclusions:

- 1) The natural resources are vested with the Government as a matter of trust in the name of the people of India. Thus, it is the solemn duty of the State to protect the national interest.
- 2) Even though exploration, extraction and exploitation of natural resources are within the domain of governmental function, the Government has decided to privatize some of its functions. For this reason, the constitutional restrictions on the government would equally apply to the private players in this process. Natural resources must always be used in the interests of the country, and not private interests.
- 3) The broader constitutional principles, the statutory scheme as well as the proper interpretation of the PSC mandates the Government to determine the price of the gas before it is supplied by the contractor.
- 4) The policy of the Government, including the Gas Utilization Policy and the decision of Government would be applicable to the pricing in the present case.
- 5) The Government cannot be divested of its supervisory powers to regulate the supply and distribution of gas.

- ***Oil & Natural Gas Corporation (ONGC) v Saw Pipes***

In another landmark case of ONGC, a government owned company Vs. Saw Pipes, a private company, the definitions of public policy was used in a wider context was held as, “some matter which concerns public good and the public interest. What is for public good or in public interest or what would be injurious or harmful to the public good or public interest has varied from time to time. However, the award which is, on the face of it, patently in violation of statutory provisions cannot be said to be in public interest. Such award/judgment/decision is likely to adversely affect the administration of justice. These are:

- (a) fundamentally policy of Indian law; or

- (b) the interest of India; or
- (c) justice or morality; or
- (d) in addition, if it is patently illegal”

Public Interest/Public Policy in India

- Public policy or interest is the key in determination of hierarchy of rights.
- Public policy/interest for pricing natural resources as held in Reliance case has these principles:
 - State has the solemn duty to protect natural resources
 - Natural resources, even its exploitation is privatized, it must always be used in the interest of the country
 - Government has a role for determination of pricing
- The case of ONGC also is in line with these principles and says the governing framework is the Constitution
- TCI, in their arguments have selectively quoted the judgments to strengthen their defense.

1.4 Board of Directors and Independent Directors

In March 2012, the BoD of CIL had met to clear draft fuel supply agreements (FSAs) with power sector, however there was opposition from some of the independent directors. According to media reports at least two of the seven independent directors opposed the move to sign the pacts with 80 per cent trigger level. Trigger level indicates the minimum supply assurance on the part of the supplier, failing which CIL should pay penalty to the buyer.

- TCI on 12 March 2012, has written to the BoD of CIL addressing their concerns emanating from the way the affairs of CIL was being conducted against public interest and later they accuse the BoD of dereliction of their fiduciary responsibilities. The key concerns were:
 - Government’s intervention in local pricing and the BoD had been directly instructed by the MoC o such pricing and there was “no push back” from the BoD on such instructions.
 - Capping of quantities under e-auction under directions of MoC.
 - BoD not opposing the draft mining bill, which increased coal mining tax by 39%.
 - Slow implementation of coal washeries.
 - Lack of action on stopping theft of coal etc.

TCI, in the letter, threatened to sue the BoD individually and collectively and claimed that the BoD continue to have “blind acceptance of unreasonable and unlawful directions of the government”.

According to a statement from the Prime Minister's Office in February, CIL was scheduled to enter into FSAs with nearly 50 power units – commissioned between April 2009 and December 2011 – before March 31, 2012. Referring to the lower price paid by the power sector for coal, directors proposed that CIL should lower the trigger level and, divert excess coal (over and above trigger) to e-auction to ensure profitability.

One of the independent directors also submitted a detailed note in this regard. The board in its pursuit to evolve a consensus avoided a poll on the resolution. It was subsequent to this development that the government issued the presidential directive to CIL to sign the FSAs with the power producers assuring them of at least 80 per cent of the committed coal delivery.

The Board of CIL have not referred to any of these TCI letters, claims or disputes arising out of FSAs in their filings with the stock exchanges as major issues/disputes/contingencies facing the company.

The company filed their annual accounts of 31 March 2012 with the stock exchanges on 18 May 2012 but these accounts do not mention these disputes in their filings.

1.4.1 The Composition of the Board and their Independence

According to the last Annual Report of the Company (y/e March 31, 2011) as on the year end, the Board of Directors of the Company comprised of a Chairman (Additional charge), 4 Functional Directors and 9 Non-Executive Directors (of which 2 are Government nominees and 7 are independent Directors). In addition to this there are 3 permanent invitees to the Board.

The Department of Personnel and Training (DoP&T) under the Ministry of Personnel, Public Grievances and Pensions is the coordinating agency of the Central Government in personnel matters and deals with cases of appointment to posts of Chairman, Managing Director, full-time functional Director/Member of the Board of Management (including independent directors) of various Public Sector Undertakings/ Enterprises, Corporations, Banks and financial institutions.

The Public Enterprises Selection Board (PESB) also functioning under the DoP&T is an expert body responsible for selection and placement of personnel for top managerial posts in the Public Sector Undertakings.

However, the administrative ministry in this case, MoC suggests the initial candidates and has almost entire influence on who gets appointed.

- The tenure of appointment of the independent directors as given in the DRHP of CIL is for a period of three years or an earlier period, if the MoC decides for a shorter period.
- The issue of governance for independent directors is difficult to determine. The majority shareholder, i.e., Government of India through its administrative ministry, i.e., MoC, appoints and decides the tenure of such independent directors, will never create a conducive environment where such directors will be able to conduct their fiduciary duties and protect the rights of the minority shareholders which is the primary responsibility of an independent director. In such cases, the position becomes merely nominal.
- In the present BoD, a few independent directors are known to be close to the MoC and any board activism in relation to not adhering to the Presidential directives or to the appeals by the Ministry of Power may not be due to exercise of independence but may be due to aligning positions with the tacit directions of MoC.
- Post TCI issuing a warning to CIL over disclosures on pricing policy in the DRHP, SEBI clarified that shareholders cannot question policies if firm makes full disclosure in filing. The clarification stated that, *“CIL made full disclosures in its offer documents as well as regulatory filings of risk factors including its coal pricing policy. We are satisfied as long as this was done. Investors who invested in the IPO were fully aware of this factor”*

1.5 Relief available to minority shareholders under Indian law

The mechanisms available to individual shareholders for breaches in governance are primarily the following:

- 1) Listing rules, (clause 49 of the listing agreement under the SEBI Act/securities law);
- 2) The Companies Act 1956;
- 3) Common law; and
- 4) External market mechanisms – i.e. impairing capital raising ability/secondary market attractiveness.

Some of the key rights available under these laws are listed below:

1.5.1 Under the Companies Act, 1956

- Convene an EGM (Extra-ordinary General Meeting)– requires 10% of paid-up share capital or 100 members (under section 169).

- Vote at AGM (Annual General Meeting)/EGM – either directly or through proxy. Under the Companies Act voting is done by a show of hands unless a poll is requested. Investors can request a poll, under section 179, if they hold >10% of voting rights or Rs.50,000 of paid up capital. Though in practice investors often find it difficult to get polls done, due to issues with custodians and companies' reluctance on grounds such as cost (due to large shareholder bases).
- Appointment and removal directors – under section 257 shareholders can propose removal/appointment of a director at an AGM/EGM., but needs a majority vote.
- Application to the GoI to investigate the affairs of a company (sections 235, 236 and 237), but the burden of proof is very high (and odds of this happening on a PSU are very low).
- Documentation requests (section 163) – with the exception of board minutes, no formal documentation can be requested.
- Compensation for misstatements in prospectus. (This needs to be proved both to MCA and the Court).
- Complain to the Company Law Board on grounds of oppression of minority and/or mismanagement by the majority (sections 397, 398, 399). This needs 100 members or 10% share capital. Minority shareholders can apply for 'relief' (there is even a winding up provision – though onus of proof understandably high).
- Relief can mean a number of things – future regulation of the company's affairs, buy-out of the complaining shareholders, termination/modification of agreements.

1.5.2 Common Law

- Right to Information Act – as TCI has illustrated, this can be a useful tool for getting information from the government.
- Sue management/dominant shareholders under common law for negligence or misconduct, fraud, misappropriation of company assets, of fiduciary duty etc.

TCI's chances of success under the above provisions of law

- Instituting a suit against Coal India's directors for breach of fiduciary duty under Common Law appears to be the most viable option available to TCI. Civil courts would have jurisdiction over this. However any law suit in India is a long, drawn out, unwieldy process, technical in nature and difficult, to achieve the purpose of directing the company to reverse a decision not in the interests of the company. Civil courts will not interfere in what a company (as decided by majority shareholders) has chosen to decide legally. In this case the over-riding principles of public policy and interest will come into play.
- Action under sections 235 and 236 of the Companies Act is unlikely as the Government will not initiate an investigation against itself.
- The other routes under company law cited above are open to TCI. But all references to the case so far have cited 'legal action against directors' which suggests the common law route.
- The disclaimer in the Draft Red Herring Prospectus (DRHP) may appear to offer protection to the Company and its directors (given the disclosure that coal may not be priced at levels that would adversely impact the power sector or Indian economy), this only goes so far, as a DRHP disclaimer cannot protect CIL against the specific provisions of law giving minority shareholders an opportunity to prove oppression/mismanagement and obtain relief.
- SEBI does not have any direct powers to investigate in case of oppression of minority shareholders and they would refer the matter to the Ministry of Corporate Affairs.
- Post TCI issuing a warning to CIL over disclosures on pricing policy in the DRHP, SEBI clarified around 18 May 2012 ,that shareholders cannot question policies if firm makes full disclosure in filing. The clarification stated that, "*CIL made full disclosures in its offer documents as well as regulatory filings of risk factors including its coal pricing policy. We are satisfied as long as this was done. Investors who invested in the IPO were fully aware of this factor*"

2.0 Conclusions

Conclusions

- TCI has a number of options, and past experience in India suggests that this is going to a long haul.
- The Government and CIL are likely to be extremely reluctant to be pushed towards a situation where prices of coal are materially raised considering the challenges facing the power sector today. The DRHP disclaimer and the Supreme Court rulings discussed above which suggest that the government is the trustee of natural resources and does have the right to fix prices, make TCI's case harder. Experts predict that an out-of-court settlement is the most likely outcome rather than a protracted legal battle.
- Mounting a successful press and shareholder campaign may be as effective as the Courts, as the Coal Ministry and Secretary of Divestment would prefer not to get into a very public battle. The Secretary of Divestment in particular will want to avoid a long-running public spat that highlights governance failings in PSUs and unnerves all those minority shareholders it wants to buy some Rs.300bn of equity in the next 12 months.
- Furthermore considering TCI's activism in the past in other regions the Government may not be able to simply assume that TCI will sell its stake. The hedge fund, which gives a large proportion of its profits to a child-focused charity of the same name, has made a name for itself through such campaigns. It caused the split-up of ABN AMRO; it forced the resignation of Deutsche Borse's CEO following his abortive attempt to take over the London Stock Exchange; and it helped push through the Mittal takeover of Arcelor in the teeth of political opposition.
- The problem of state control over natural assets extends beyond Coal India. State-controlled companies in the petroleum sector, in particular, have suffered greatly from the government's unwillingness to depoliticise pricing decisions. They, too, are ripe for shareholder activism, which holds the government to account for ignoring the legitimate rights of investors. In the absence of government commitment to reforming PSU operations, market discipline must be imposed by market participants.
- The critical decision on whether what the government considers as public policy/interest overrides minority interest will be determined by the Supreme Court and it would take years before such judgment is made.