

Position and Rights of Minority Shareholders in Listed State owned Enterprises (SOEs)- experiences and lessons from India.

1. BACKGROUND

Corporate Governance Literature has recognized the fundamental differences in the nature of the agency problems underlying controlled and widely held firms and in the means that are adopted for addressing these problems¹.

Furthermore, since the fundamental governance issues in controlled and widely held firms differ significantly, the effect of many governance arrangements critically hinge on whether or not the company has controlling (dominating) shareholder. Arrangements that enhance investor protection in companies without a controlling shareholder are often inconsequential—or even detrimental—to outside investors in companies that have a controlling shareholder, and vice versa².

Most research dealing with corporate governance issues in developed economies has focused on the traditional principal–agent conflicts whereas, in emerging economies, the principal–principal conflict is the major concern of corporate governance. Such principal–principal conflicts, between controlling shareholders and minority shareholders, result from concentrated ownership, extensive family ownership and control, business group structures, and weak legal protection of minority shareholders³.

Principal–principal conflicts alter the dynamics of the corporate governance process and, in turn, require remedies that are different from those that deal with principal–agent conflicts. Since the conflict actually is between the controlling shareholders on the one hand and fragmented, dispersed minority shareholders on the other hand, the redrawing of the battle lines changes the dynamics of corporate governance in such cases. For instance, since the controlling shareholders can decide who is on the board of directors, the ability of the board of directors to oversee controlling shareholders is effectively nullified and, in an environment where the recourse to the courts for the board not overseeing minority shareholders' interests is limited, this has a serious impact on the rights of the minority shareholders.

Furthermore, unlike in developed economies, where concentrated ownership has been promoted as a possible means of addressing traditional principal-agent conflicts⁴, in emerging economies where concentrated ownership

¹ Shleifer, Andrei and Vishny, Robert W., (1997); A Survey of Corporate Governance; The Journal of Finance, Volume 52, Number 2 (June 1997).

² Lucian A. Bebchuk & Assaf Hamdani; (2009) The Elusive Quest for Global Governance Standards - downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1374331 - have suggested that efforts need to be directed towards developing and implementing separate methodologies for assessing governance in companies with and without a controlling shareholder.

³ Michael N. Young, Mike W. Peng, David Ahlstrom, Garry D. Bruton and Yi Jiang (2008); Corporate Governance in Emerging Economies: A Review of the Principal–Principal Perspective, Journal of Management Studies 45:1 January 2008

⁴ Demsetz, Harold and Lehn, Kenneth (1985); The Structure of Corporate ownership: Causes and Consequences; Journal of Political Economy, 1985, Volume 93, Number 6.

is a root cause of principal-principal conflicts, increasing the ownership concentration cannot be a remedy to corporate governance malaise- on the other hand it may actually make things worse⁵

The pitting of controlling shareholders against minority shareholders often results in the expropriation of the value from minority shareholders and transfers value from the minority shareholders to the majority or controlling shareholders .

There is enough anecdotal evidence that points to the dysfunctional role of the dominating shareholder, commonly seen in Indian business organizations, as well as 'prescriptive' solutions to reduce the likelihood of such occurrence⁶.

The presence of the State as a dominant shareholder adds additional complexity to the corporate governance challenges in an organization as the State is likely to have different goals than the classic overreaching private shareholder who seeks private gain⁷. A 2000 study⁸ of the evolution of the control structure for a large sample of privatized firms in OECD countries found evidence broadly consistent with the concept of "reluctant privatization", defined as the transfer of ownership rights in State-owned enterprises without a corresponding transfer of control rights⁹, and showed that the picture on the state ownership of enterprises looks significantly different when indirect voting rights are accounted for; based on the evidence that by employing pyramids and dual-class share structures to retain majority control, the study found that the government is the largest ultimate shareholder in more than 50% of privatized firms.

In addition to direct and indirect shareholding the State holds many different levers – as controlling shareholder, as present and potential future regulator, and sometimes as lender and creditor. Potentially, it has much larger role than a regular controlling (dominating) shareholder and conflicts between the controlling shareholder and the minority shareholders are much harder to monitor in such cases. For regular controlling shareholders, the

⁵ Bernardo Bortolotti & Mara Faccio ; "Reluctant privatization";Center for Economic Institutions Working Paper Series ;CEI Working Paper Series, No. 2006-5 ;Institute of Economic Research ,Hitotsubashi University.

⁶ Varma, Jayanth Rama, (1997), "Corporate Governance in India: Disciplining the Dominant Shareholder", *IIMB Management Review*, December 1997, 9(4), 5-18;
Available at: <<http://www.iimahd.ernet.in/~jrvarma/papers/iimbr9-4.pdf>.

In Varma's view, some of the most glaring abuses of corporate governance in India have been defended on the principle of 'shareholder democracy' and, since they have been sanctioned by resolutions of the general body of shareholders, the Board of the Company has been powerless to prevent such abuses. Therefore, in his view, the remedies against corporate governance abuses can lie only outside the company itself and suggests stronger regulation to prevent the abuse of corporate governance in India.

⁷ Marcel Kahan & Edward Rock; When the Government is the Controlling Shareholder , available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616266

⁸ Bernardo Bortolotti & Mara Faccio ; "Reluctant privatization";Center for Economic Institutions Working Paper Series ;CEI Working Paper Series, No. 2006-5 ;Institute of Economic Research ,Hitotsubashi University, documented the evolution of corporate control in privatizations by carrying out a comprehensive analysis of the structure of ultimate control (voting) rights in a sample of 141 privatized (publicly traded) companies from developed economies, over the period 1996 to 2000, and found that the most common privatization outcome is that the State remains the largest ultimate owner.

⁹ Id. The transfer of ownership rights without the corresponding transfer of control rights may happen because the government remains the largest ultimate shareholder of the company, although it no longer directly owns the majority of the stocks, or because it enjoys veto or special powers through its possession of so-called "golden" shares. The study found that, as of 2000, governments are the largest shareholder or use special control powers to retain voting control of 62.4% of privatized firms.

conflicts of interests, between the dominant and minority shareholders, are predominantly financial in nature where such conflicts arise in the so-called “self-dealing” transactions – where the controlled entity deals either directly with the controlling shareholders or with another entity in which the controlling shareholder has an interest – or in “conflicts” transactions, where the controlling shareholder stands to receive some financial benefit that is not proportionally shared with the minority shareholders.

Self-dealing transactions and conflicts transactions can be subjected to objective review for their fairness¹⁰.

However, on the other hand since the State has a wide variety of interests other than financial ones, the predominant worry, when the State is the controlling shareholder, is unlikely to be whether or not the State wants to enrich itself financially at the expense of the minority shareholders but whether the State will induce the organization to pursue alternate political or policy goals other than maximizing its value for the proportionate benefit of all its shareholders. Under such circumstances the task of protecting the interest of minority shareholders becomes quite challenging because, unlike self-dealing transactions and material financial conflict transactions that are relatively easy to identify by benchmarking against objective standards, it is far more difficult to determine whether a transaction serves the State’s political or policy goals (in conflict with the goals of its shareholders) since such political or policy goals are amorphous and far-reaching and many transactions can plausibly be argued to serve these goals¹¹.

Even though the corporate governance issues arising from the role of State as a Dominant Shareholder are a subset of the broader issues that arises from the role of Dominant Shareholders in organizations and the expropriation of minority shareholder rights by the majority shareholders, there is one fundamental difference between the positions of minority shareholders in an organization controlled by the State as compared to the position of minority shareholders in a normal business enterprise. It can be conceivably argued that the mere act of listing of a State controlled enterprise does not make them “capitalist” entities whose sole aim becomes that of maximizing the value of the enterprise as the inherent conflict between broader “national interest” (pursued by the State) and the “minority interest”(pursued by the minority shareholders) would continue and what we see is principal-principal problem between two sets of shareholders who may pursue different objectives.

Privatization of SOEs, by definition, reduces the policy space open to government. It sets new terms for the relationship between the state and private capital which could give the latter an edge. In the transition period when State owned enterprises are being privatized, foreign investors, even minority ones, who have bought into such enterprises on listing, may declare any policy that restricts profiteering, in the interest of development, as amounting to oppression of minority shareholders; and that may attempt to cow the State down.

However, it should be recognized that the value of the listed state entity arises, in many cases, from its monopoly position or from assets created earlier with public money or from assets/rights granted to the entity by the State. From this fact the obvious question that arises is to what extent are the new minority shareholders (after listing) entitled to claim exclusive rights on the value unlocked (post listing) and whether the State as the majority shareholders is justified in protecting its own interests (which include broader social interests), however wrong they may be in the eyes of the minority.

¹⁰ Supra, Reference 7.

¹¹ Id.

This is the crux of the current debate in India and the challenge is to find an equitable position between the two extreme positions, one where the majority owners view the Company's objective as being run to serve the public interest and not necessarily to maximize its profits and the second where the minority owners see the Board members to be in breach of their fiduciary responsibility when they meekly acquiesce to the decisions of the majority owners¹².

2. **DISINVESTMENT IN INDIA**

In line with the prevailing socialist leanings the first prime minister of post-independence India, Pandit Jawaharlal Nehru envisaged the role of government-owned firms as occupying the ".commanding heights of the economy"; the Industrial Policy Resolution of 1956, stated, "The State will progressively assume predominance and direct responsibility for setting up new industrial undertakings and for developing transport facilities"¹³.

While there were only five Central Public Sector Enterprises (CPSEs) with a total investment of `Rs 290 million (US \$ 5.8 mil at an exchange rate of IUS\$=Rs50) at the time of the First Five Year Plan, there were as many 248 CPSEs (excluding 7 Insurance Companies) with a total investment of `Rs 6,668 Billion (US \$ 133.4bil) as on 31 st March, 2011¹⁴.

¹² For instance, the corporate governance issues raised by The Children's Investment Fund of UK (TCIF) in respect of the management of Coal India, a State owned enterprises in India, is an example of the conflict between the external minority shareholders and the State as the dominating shareholder.

TCIF is Coal India's second largest shareholder and owns around 1.1% of the company's equity whereas the State ownership in Coal India is 90%. On March 12,2012 TCIF sent a of letter to Coal India's Board of Directors in which they accused Coal India's Board of Directors of "not taking into account its fiduciary duty" and listed the following principal charges against the Board of Directors; (1) not resisting government's "request" to roll back coal price hikes even though when, as claimed by TCIF, Coal India sells coal at a price that is 70% below landed international levels for Fuel Supply Agreements; (2) refusing to defy the orders of India's Prime Minister directing the company to urgently enter into fuel supply agreements with power producers with the stipulation that Coal India would supply at least 80% of the contracted quantity(even if meant that it would have to import coal) else Coal India would accept penalties; and (3) refusal to resist the Draft Mining Bill in India's Parliament, which the fund claims is detrimental to the interests of Coal India.

The Children's Investment Fund ended its letter by threatening Coal India's individual Board members with legal action.

Refer to <http://www.coal4india.com> for the views of TCIF on the ongoing dispute with Coal India.

¹³ After independence and with the advent of planning, India opted for the dominance of the public sector, firmly believing that political independence without economic self-reliance was not good for the country. The passage of Industrial Policy Resolution of 1956 and adoption of the socialist pattern of society led to a deliberate enlargement in the role of India's public sector as the planners believed that a dominant public sector would reduce the inequality of income and wealth and advance the general prosperity of the nation. Refer to Chapter 3 of the Disinvestment Manual available at <http://www.divest.nic.in/chap3.asp>

¹⁴ Public Enterprises Survey, 2010-2011- Overview, Annual Report on the Performance of Central Public Sector Enterprises available at http://dpe.nic.in/sites/upload_files/dpe/files/survey1011/survey01/Overview.pdf

The market capitalization of the 45 listed CPSEs, based on the stock price in Mumbai Stock Exchange, stood at Rs 15,067 Billion (US \$ 301.4 Billion) as on 31.03.2011 and they accounted for nearly 22% of the total market capitalization of the BSE¹⁵.

The policy regime that governed the evolution of the state owned sector in the post-independence India can be divided into following four phases: (i) 1950-1965, (ii) 1966-1984, (iii) 1984-91 and (iv) post1991 period¹⁶. During the first phase of evolution, i.e. 1950-65, the state owned sector was occupying the position of 'commanding heights'. The second phase (1966-84) is further sub-divided into two periods 1966-73 and 1973-84. Although the economy passed through a crisis during this phase, the state owned sector was by and large still enjoying a significant position. The second sub-period, i.e. 1973-84 recorded a slow process towards liberalization, which culminated into an irreversible process of liberalization of the economy through the third (1984-91) and during the final phase (1991 onwards) of the evolution of the economic policy in India.

In the present phase of economic evolution, not only the state owned sector no longer occupies the position of commanding heights but also old concepts of socialism and mixed economy have been replaced by the concepts such as liberalization, privatization, disinvestment and a market-friendly approach.

Disinvestment and Privatization of State owned enterprises in India started primarily in response to a balance of payments crisis in 1991 when successive governments undertook sweeping economic reforms.

The policy of disinvestment has been spelt out through the statements of Finance Ministers in their annual budget speeches. Outlining the economic reforms, the Industrial Policy Resolution of 1991 argued for partial divestiture in government-owned ...firms "in order to provide further market discipline to the performance of public enterprises". Between 1991 and 2004, nearly every government's annual budget declared that the privatization goal is to reduce government ownership to 26% of equity, the minimum equity holding necessary for certain voting powers, in all government-owned firms except in the strategic sectors of defense, atomic energy, and railway sector¹⁷. However, until 1999, successive governments sold only minority stakes, sometimes as little as 0.1%, without transferring management control and partial privatization proved to be a lucrative source of revenues without the accompanying political controversy of transferring control of government-owned assets to private owners¹⁸.

Post liberalization of the Indian Economy, the disinvestment policy of the Government of India can be briefly divided into three phases¹⁹, viz,

(i) 1991-92 to 1998-99: when the focus was on disinvestment of minority shareholding in favor of financial institutions.

¹⁵ Id.

¹⁶ Bala, Madhu: SSRN network, 14. November 2006. Economic Policy and State Owned Enterprises: Evolution towards Privatization in India, available at <http://mpra.ub.uni-muenchen.de/17946/>.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id.

(ii) 1999-2000 to 2003-04: when the focus was on disinvestment through strategic sale and,

(iii) Since 2004-05: the current focus is on disinvestment of only minority stakes in conjunction with issue of fresh equity by CPSEs with partial disinvestment as the stated policy of the State.

The current policy on disinvestment was approved by the Government on 5th November, 2009²⁰. It recognizes that CPSEs are the wealth of the nation whose ownership should rest in the hands of the people while ensuring that Government ownership does not fall below 51% and Government retains the management control.

Keeping in view the policy on disinvestment, the following approach to disinvestment in CPSEs has been adopted²¹:

- (i) Already listed profitable CPSEs (not meeting mandatory shareholding of 10%) are to be made compliant by 'Offer for Sale' by Government or by the CPSEs through issue of fresh shares or a combination of both.
- (ii) Unlisted CPSEs with no accumulated losses and having earned net profit in three preceding consecutive years are to be listed.
- (iii) Follow-on public offers would be considered taking into consideration the needs for capital investment of CPSE, on a case by case basis, and Government could simultaneously or independently offer a portion of its equity shareholding
- (iv) In all cases of disinvestment, the Government would retain at least 51% equity and the management control.
- (v) All cases of disinvestment are to be decided on a case by case basis
- (vi) The Department of Disinvestment is to identify CPSEs in consultation with respective administrative Ministries and submit proposal to Government in cases requiring Offer for sale of Government equity

While disinvestments has been a consistent policy that has been followed by successive governments from 1991, the ideologically-left of centre Congress led UPA government ,which initiated the privatization program in 1991, has refrained from selling the majority stake and transfer management control in State owned enterprises – which was briefly pursued by the BJP led NDA government.

The slow progress in privatization since 2004 is mainly attributed to the fact that the Congress led UPA coalition government is dependent on the support of anti-privatization political parties to maintain a parliamentary majority and has not received support from its alliance partners to the privatization program²².

²⁰The Disinvestment Policy of the Gol is available on the website of the Department of Disinvestment at

http://www.divest.nic.in/Dis_Current.asp

²¹ Id.

²² For example, the privatization of Neyveli Lignite located in Tamil Nadu was severely opposed by a coalition member, the DMK party, which is based in the same State -refer to the debate in the Indian parliament reported at http://articles.timesofindia.indiatimes.com/2009-06-09/india/28155814_1_disinvestment-policy-psus-dmk where the Congress-led government's agenda for disinvestment faced opposition from its key political ally in the UPA government- DMK

The anecdotal evidence that in India political considerations and compulsions have played a major role in how successive governments have looked at privatization is backed by empirical research studies²³.

Since the start of the privatization program after 1991, so far the Government of India has been able to raise nearly Rs 1002 billion (approx US\$ 20 billion at a parity of 1 US \$=Rs50), however the bulk of the receipts (nearly 82%) have come from the sale of minority shareholding in CPSEs; receipts from strategic sales account for a miniscule 6% of the total receipts.

<u>Serial No.</u>	<u>Method of Disinvestment</u>	<u>Amount Raised from 1991-92*</u> <u>(Rs Million)</u>
1	Receipts through sale of minority shareholding in CPSEs	821,996.9
2	Receipts through sale of majority shareholding of one CPSE to another CPSE	13,172.3
3	Receipts through Strategic sale	63,443.5
4	Receipts from other related transactions	40,051.7
5	Receipts from sale of residual shareholding in disinvested CPSEs /companies	63,982.7
6	Total receipts	1002,647.1

*Source: <http://www.divest.nic.in/SummarySale.asp>

In the 1991-1999 decade, governments worldwide have raised over US\$1 trillion from the sale of state- owned enterprises (SOEs)²⁴. However, the South Asian economies of Bangladesh, India, Pakistan, and Sri Lanka have been slow to divest from government- owned firms and revenues raised from privatization between 1991 and 1999

²³ Nandini Gupta, (November 2010) Selling the family silver to pay the grocer's bill? The case of privatization in India; available at http://www.bus.indiana.edu/nagupta/gupta_nov2010.pdf

This study investigated the influence of political and financial factors on the decision to privatize government-owned firms using firm-level data from India and found that the government significantly delayed privatization in regions where the governing party faces more competition from opposition parties and also that political patronage is an important consideration for privatization as no government-owned firm located in the home state of the minister in charge was ever privatized.

²⁴ Netter, Jeffrey M. and Megginson, William L., From State to Market: A Survey of Empirical Studies on Privatization. Journal of Economic Literature, Vol. 39, No. 2, June 2001. Available at SSRN: <http://ssrn.com/abstract=262311>

totaled just US\$11.9 billion in South Asia whereas, in contrast, Latin America raised over US\$177 billion over the same period²⁵.

3. Minority Shareholder Rights in SOEs.

Equitable treatment of all shareholders is one of the six principles of good governance prescribed by the Organization for Economic Co-operation & Development (OECD)²⁶. This principle seeks to protect the non-controlling shareholders from potential abuse such as manipulation by boards, managers and controlling shareholders and thereby preserve the integrity of the capital markets. The confidence of the investors that their invested capital would be protected from misappropriation by managers, board members and controlling shareholders is an important factor in the development of capital markets as such confidence will reduce the risk premium that investors will demand for making an investment and this in turn will lower capital costs and raise the value of equity

The annotations to the OECD principle notes that, in providing protection to investors, a distinction should be made between ex ante and ex post shareholders' rights. Ex ante rights are pre-emptive rights for shareholders, for example, certain decisions of the company can only be taken by an overwhelming majority of shareholders while ex post rights cover access to redress once the rights of the shareholders have been violated – they define whether shareholders can obtain redress of their grievances at a reasonable cost and without excessive delay.

Furthermore, the OECD Principles of corporate governance support equal treatment for foreign and domestic shareholders and pay much attention to the protection of the rights of the non-controlling (minority) shareholders. Besides a transparent disclosure policy to all shareholders, a key to protecting the interest of non-

²⁵ Nandini Gupta, Privatization in South Asia (November 2006) in Privatization-Successes and Failures (edited by Gerard Roland) available at <http://www.kelley.iu.edu/nagupta/privsouthasiaport.pdf>

²⁶ The OECD Principles of corporate governance, available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>, define the principle for the equitable treatment of Shareholders as follows;

“The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same series of a class should be treated equally.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.
2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.
3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
4. Impediments to cross border voting should be eliminated.
5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation”.

controlling shareholders is a clearly articulated duty of loyalty by board members to the company and to all shareholders.

In addition to the same core problem, in terms of separation of control and ownership that is faced by private organizations, State owned enterprises (SOEs) face additional and significant challenges that can severely undermine their governance process.

A World Bank Study on the challenge of SOE Corporate Governance²⁷ lists three additional and significant governance challenges for SOEs as compared to a normal organization.

Firstly, unlike a widely held corporation in the private sector, an SOE generally cannot have its board changed via a takeover or proxy contest and most cannot go bankrupt. Not only does the incentives of board members and managers to maximize the value of the company gets reduced in the absence of potential takeovers and proxy contests but also the lack of the threat of bankruptcy can lead to the introduction of a soft budget constraint, which reduces pressure on the SOE to contain costs. Consequently, two of the most important checks on underperformance by an organization are absent in the case of SOEs.

Secondly, even though an SOE has very diffused owners (citizens) it generally has a higher body or bodies that oversee its functioning. This could be in the form of one or more ministries or an ownership entity specifically created to oversee SOEs or the Parliament, or some combination of these. In the worst case situation, these various authorities may use SOEs to achieve short-term political goals at the cost of both efficiency and longer-term policy objectives. Even without flagrant abuse, this complex agency chain through and across various levels of the government may present difficulties, which would be absent in a more straightforward relationship between a company's board and managers on the one hand and its shareholders on the other, and lead to significant governance challenges. This would also lead to a dilution of accountability in the SOE; it is also pertinent to point out that SOEs may suffer equally from undue hands-on and politically motivated ownership interference as from a totally passive or distant ownership by the state.

Thirdly, given that each relevant part of the government has somewhat different objectives, each could attempt to influence the SOE accordingly so the SOEs also have the problem of common agency. Even if the various objectives are perfectly legitimate, the overall impact of this competition for influence reduces accountability and weakens the incentives for managers and board members.

Managing multiple and potentially conflicting objectives, therefore, is the key challenge in the governance of SOEs.

Recognizing that there are specific governance challenges that arise in SOEs as compared to normal organizations, and given the fact that in several countries (including India), SOEs represent a substantial part of GDP, employment and market capitalization with presence in utilities and infrastructure industries whose performance is of great importance to broad segments of the population and to other parts of the business sector, OECD

²⁷ The World Bank, Corporate Governance; Held by the Visible Hand, The Challenge of SOE Corporate Governance for Emerging Markets (May 2006) available at <http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>

formulated a set of non-binding prescriptions to improve governance in SOEs²⁸. These Guidelines are complementary to the OECD Principles of Corporate Governance, on which they are based, and with which they are fully compatible.

Equitable treatment of shareholders in accordance with the OECD principles of corporate governance provides the base for the OECD guidelines for corporate governance in SOEs²⁹. According to OECD, it is in the state's interest to ensure that, in all enterprises where it has a stake, the minority shareholders are treated equitably, since its reputation in this respect will influence its capacity of attracting outside funding and the valuation of the company. The state should therefore ensure that other shareholders do not perceive the state as an opaque, unpredictable and unfair owner but, on the contrary, it should follow best practices regarding the treatment of minority shareholders.

Conventionally, it may seem that, in order to escape expropriation by the main block holder, the minority shareholders in a SOE have only one option and that is to exit (on relatively unfavorable terms) and make alternative investments - as some of the statements made by representatives of the Government of India during the recent Coal India imbroglio seem to suggest³⁰.

However, a variety of other feasible, alternative courses of action are also available to the minority shareholders. Based on a study carried out of the performance of a leading Italian SOE, Istituto per la Ricostruzione Industriale (IRI) between 1950s and 1970s, that highlighted many of the governance issues that arise in listed companies where the state is a controlling shareholder and which operate in an environment that is characterized by an absence of appropriate minorities protection, Andrea Colli³¹ has suggested that there are at least four possible options to the option of minority shareholders exiting in a situation where their rights are being expropriated.

The first alternative is the establishment of appropriate governance independent mechanisms or agencies while the second alternative is to incentivize the creation of associations of minority shareholders, as in some European countries, that is able to exert formal and informal pressures on the companies' top management. A third

²⁸ OECD Guidelines on Corporate Governance of State-owned Enterprises, available at <http://www.oecd.org/dataoecd/46/51/34803211.pdf>.

²⁹ The state and state-owned enterprises should recognize the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information.

A. The coordinating or ownership entity and SOEs should ensure that all shareholders are treated equitably.

B. SOEs should observe a high degree of transparency towards all shareholders.

C. SOEs should develop an active policy of communication and consultation with all shareholders.

D. The participation of minority shareholders in shareholder meetings should be facilitated in order to allow them to take part in fundamental corporate decisions such as board election.

³⁰ During the controversy on the rights of the minority shareholders in Coal India when some minority shareholders had taken a view that was different from the view of the majority shareholder (Government), in an interview to Firstpost. Business, Shri Sripralash Jaiswal, Union Minister for Coal said "Whoever wants to stay invested in CIL can stay or otherwise leave. Someone's notice or threats will not bend the government. It is CIL's job to make profit and to produce coal but only making profit is not its job till it remains with the government. If TCI wants to sell out, it will not affect our capital markets" - available at <http://www.firstpost.com/business/54-coal-blocks-to-be-auctioned-in-1-2-months-minister-261045.html>

³¹ Andrea Colli, Bocconi, University – Milan; Coping with the Leviathan. Minority shareholders in State-owned enterprises: evidence from Italy;(2011) available at http://www.erim.eur.nl/portal/page/portal/ERIM/Content_Area/Documents/paper%20Andrea%20Colli.pdf

possibility would be to, at least, partially improve the conditions of minorities, by increasing the efficiency of the market for corporate control, allowing in this way for the mobilization of illiquid assets. A fourth option would be a sort of activism by institutional investors that is by other financial and non financial companies acting as minority shareholders.

4. Corporate Governance in SOEs - International practices and trends.

The relationship between the state as a controlling or significant shareholder and the minority shareholders is particularly delicate in SOEs, especially those commercial organizations that are listed. As the dominant shareholder, the state may be in a position to abuse minority shareholders as it is able to take decisions in general meetings of shareholders without the approval of minority shareholders and it is also usually in a position to control the board's composition. Moreover, the state is likely to have other political and policy objectives which might be implemented at a cost to the minority shareholders.

Good governance of SOEs is the key to protecting the interest of minority shareholders in SOEs

Given that managing multiple and potentially conflicting objectives is the key challenge in the governance of SOEs it would appear to be more likely than not that a SOE would not function as effectively as a private enterprise. A World Bank study³² that reviewed empirical evidence from 1970s onwards found that a majority of empirical studies supported the superior performance of private firms and found that even though there was greater ambiguity about the impact of ownership on performance in theory, the empirical evidence largely supported the hypothesis that private firms would outperform SOEs. A similar study over OECD countries, however, showed contrary findings³³.

Scholars and practitioners have suggested that the main governance problem in an organization characterized by a dominant shareholder (as in the case of a SOE where the state is the dominant shareholder) is the squeeze-out of minority shareholders by the controlling shareholder and, as a solution, it is usually recommended that the main shareholder should surrender some control to minority shareholders at the outset; with shared control rights, no shareholder can take unilateral actions for his own benefit at the expense of the firm and other shareholders³⁴.

³² Shirley, Mary M. and Walsh, Patrick Maurice, Public vs. Private Ownership: The Current State of the Debate (January 2001). World Bank Policy Research Working Paper No. 2420; available at SSRN: <http://ssrn.com/abstract=26185>.

Of the 52 studies reviewed in this study, the performance of private and privatized firms in 30 studies was significantly superior to that of public firms. 15 studies found either that there was no significant relationship between ownership and performance, or that the relationship was ambiguous (different evidence supports both public and private superiority). Five studies concluded that publicly-owned firms performed better than private firms.

³³ Supra. Refer Note No. 8,

Bortolotti & Faccio's large sample study over OECD countries found that, contrary to accepted theory, greater government control over privatized firms does not negatively affect market valuation and, in fact, government stakes were positively and significantly related to peer-adjusted market-to-book ratios. It appeared that the relationship documented reflected more frequent financial aid (bailouts) accruing to privatized firms that remain under government control than to other firms..

³⁴ Venky Nagar, Kathy Petroni, and Daniel Wolfenzon, Governance Problems in Closely Held Corporations,(Vol. 46, No. 4, Aug. 2011) Journal of Financial and Quantitative Analysis

Venky Nagar et al³⁵ tested this proposition on a large data set of closely held corporations and found that shared-ownership firms reported a substantially larger return on assets and lower expense-to-sales ratios. They provided evidence on the presence of governance problems and the effectiveness of shared ownership as a solution in settings characterized by illiquidity of ownership.

It follows, therefore, that a state owned enterprise that respects the rights of the minority shareholders would end up creating better value for the enterprise since its focus would be solely on enhancing the value of the business. Moreover, it needs to be appreciated that when an SOE sells shares to the public, it also takes on the obligations of other listed companies and minority shareholders in state-controlled companies have the same legal rights that shareholders in other listed companies have and law & good practice indicate that they should be treated equally. Not only does this imply that the state should avoid using its power to abuse minority shareholders, but that it should exercise its policy objectives in a way that preserves the legal rights of other shareholders and board members of the SOE should serve in the interest of all shareholders. To ensure the confidence of outside investors, special measures may even be warranted to ensure equal treatment of shareholders.

In an attempt to establish the best practices for managing minority shareholder interests, a research report published by the OECD³⁶ reviewed the relationship of state owned enterprises with other shareholders on the various parameters that impact the rights of the minority shareholders and identified the following trends;

- *Reference to a general legal framework* -In most OECD countries, minority shareholders in SOEs have no more rights than they would usually have as members in privately owned companies. Almost all countries assert that SOEs follow the regulatory provisions provided in their company law, listing requirements or in the corporate governance principles/codes. Since the respective legal frameworks are deemed to ensure fair and equitable treatment among all shareholders, and no special protection or provision is made for shareholders other than the state in SOEs.
- *Strengthened decision making powers within general shareholder meetings or boards* – Minority shareholders in SOEs are likely to be particularly concerned about the actual decisions being made outside of the company's general meeting of shareholders or board meetings, or prior to such meetings which reduces them to mere rubber stamps. To prevent such a situation SOE minority shareholders are, in some countries, granted access to the decision making process, often through stronger representation on the board³⁷. In a few OECD countries and for some SOEs, minority shareholders are actively encouraged to participate in general shareholder meetings by the adoption of specific mechanisms at the company level, including facilitating voting in absentia or developing the use of electronic means as a way to reduce

³⁵ Id.

³⁶CE Sifo DICE Report ;(2007); Corporate Governance: Relationship of State owned Enterprises with other Shareholders; originally published as chapter 3 of " Corporate Governance of State-Owned Enterprises – A Survey of OECD Countries" (ISBN 92-64-00942-6; c OECD 2005).

available at <http://www.cesifo-group.de/portal/pls/portal/docs/1/1193170.PDF>

³⁷ Id. For example in Turkey, if private shareholders control 20 percent of the shares, they may appoint one board member (at 40 percent they can appoint two). In Vietnam, minority shareholders are represented on the board through cumulative voting. They are encouraged to participate in the general shareholder's meeting and have certain guarantees to share in the profits of the SOE.

participation costs. In some countries, a specific regulation applies to all SOEs and grants minority shareholders additional rights, mainly with regard to their representation on boards and cumulative voting may be allowed, according to the general Company Law or following specific SOE by-laws. This allows minority shareholders to concentrate their voting rights and may help in rebalancing the dominant state position by a stronger influence of private minority shareholders.

- *Ex ante rights* - Granting minority shareholders specific ex ante rights may also be quite useful in strengthening the rights of the minority shareholders, and in most cases these rights are granted by the general legal framework and are not specific to minority shareholders in SOEs
- *Information rights* - A crucial condition for protecting minority shareholders is to guarantee a high degree of transparency. However, few countries document the provisions taken, if any, to ensure that the ownership entity does not make any potentially abusive use of the information it receives as a controlling shareholder.
- *Right of redress* - Minority shareholders do enjoy in most OECD countries the same rights in SOEs as in other companies, based on the general company legal framework applicable for the country.
- *Protecting the rights of the state as a minority but dominant shareholder; the cases of "golden shares"* - Special rights have usually been introduced in some countries in the context of privatization: they allow the state to divest itself of national flagships but without relinquishing its control over them. Such structures which allow the state to retain specific powers over the future ownership control or the strategic conduct of a private company are not in the interest of the minority shareholders³⁸.

Corporate Governance in an SOE is also impacted by how the SOE is structured in terms of ownership; three main types of ownerships of SOEs have been found to be prevalent across the OECD countries: the decentralized or sector model, the dual model and the centralized model³⁹. The decentralized model is the one where SOEs are under the responsibility of relevant sector ministries. The dual model is the one where the responsibility is shared between the sector ministry and a "central" Ministry or entity (usually the Finance Ministry or the Treasury) while the centralized model is one in which the ownership responsibility is concentrated under one main ministry and has been found to be on the increase more recently.

The decentralized or sector model has been the traditional model for exercising the ownership function and still exists today in a few OECD countries, such as Finland and to a less extent Germany⁴⁰. In some cases, a specific ministry plays a coordinating role, in addition to the main role played by sector ministries, and is in charge of elaborating the overall ownership policy as well as specific guidelines. The main advantages and rationale for such a decentralized organization are due to the much greater availability of sector expertise. The main drawbacks

³⁸ Id. In several landmark decisions of 2002 and 2003 against Portugal, France and Belgium as well as the UK and Spain, the European Court of Justice struck down diverse special rights mechanisms and established as a general principle that any legislation liable to deter potential direct investment restricts the EC Treaty freedoms of capital movement and establishment.

³⁹ Maria Vagliasindi; Governance Arrangements for State Owned Enterprises;(2008); Policy Research Working Paper 4542 available at <http://elibrary.worldbank.org/docserver/download/4542.pdf?expires=1340417360&id=id&accname=quest&checksum=6D00C7849E0ABA9FF2853740A48F4300>

⁴⁰ Id. In Finland, 9 different ministries exercise the ownership function over 50 SOEs. In the UK (up to 2003), the ownership function was historically dispersed among a wide number of ministries, and is now under the responsibility of 9 different Departments, Ministries or Offices.

resulting from such an organization are the difficulty in clearly separating the ownership function from the regulatory role and the increased risk of governmental interference in day-to-day operational functions.

In the dual model both sector ministries and a “common” ministry are responsible for exercising ownership rights. The “common” Ministry is usually the Ministry of Finance, due to the importance of the SOE sector to the state’s overall economic and financial objectives. Both ministries may have the right to nominate representatives for the board of directors and the dual responsibilities often also include the approval of major transactions and strategic plans. In the dual form, one single ministry such as the ministry of finance, or a specialized body, performs certain ownership functions for all SOEs, but other functions are performed by different ministries for different SOEs. In this model, the power of the central ministry or body can range from being close to that of the centralized case, with other ministries playing a fairly limited governance role, to being much more circumscribed, with the central entity serving only as a consulting and advisory unit for the rest of the government and having no direct control over SOEs. Brazil, Bulgaria, India, Kenya, Mexico, South Africa, Turkey, and Vietnam all have variations on the dual system⁴¹.

An important potential advantage of the dual model is that it can reduce the conflict of interest that the government typically has in its dual role as both the owner of an SOE and the representative of that SOE’s stakeholders. When these two roles are divided between the two ministries, competing constituencies are introduced into the SOE’s corporate governance framework which is likely to subject the SOE’s corporate policy to more rigorous checks and balances than what would have taken place under a single government ministry, this leads to a better protection for the minority shareholders. Another potential advantage of the dual model is that it facilitates both technical (from the officials of a sectoral ministry) and fiscal oversight (from the Ministry of Finance, or perhaps a ministry of public enterprises). The main disadvantages of the dual model are the potential for the blurring of responsibilities between the two ministries involved and the possibility that SOE management perceives itself to be “the servant of two masters”, with detrimental results for morale and performance.

The centralized model has become more popular in the current implementation of privatization programs. In this model, most SOEs are put under the responsibility of one Ministry or Agency. Chile, Indonesia, Jordan, Peru, Poland, and Singapore all have what is an essentially centralized system⁴².

⁴¹ Id. In Brazil, Mexico, and Vietnam, although different line ministries oversee different SOEs, the Ministry of Finance is responsible for the financial performance and asset management of each. In Kenya, the Ministry of Finance also sets other guidelines for SOEs. In Turkey, the Treasury and the Privatization Administration are the legal owners of SOEs and share responsibility for the SOE with the relevant sector ministry. In India, while SOEs are overseen by specific ministries, the Department of Public Enterprises issues guidelines and a number of government bodies have an oversight or advisory role while in South Africa, the Department of Public Enterprises develops policies and processes for the governance of SOEs and directly oversees six major enterprises, while line ministries are responsible for the rest. The South African National Treasury also has an oversight role in SOE.

⁴² Id. In Singapore, SOEs are owned by Temasek, the national holding company, which in turn is 100 percent owned by the Ministry of Finance. As a holding company, Temasek has substantial authority in its subsidiary companies.

The Chilean State Owned Enterprise System is not considered the direct owner of SOEs, but carries out the ownership function for the state in all of them. In Poland, the bulk of SOEs are under the Ministry of the Treasury, which has special units for privatization and SOE governance. In Indonesia, the Ministry of State-Owned Enterprises exercises the states ownership rights in SOEs. In Jordan, the ownership function is carried out by the Jordan Investment Corporation

The main advantages of the centralized model are the clear line of accountability from the SOE to the government, the ability of the government to exert close fiscal supervision and to form a coherent SOE policy, and the fact that it allows the best use of the typically limited human resources available within the civil service to undertake the specialized job of exercising the government's ownership function. The main disadvantage is the likelihood that the depth of sectoral expertise available in a Ministry of Finance, for example, will be shallower than in sectoral ministries. In such a model of good governance better protection of the rights of minority shareholders would depend upon on how effectively the centralized agency is insulated from political interference, the degree of clarity with which its objectives have been defined and the autonomy granted to it to fulfill its mandate.

Globally there is a trend of less reliance on a purely decentralized system, with many countries establishing a single ownership entity or coordinating body.

Temasek Holdings, Singapore⁴³ is an example of a successful holding company structure to manage the assets of SOEs. Wholly owned by the Singapore Government, it is an investment company headquartered in Singapore, with 10 locations in cities across Asia and Latin America and manages a portfolio of around US \$ 153 billion, as on 31st March 2011.

Temasek is wholly owned by the Ministry of Finance and is governed by the provisions of the Singapore Companies Act and all other applicable laws and regulations governing companies incorporated in Singapore. Subject to the President of Singapore's concurrence, its shareholder has the right to appoint, remove or renew Board members.

Under Singapore's constitution and laws, neither the President of Singapore nor the Government is involved in Temasek's investment, divestment or other business decisions, except in relation to the protection of Temasek's past reserves. Within this regulatory framework, Temasek operates with full commercial discretion and flexibility, under the direction of its Board. Its governance framework emphasizes substance over form and long term over short term and provides for accountability and a robust balance between empowerment and compliance⁴⁴.

Temasek has delivered a total shareholder return of 17% compounded annually since its inception in 1974 and provides a good example of a successful holding company structure for SOEs that works independently with minimal interference from the government.

There have been a number studies aimed at identifying key factors which, if adopted, would lead to promoting and implementing good governance practices in SOEs and therefore help to protect the rights of the minority shareholders.

For instance three key policy recommendations, which impact corporate governance, emerge from a World Bank review⁴⁵ of SOE performance evaluation and monitoring in the case of infrastructure sectors in developing countries. First, governments need to spend as much time and effort in monitoring the performance of public operators as they would do for private operators. Better corporate governance of such projects would lead to more transparency and accountability of the infrastructure sectors and minimize the cost of such projects. Second,

⁴³ Details obtained from Temasek's website: <http://www.temasek.com.sg/>

⁴⁴ Id.

⁴⁵ Supra. Refer Note No. 39.

some of the structures implied in the OECD Principles of Corporate Governance for SOEs (e.g., favoring a centralized ownership function through an independent agency versus a decentralized or dual structure) have not yet been sufficiently "tested" in practice and may not suit all developing countries. Developing countries are characterized by tight budget constraints that need to be taken into account when it comes to determine the most appropriate governance structure and a centralized structure, where the ownership is exercised by the Ministry of Finance rather than an independent agency, seems to be better suited and also to be relatively successfully implemented in developing countries. Thirdly, general corporate governance guidelines (and policy recommendations) need to be carefully adapted to infrastructure sectors, particularly in the natural monopoly segments and market structures and governments should distinguish between SOEs operating in potentially competitive sectors from the ones operating under a natural monopoly structure. Competition provides not only formidable benefits but also unique opportunities for benchmarking, increasing the transparency and accountability of the sector.

Adherence to National Governance codes by SOEs has also been seen as an important vehicle better corporate governance in SOEs though the empirical evidence is quite mixed and the issue gets subsumed in the broader issue of how effective are the National Governance codes. An Indonesian Study⁴⁶ based on a document analysis method attempted to answer the question as to what extent Indonesia's concept of corporate governance solved the existing governance problems of SOEs, including pure SOEs -which had the government as the sole shareholder's representative. The study found that the mainstream corporate governance in Indonesia was designed to deal with agency problem that occurs in publicly traded companies with widely dispersed shareholders as opposed to non-listed companies such as pure SOEs. The study found that the code had failed to solve the crucial problems of conflicting objectives and political interference and concluded that the current Indonesian code of corporate governance, conceptually, could not remedy the governance issues in Indonesia's pure SOEs which primarily needed specific laws and regulations in addition to a strong code that was free from political interference and unprofessional supervisory boards and able to cope with the conflicting objectives.

5. Corporate Governance in SOEs – the Indian experience.

India has a complex dual ownership form where a number of bodies oversee the Central Public Sector Enterprises (CPSEs), as the SOEs are more commonly referred to in India.

The Department of Public Enterprises (DPE), under the Ministry of Heavy Industries & Public Enterprises, issues guidelines on governance related issues, including board appointments, appointments of other personal, wages and salaries. The Central Vigilance Commissioner issues guidelines on conduct, disciplinary cases, investigations and related issues. Departmental enterprises are subject to a special additional audit by the Comptroller and Auditor General. The Central Bureau of Investigation, an autonomous police organization of the government, assumes jurisdiction over the employees and board members. The Planning Commission has a role in planning and

⁴⁶ Miko Kamal; PhD Candidate in Business Law, Macquarie University; (2010); Corporate Governance and State-owned Enterprises: A Study of Indonesia's Code of Corporate Governance, Journal of International Commercial Law and Technology Vol. 5, Issue 4

project proposals. The Public Enterprise Selection Board (PESB) recommends and selects potential SOE board members. Finally, it is the various ministries that exercise ownership rights and set policy objectives (sometimes together with the legislature) and they make the final choice for certain board members and the chief executive, through whom they exert substantial influence and can also issue directives to and veto major decisions of SOE boards.

In June 2007 the DPE issued Guidelines on Corporate Governance for CPSEs on an experimental basis, these which was adopted by CPSEs on a voluntary basis in 2008-09. In the light of the experience gained, the Guidelines were modified and then adopted on a mandatory basis in May 2010; these now form the cornerstone for corporate governances in all CPSEs.

The guidelines⁴⁷ on Corporate Governance apply to listed as well as unlisted CPSEs and cover the following issues:

- Board of Directors
- Audit Committee
- Remuneration Committee
- Subsidiary Companies
- Disclosures
- Report, Compliance and Schedule of Implementation.

In so far as listed CPSEs are concerned, they have to follow the Securities & Exchange Board of India (SEBI) Guidelines on Corporate Governance as prescribed from time to time⁴⁸ additionally, they are required to follow those provisions in the DPE prescribed guidelines on Corporate Governance which do not exist in the SEBI Guidelines and which do not contradict any of the provisions of the SEBI Guidelines.

In addition to the mandatory corporate governance guidelines issued by the DPE, the CPSEs are also governed by the Companies Act, 1956 and regulations of various authorities like Comptroller and Auditor General of India (C&AG), Central Vigilance Commission (CVC), Administrative Ministries, and other nodal Ministries. The Right to Information Act 2005 is also applicable to the CPSEs⁴⁹.

DPE believes that, because of the implementation of its guidelines, key principles of Corporate Governance are in vogue in CPSEs⁵⁰ because (a) the Chairman, Managing Director and Directors are appointed independently through a prescribed procedure; (b) Statutory auditors are appointed independently by the Comptroller & Auditor General; (c) Arbitrary actions, if any, of the Management can be challenged through writ petitions; (d)

⁴⁷The DPE guidelines for CPSEs are available at http://dpe.nic.in/sites/upload_files/dpe/files/gcgcpcse10.pdf

⁴⁸ Clause 49 of the Listing Agreement contains the guidelines on Corporate Governance for all Listed Companies and applies to all Listed Companies (or those that are seeking listing), except for very small companies (that is, those that have a paid-up capital of less than Rs. 30 million and a net worth of less than Rs. 250 million throughout their history). While several requirements of Clause 49 are mandatory in nature, there are certain requirements (such as the setting up of a remuneration committee, training of board members and whistleblower policy) that are merely recommendatory in nature. See Securities and Exchange Board of India circular no. SEBI/CFD/DIL/CG/1/2004/12/10 dated 29 October 2004, Available at: <<http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf>>.

⁴⁹Supra. Refer Note No. 47.

⁵⁰ Id.

Remuneration of Directors, employees, etc. are determined on the basis of recommendations of Pay Committees constituted for this purpose; and so on.

However, despite the various initiatives that have been taken by the GoI and the guidelines that have been issued for better corporate governance in CPSEs, the CPSEs are constrained from acting as normal commercial organizations since some judicial pronouncements have declared public enterprises to be an extension or arm of the State under Article 12 of the Constitution⁵¹ leading to their functioning in an environment which undermines the entrepreneurial and commercial functioning of public enterprises and puts them at a disadvantageous position vis-à-vis their private sector counterparts and competitors. As the State is the majority shareholder, the State owned enterprise have to work under the aegis of the State and are, therefore, subject to multiple levels of authority and reviews which not only can be quite onerous but also quite time consuming⁵².

A key factor that would impact good governance in CPSEs would be the role played by the Independent Directors on the board of such enterprises.

The Corporate Governance Guidelines mandated by the DPE prescribe⁵³ that in case of a CPSEs listed on the Stock Exchanges and whose Board of Directors is headed by an Executive Chairman, the number of Independent Directors shall be at least 50% of Board Members and in case of all other CPSEs (i.e. listed on Stock Exchange but without an Executive Chairman, or not listed CPSEs), at least one-third of the Board Members should be Independent Directors.

The DPE has laid down the following criteria for consideration of appointment as an Independent Director⁵⁴

- Criteria of Experience
 - a. Retired Government officials with a minimum of 10 years experience at Joint Secretary level or above.

⁵¹ Under Article 12 of the Indian Constitution the definition of , 'State', unless the context otherwise requires, includes the Government and Parliament of India and the Governments and Legislature of each of the States and all local or other authorities within the territory of India or under the control of the Government of India. Although Article 12, in so many words, does not provide that CPSEs fall within the definition of the 'State', they are still deemed as being included in the category 'other authorities' and therefore, covered under the definition of 'State' as pronounced by different Courts including the Supreme Court of India.

Refer to the report of the Ad-hoc Group of Experts on the Empowerment of central Public Sector Enterprises (Arjun Sengupta Committee), 2007: available at

http://dpe.nic.in/publications/report_of_ad_hoc_group_of_experts_on_empowerment_of_cpse.

⁵² Mr Arun Balakrishnan, CMD of Hindustan Petroleum Corporation (HPCL) has identified the inclusion of PSEs under the definition of State as, ".....the genesis for a plethora of controls. Thus in addition to the audit committee, the statutory audit, internal audit the State owned enterprises have audits/reviews conducted by the parent ministry, the Department of Public Enterprises, Comptroller & Accountant General, the Chief Vigilance Commissioner, Parliament and Parliamentary Committees and the CBI. The State owned enterprises are also subject to writ petitions to the Supreme Court under Article 32 of the Indian Constitution and to the High Court under Article 226 of the Indian Constitution".

Available at-

<http://www.hindustanpetroleum.com/Upload/En/ChairmansSpeech/files/SOE%20Corporate%20Governance%20June08.pdf>

⁵³ Supra., Refer Note No. 39

⁵⁴ The criteria laid down by the GoI for consideration of candidates as non-official Director(s) in CPSEs are available at http://dpe.nic.in/publications/databank_of_independent_directors

- b. Persons who have retired as CMD/CEOs of CPSEs and Functional Directors of the Schedule 'A' CPSEs. The ex-Chief Executives and ex-Functional Directors of the CPSEs will not be considered for appointment as non-official Director on the Board of the CPSE from which they retire. Serving Chief Executives/Directors of CPSEs will not be eligible to be considered for appointment as non-official Directors on the Boards of any CPSEs.
 - c. Academicians/Directors of Institutes/Heads of Department and Professors having more than 10 years teaching or research experience in the relevant domain e.g. management, finance, marketing, technology, human resources, or law.
 - d. Professionals of repute having more than 15 years of relevant domain experience in fields relevant to the company's area of operation.
 - e. Former CEOs of private companies if the company is (a) listed on the Stock Exchanges or (b) unlisted but profit making and having an annual turnover of at least Rs.250 crore.
 - f. Persons of eminence with proven track record from Industry, Business or Agriculture or Management.
- Criteria of Educational Qualification
Minimum graduate degree from a recognized university.
 - Criteria of Age
The age band should be between 45-65 years (minimum/maximum limit). This could, however, be relaxed for eminent professionals, for reasons to be recorded, being limited to 70 years.

The proposals for appointment of non-official Directors on the Boards of CPSEs are initiated by the concerned Administrative Ministries/Departments and the selection of non-official Directors is made by the Search Committee⁵⁵.

The concerned Administrative Ministry/Department appoints the non-official Directors on the basis of recommendations of Search Committee after obtaining the approval of competent authority and clearance by the Chief Vigilance Commissioner after which it is put up to the Cabinet's Appointment Committee for final approval.

The process for the appointment of Independent Directors has come in for a lot of criticism because of the time lag and delay in the appointment of the Board members⁵⁶. This is despite the fact that the selection process starts the process for selecting the Independent Director one year before the vacancy arises. Pointing to the dysfunctional consequences of such delays in appointment Shri U.D. Choubey, Director General of Standing

⁵⁵ Id. The present composition of the Search Committee is as under.

1. Chairman (PESB)
2. Secretary, DPE
3. Secretary of the concerned Administrative Ministry/Department
4. 2 non-official Members, viz. Shri Vivek Mehrotra, Ex-Secretary to GOI and Dr. Pritam Singh, Director General, International Management Institute.

⁵⁶ As reported in a Comptroller and Auditor General (CAG) Report tabled in the Indian Parliament on 10.5.2012, of the 466 Central Public Sector Enterprises (CPSEs) audited by the CAG during 2010-11, 18 companies did not have the required number of independent directors and in 29 companies there was no such representatives on board.

Refer to: http://articles.economicstimes.indiatimes.com/2012-05-10/news/31655558_1_independent-directors-cag-report-cpses.

Committee of Public Enterprises (SCOPE) said⁵⁷, "This (the delay in appointment) is coming as a serious obstacle in way of optimal performance of public sector units," and went to identify that the main reasons behind such a state as being the long-drawn existing procedures and the unwanted delay in awarding vigilance clearances.

Leaving aside the issue of inordinate delay in the appointment of independent directors on the Boards of CPSEs, some have argued⁵⁸ that while due to the diffused shareholding structures in the U.S. and the U.K., independent directors were ushered into corporate governance norms in those countries in order to operate as an effective monitoring mechanism over managers in the interest of shareholders, a transplantation of the concept to a country such as India without placing emphasis on local corporate structures and associated factors is likely to produce unintended results and outcomes that are less than desirable.

However, a more critical issue that arises with respect to the role played by the independent directors is to understand whose interest the Independent Directors (on boards of CPSEs) represent as only they can protect the interests of the minority shareholders by taking decisions which are taken in the interest of the organization. Under the current process of appointing Independent Directors in CPSEs, the administrative ministries overseeing the CPSE, indirectly but effectively, control the appointment of independent directors in enterprises that are associated with them. Given that the dominant shareholder in most of the CPSEs is the Central Government, who has declared its intent to maintain its stake at above 51% in the enterprise, the responsibility of the government nominated independent directors effectively would translate to the independent directors remaining loyal to the appointing ministry and supporting them in the board meetings.

It can be argued that an independent directors in a CPSE ought to shoulder an obligation that extends beyond their accountability only to the dominant shareholder, as the Government is not the actual 'shareholder' of the enterprise. As Shri Pranab Mukherjee, Finance Minister of India has rightly pointed out⁵⁹; the CPSEs in India are symbols of 'public wealth' and, therefore, an independent director should be mindful of public and societal concerns.

This debate becomes quite pertinent in the context of an analysis on how the realization from sale of minority shareholding of the Government in profitable CPSEs has been channelized and whether it has been used in the best interest of the people of India. On 27 January 2005, the Government of India had decided⁶⁰ to constitute a

⁵⁷ As reported in: <http://www.livemint.com/2011/09/12224756/60-CXO-250-independent-direct.html?atype=tp>

⁵⁸ Varrotil, U., Evolution & Effectiveness of Independent Directors in Indian Corporate Governance; (Summer 2010) Hastings Business Law Journal, Volume 6, Number 2; feels that due to the concentrated ownership structures in Indian companies, the minority shareholders require the protection of corporate governance norms from actions of the controlling shareholders and Board independence, in the form it has originated in the western countries, does not provide a solution to this problem.

⁵⁹In his budget speech while presenting the FY 09-10 Budget, the Finance Minister said, "The Public Sector Undertakings are the wealth of the nation, and part of this wealth should rest in the hands of the people. While retaining at least 51 per cent Government equity in our enterprises, I propose to encourage people's participation in our disinvestment programme. Here, I must state clearly that public sector enterprises such as banks and insurance companies will remain in the public sector and will be given all support, including capital infusion, to grow and remain competitive"; reported at: <http://indiabudget.nic.in/ub2009-10/bs/speecha.htm>.

⁶⁰The investment objectives of the National Investment Fund are given at: http://www.divest.nic.in/Nat_inves_fund.asp

'National Investment Fund' (NIF) into which the realization from such disinvestment sale was to be channelized and which was meant to be maintained outside the Consolidated Fund of India; furthermore the corpus of the NIF was expected to be of a permanent nature. It was also envisaged that the NIF would be professionally managed to provide sustainable returns to the Government, without depleting the corpus and selected Public Sector Mutual Funds would be entrusted with the management of the corpus of the Fund. 75% of the annual income of the Fund was meant to be used to finance selected social sector schemes, which promoted education, health and employment while the residual 25% of the annual income of the Fund was meant to be used to meet the capital investment requirements of profitable and revivable CPSEs that yield adequate returns, in order to enlarge their capital base to finance expansion/ diversification

However, in view of the difficult economic situation caused by the global slowdown of 2008-09 and a severe drought that was likely to adversely affect the 11th Plan growth performance, the Government, in November 2009, decided to give a one-time exemption⁶¹ to utilization of proceeds from disinvestment of CPSEs for a period of three years – from April 2009 to March 2012 (subsequently extended up to March 2013) and the disinvestment proceeds during this period were to be made available, in full, for meeting the requirements of selected social sector programs as decided by the Planning Commission/Department of Expenditure.

The diversion of disinvestment proceeds from their earlier stated objectives and their use to fund the current account deficit of the Union Government (and meet its fiscal objectives) has been questioned by some⁶² as not being the best use of such funds and as “frittering away the gains, if any, of disinvestment”!

However, despite the limitations and inefficiencies in the operating models of SOEs in India, empirical evidence does not show that Indian SOEs perform badly as compared to their private sector counterparts.

An early study by K Ramaswamy⁶³ reports findings from a study comparing the performance of Indian State Owned Enterprises (SOEs) and private firms and found that SOEs do not perform badly as compared to their peer group in the private sector. While the privately held firms performed better in terms of commercial profitability, the two groups did not differ in respect of managerial efficiency and the SOEs were found to be markedly better in accomplishing public interest objectives.

Using data on Indian government-owned firms, Nandini Gupta investigated⁶⁴ the effect of privatization on the performance of government owned firms and, based on empirical evidence, has suggested that privatization is positively associated with profitability and efficiency of government-owned firms. Despite the small number of

⁶¹ Id.

⁶² In a column posted on www.suchetadalal.com former Union Secretary, Dr E A S Sarma has written, “Instead of deploying the disinvestment proceeds in more viable long-term investment opportunities, successive governments used them to fill the widening budgetary gap between the revenue and the unproductive expenditure, thus frittering away the gains, if any, of disinvestment”, available at <http://www.suchetadalal.com/?id=def31eae-ef70-4e27-4f840b0b12f9&base=sections&f..>

⁶³ Kannan Ramaswamy, Dept of Management & Intl. Business, Florida International University, Miami, FL 33199 ; (1994), Evaluating the comparative performance of state owned enterprises and privately owned firms: the Indian experience, Academy of Management Best Papers Proceedings;1994, p297

⁶⁴ Nandini Gupta; (November, 2010); Selling the family silver to pay the grocer's bill? The case of privatization in India.; available at http://www.bus.indiana.edu/na Gupta/gupta_nov2010.pdf

transactions, selling majority equity stakes to private owners has even economically significant impact on firm performance. Furthermore, privatization is not associated with layoffs or a decline in employee compensation.

A recent study by Espirito Santo Securities⁶⁵ analyzed some of the possible governance failures and abuses, in the Indian context, by dominant shareholders in different ownership categories (government, MNCs, private ownership) and reviewed the performance impact of ownership structure on firm performance. Based on an analysis of ownership and performance data of 463 BSE 500 companies, that have a 'dominant' shareholder (owning greater than 26% holding), the study concluded that;

- Public Sector Undertakings (that had majority ownership from the government) actually outperformed companies that had majority ownership from the other groups and;
- The worst performers, by a distance, are family promoter group companies where the dominant shareholder control is more than 76%.

In India, various remedies are available to minority shareholders for 'disciplining' a company and its dominant shareholder for breaches of governance; these are summarized as under;

- SEBI Listing rules - clause 49;
- The Indian Companies Act 1956;
- Common Law provisions and
- External Market mechanisms – i.e. impairing capital raising ability/secondary market attractiveness of a company with a bad governance record.

As the provisions under the Securities Law can be initiated (for investigation) only by SEBI, the redressal routes for minority shareholders are mainly restricted to those available under common law and under the Companies Act, 1956.

The key remedies available to the minority shareholders in India are as follows;

- Convene an EGM and vote at AGM/EGM– Shareholders holding 10% of paid-up share capital or 100 members can convene an EGM of the shareholders (section 169 of the Companies Act) and all shareholders have the right to vote at an AGM/EGM, either directly or through proxy. Under the companies act voting is by a show of hands unless a poll is requested. Investors can request a poll, if they hold more than 10% of voting rights or Rs.50, 000 of paid up capital (under section 179 of the Companies Act)
- Appointing/removing directors –shareholders can propose removal/appointment of a director at an AGM/EGM (under section 257 of the Companies Act, 1956).
- Apply to the GOI to investigate the affairs of a company (sections 235 & 236 of the Companies Act), but the required burden of proof for this to happen is very high and odds of this happening on a PSU are very low.

⁶⁵ Espirito Santo Securities; (26th March 2012); India's Governance -Dominant vs. Minority Shareholders; available at http://thebenchmark.in/wp-content/uploads/2012/03/Espirito_Governance.pdf

- Complain to the Company Law Board (CLB) on grounds of oppression of minority and/or mismanagement by the majority (sections 397, 398, 399 of the Companies Act). This needs 100 members or 10% share capital. Minority shareholders can apply to the CLB for 'relief' and there is even a winding up provision in the Companies Act – though onus of proof understandably high.
- Sue management/dominant shareholders under common law for negligence or misconduct, fraud, misappropriation of company assets, of fiduciary duty etc.
- Compensation for misstatements in prospectus
- Documentation requests – with the exception of board minutes most formal documentation can be requested.
- Seek information from the Government Department/Ministry under the Freedom of Information Act.

Relief, for the minority shareholders, can mean a number of things – future regulation of the company's affairs, buy-out of the complaining shareholders, termination/modification of agreements.

Using the Coal India –TCIF case as a topical example, the study by Espirito Santos Securities looked at possible routes and chances of success⁶⁶ of the campaign by a minority shareholder against the Board of the Company and concluded that though the minority shareholders have a number of key rights under company and common law that can be used to 'discipline' a company or its directors, it appeared that TCIF going down the common law route is likely to be a long, drawn-out process. Given the challenges in the Indian power sector (which consumes the bulk of Coal India's supplies), the Indian government and CIL would be extremely reluctant to be pushed towards a situation where coal prices are materially raised. Moreover, the disclaimer in the Draft Red Herring Prospectus (DRHP)⁶⁷ and the Supreme Court rulings⁶⁸, which suggest that the government is the trustee of natural resources and does have the rights to fix prices, makes the case of TCIF even harder.

⁶⁶ Id. Under Common Law, instituting a suit against Coal India's directors for breach of fiduciary duty seems the only viable option and civil courts would have jurisdiction over this matter. However, any suit will be 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 interests of the company. Civil courts will not interfere in what a company (as decided by majority shareholders) has chosen to decide legally. Sections 235/236 of the Companies Act are out of question as the Government will not initiate an investigation against itself, but many of 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.

⁶⁷ In its Draft Red Herring Prospectus (DRHP), issued at the time of the IPO, Coal India had fully disclosed these risks (the risk that Coal India sells coal at prices lower than the prices in the international coal markets and that the interests of the Gol as its controlling shareholder may conflict with interests of other shareholders) were disclosed in the DRHP in a transparent manner in Clauses 17 and 55 under the section on Risk Factors. It can be argued that prospective investors were fully aware of these risks when they invested and had no rights to complain at a subsequent date.

Please refer to the Coal India DRHP available at <http://www.sebi.gov.in/dp/coaldrhp.pdf>

However, while the DRHP disclaimer may appear to offer protection to CIL/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. If that were the case, it would amount of 'contracting out of law'.

⁶⁸ The Children's Investment Fund ;(April 2012); Cheap Coal Does Not Benefit the Indian People available at:

[http://coal4india.com/Coal4India/\(S\(ciyxscp53ag0dd40r3wramy\)\)/c4i10.pdf](http://coal4india.com/Coal4India/(S(ciyxscp53ag0dd40r3wramy))/c4i10.pdf).

In the 2G Spectrum Licences Judgment, the Indian Supreme Court has emphasised that, "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 and natural resources must always be used in the interests of the country and not private interests".

The anecdotal evidence as regards corporate governance in Indian SOEs is quite poor; indeed there have been many instances where decisions have been prompted by political and policy considerations of the government and against the long term interest of the minority shareholders.

Adopting a liberal dividend policy in SOEs to bridge Gol's fiscal deficit:

Liberal dividends from cash-rich PSUs has been a way used by the Indian government to bridge the shortfall in revenues especially in years when the government did not have time to complete its ambitious disinvestment targets. India's widening fiscal deficit, on account of a shortfall in disinvestment target and drop in tax collections because of slowdown in economic growth, has on several occasions forced the government to ask profit-making state-owned enterprises to pay additional dividends⁶⁹.

A review of the dividend payout by the cash rich ONGC over the years shows how Gol (as the majority shareholder) has used the resources of ONGC to meet its fiscal objectives.

As stated in the dividend policy of ONGC⁷⁰, dividends are declared at the Annual General Meeting of the shareholders based on the recommendation by the Board; generally, the factors that are considered by the Board before making any recommendations for the dividend include, but are not limited to, future capital expenditure plans, profits earned during the financial year, cost of raising funds from alternate sources, cash flow position and applicable taxes including tax on dividend. ONGC dividends are also subject to Gol guidelines dated February 11, 1998 from the Government of India which prescribe that, all profit-making PSUs which are essentially commercial enterprises should declare the higher of a minimum dividend of 20 percent on equity or a minimum dividend payout of 20 percent of post-tax profit. Furthermore, the minimum dividend pay-out in respect of enterprises in the oil, petroleum, chemical and other infrastructure sectors such as us should be 30 percent of post-tax profits.

The actual dividend paid out by ONGC, over the years from 2000-01, is as below;

Financial Year	Dividend Rate –in %	Dividend – Rs Mil	Dividend Payout Ratio* - %
2000-01	110	15,685	30
2001-02	140	19,963	32.2

However, the Indian Supreme Court in the matter of Ashoka Smokeless Coal India (P) Ltd. v. Union of India reported at (2007) 2 SCC 640 has taken strong exception to the Central Governments' interference in coal pricing. The court noted: "The coal companies evolve price fixation but admittedly, they have been doing so at the instance of the Central Government. The Central Government seeks to exercise its statutory power. Such a power, however, is confined to four corners of the 2000 Order. When there is no control over the price, the Central Government is forbidden to issue any direction that will have an impact there over."

⁶⁹ Business Standard, (Mar 26, 2012); Cash-rich PSUs shower dividends on govt; available at <http://www.business-standard.com/india/news/cash-rich-psus-shower-dividendsgovt/469010/>. As reported, the Gol received a windfall of more than Rs 16,000 crore by way of interim dividends from public sector undertakings (PSUs) in the financial year 2011-12.

⁷⁰ Available at http://www.ongcindia.com/invest_div_pol.asp.

2002-03	300	42,778	40.6
2003-04	240	34,222	39.5
2004-05	400	57037	43.9
2005-06	450	64,167	44.47
2006-07	310	66,305	42.39
2008-09	320	68,444	40.98
2009-10	320	68,444	42.44
2009-10	330	70,583	42.09
2010-11	175	74,861	39.56

*is the ratio of the dividend amount (computed without considering dividend tax) to the net profit in any given fiscal year.

Source: ONGC Website http://www.ongcindia.com/invest_div_paid.asp

The actual dividend payout is considerably in excess of the stated dividend policy of ONGC and has been so for every year from 2001-02 onwards! This fact is even acknowledged by ONGC in a statement on their website that reads as follows; "The amounts paid as dividends in the past are not necessarily indicative of our dividend policy in the future"⁷¹.

The liberal dividend payout by ONGC has also to be seen in the context of the high level of capital expenditure of ONGC – Rs 282,755 mil (FY 10-11), Rs 235,591 mil (FY 09-10)⁷² and raises the question whether conserving resources for internal growth would have been a better option long term option for the ONGC shareholders. Given the magnitude of its capital expenditure program, domestic and overseas, which assumes more importance as competitors are set to emerge in the private sector; prudent and rational owners would have allowed ONGC to plough back as much profit as possible rather than adopting a liberal dividend policy as was followed by Gol.

Protecting minority shareholder interest in Coal India:

The ongoing spat between The Children's International Fund (TCIF) and Coal India has brought to the forefront various corporate governance issues in Coal India that adversely affect minority shareholders⁷³.

In a letter⁷⁴ dated 12th March 2012, TCIF wrote to the board of directors of Coal India threatening to take legal action against their board members unless clear public commitments were made on several governance issues that were raised in their letter.

The essence of TCIF's concerns has been the abuse of minority shareholders (by the Government of India as the majority shareholder) and poor corporate governance in Coal India. To support their charge they provided the following details;

- Evidence that the Board of Coal India 'blindly' accepted instructions from the Secretary of the Ministry of Coal, Mr. Alok Perti, to revise down the effective price notification dated 30.12.2011 for various calorific

⁷¹ Id.

⁷² http://www.ongcindia.com/download/Annualreports/ONGC_Annual_Report_10-11.pdf

⁷³ Supra. Note No. 12

⁷⁴ Available at <http://coal4india.com/Coal4India/c4i5.pdf>.

bands of coal despite the fact that under the Colliery Control order, 2000 the coal prices have been de-regulated and the power of the central government was confined to merely regulate the supply of coal and not to regulate its price.

- Coal India is effectively subsidizing the (private) power sector and was forced to continue to operate loss making underground mines as coal prices under the FSAs signed by it with the power producers were at 70% discount to the international coal market prices putting over 200,000 jobs at risk.

Other issues, arising from poor governance that TCIF wanted to be addressed were;

- under pricing of coal to be supplied under the Fuel Supply Agreements (FSAs) to market levels
- acquiescence of the mining bill
- slow implementation of the coal washeries
- lack of action on prevalent theft of coal
- tolerance of inefficiencies in underground mines
- under delivery of coal production targets despite abundant reserves

By not acting in the interest of the company, TCIF claimed that the Board of Coal India was effectively destroying huge amount of value which, given that the government owned 90% of the company, affected the people of India the most.

The activism shown by TCIF was unprecedented in India and resulted in a number of events that followed⁷⁵.

CIL's independent directors opposed the penalty clause on Fuel Supply Agreements (FSAs) at a time when mining projects in India are being put on hold owing to delays in environmental clearances. Following this CIL was issued a Presidential directive to sign FSAs with power producers binding the state-owned producer to ensure that power producers have enough fuel. However, following the resistance on the part of the independent directors, the government allowed the company to decide the penalty amount and the board of CIL drastically reduced the penalty the company would incur on any shortfall in fuel supplied to power producers to 0.01% of the value of the shortfall (if 80% of the agreed coal isn't supplied) from the earlier proposed 10%.

Subsequently, on 16th May 2012 TCIF has sent a written notification to the Government of India of a dispute raised by it under the 2002 agreement between India and Cyprus for the mutual promotion and protection of interest⁷⁶.

Gradual Erosion in the value of MTNL:

From 1992, as a part of its policy of gradually reducing its shareholding in SOEs, the Government of India gradually started divesting its holding in Mahanagar Telephone Nigam Limited (MTNL) – the current government holding in

⁷⁵ Refer to the subsequent developments at:

<http://www.livemint.com/2012/04/17002802/CIL-board-cuts-penalty-on-fuel.html>

⁷⁶ The written notification of a dispute raised by TCIF, arising under the agreement between the Government of the Republic of India and the Government of the Republic of Cyprus for the mutual promotion and protection of Investments, is available at: <http://coal4india.com/Coal4India/Letter16052012.aspx>

MTNL is 56.25%. MTNL is the service provider in Delhi and Mumbai while Bharat Sanchar Nigam Ltd. (a 100% GOI owned SOE) is the service provider in the rest of the country

Unfortunately the absence of a suitable corporate governance mechanism to cope with a fiercely competitive market that is characterized by fierce competition has resulted in gradual and slow erosion of the value of MTNL – as reflected in the slow and gradual decline of its share price; much to the detriment of its shareholders.

<u>Year</u>	<u>Closing Price* -in Rs.</u>
1995	150
1996	237
1997	258
1998	183.2
1998	181.5
1999	193
1999	188
2000	179.1
2000	166
2001	126.25
2001	126.65
2002	94.85
2003	137.7
2004	154.9
2005	144.2
2006	142.85
2007	192.3
2008	79.05
2009	73.75
2010	54.85
2011	22.7

* Source: <http://www.bseindia.com/stockinfo/stockprc2.aspx?scripcode=500108&flag=sp&Submit=G>

Over the years there have been many diverse proposals regarding the future strategy for MTNL and BSNL viz. merging of MTNL and BSNL; a 10% initial public offering in BSNL ;creating a holding company for MTNL and BSNL . However none of these alternatives or combinations were pursued with any degree of seriousness; on the other hand, ill-advised announcement of a possible merger with Bharat Sanchar Nigam Ltd (BSNL) have serious dented

the value of MTNL on account of the fear that such a merger would mean dropping MTNL into an ocean as BSNL is far bigger in size and MTNL's shareholders would get a raw deal if the merger happens⁷⁷.

From a once very profitable business in a monopoly market, today MTNL finds itself unable to compete with its nimble competitors as is reflected in its performance parameters as compared to its private sector counterparts.

MTNL Peer Group Performance*

<u>Results</u>	<u>MTNL</u>	<u>Bharti Airtel</u>	<u>Reliance Communications</u>	<u>Tata Teleservices</u>
SALES- in Rs Millions	8430.6	107,572	26,450	6515.1
PAT - in Rs Millions	- 13,744.45	15,743	8,040	- 1,234
Operating Profit Margin%	-81.13	34.36	65.22	22.61
Net Profit Margin %	-163.03	14.63	30.40	-18.94
EPS	-21.82	4.15	3.0	-0.65

* Source:

<http://www.bseindia.com/bseplus/StockReach/StockQuote/Equity/MAHANAGAR%20TELEPHONE%20NIGAM%20TD/MTNL/500108/Scrips>

The case of MTNL points to the fact that even actions such as significant divestiture of shareholding or even granting of limited autonomy to a SOE (as in the case of MTNL which has a 43.75 % nongovernmental shareholding and was granted the maharatna status which gave it the freedom to take some decisions without reference to the government) are not sufficient when it comes to competing in the competitive market where the organization needs to be much more fleet footed to compete and grow.

Oil subsidies and the erosion in value of the oil companies:

The woes of the Indian oil companies –marketing as well as producing companies – is another example of corporate mis-governance in Indian SOEs where the interest of the minority shareholders are sidelined on account of extraneous considerations.

Given that India meets as much as 76 per cent of its total petroleum requirement in 2011-12 through imports the State has always played a major role in fixing oil prices. Petrol prices have officially been decontrolled since June 2010 while the prices for diesel, kerosene and domestic LPG are fixed by the Government. However, because of domestic political and policy compulsions the prices of petroleum products have not been increased sufficiently in order to pass on cost increases to consumers. This inability to pass on international crude prices to consumers has always affected the oil marketing companies more in recent months due to the depreciating rupee, which has further increased their losses. India has a complex environment where diesel, LPG and Kerosene are hugely

⁷⁷ A premature and poorly conceived merger announcement in 2002 knocked off close to 40 per cent of the value of the MTNL stock and pushed it to well below Rs 100. Subsequent to the announcement, most institutional investors without a government connection sold; refer to: <http://www.thehindubusinessline.in/iw/2002/11/17/stories/2002111700040800.htm>

subsidized and cause significant losses to oil companies but they (oil marketing companies) are unable to correct the situation because the pricing for these products is controlled by the GoI.

As the prices of diesel, LPG and kerosene, which are responsible for the huge under recoveries, have remained unchanged the oil marketing companies – IOC (Indian Oil Corporation), HPCL (Hindustan Petroleum Corporation) and BPCL (Bharat Petroleum Corporation Limited) end up buying crude from the upstream companies and then selling the same at discounted rates and in the process they incur huge losses. These losses are subsidized by the government directly in the form of cash subsidy (grants) and by sharing of the subsidy burden by the upstream oil companies – OIL (Oil India Limited), ONGC (Oil and Natural Gas Corporation) and GAIL (Gas Authority of India Limited).

The oil marketing companies have been incurring huge losses on the sale of three products, namely Diesel, Domestic LPG and PDS Kerosene at highly subsidized prices. In FY 2011-12, it was only after accounting for the assistance of Rs. 83,500 crore from the Government and Rs. 55,000 crore from the upstream oil companies (ONGC, OIL and GAIL), totaling to Rs. 1,38,500 crore that the three Public Sector oil marketing companies could declare nominal profits. Had this assistance not been given, the three OMCs would have reported a combined loss of Rs. 1,32,000 crore⁷⁸. The share of the subsidy of the upstream companies' in 2011-12 was nearly 39.7% of the losses of the oil marketing companies. Not only has the subsidy burden, borne by the upstream companies, been creeping up from the previous years (in FY 10-11 it was 36.75% of the losses of the oil marketing companies while in FY09-10 it was about 33.3%), it has been ad-hoc and is usually arbitrarily inflicted at the last minute – just before the books are closed – in a non transparent manner⁷⁹.

Because of the highly subsidized sale of Diesel, Domestic LPG and PDS Kerosene, the oil marketing companies have been under a huge financial strain. Their combined borrowings have gone up from Rs. 97,000 crore in March 2011 to a whopping amount of Rs. 1,28,000 crore in March 2012. Similarly, their interest burden has gone up from Rs. 4,700 crore in 2010-11 to Rs. 9,500 crore in 2011-12⁸⁰. If the government and upstream assistance was not made available to the oil marketing companies, to make good their losses, they would not have been in a position to raise necessary finance to purchase crude from the international market and maintain uninterrupted supply of petroleum products in the country.

⁷⁸ As per an official statement, released on June 3, 2012 by the CMDs of IOC, HPCL and BPCL, the three oil marketing companies (OMCs) together had a combined turnover of Rs. 8,33,000 crores during 2011-12. Against this, they had declared a combined profit of mere Rs. 6177 core, which is only 0.7% of their turnover. This level of profit is not adequate for OMCs to enable them to incur huge expenditure on continuous modernization, making available environmentally compliant fuels, laying of pipelines, enhancing storage, and development of other infrastructure.

The joint statement also pointed out that the OMCs need to be enabled to announce at least nominal profits so as to ensure that they maintain their blue chip status and credit ratings at the global level.

Available at <http://www.hindustanpetroleum.com/En/UI/PressnMedia.aspx?Id=164>.

⁷⁹ <http://www.firstpost.com/business/when-will-pranab-stop-the-loot-of-oil-companies-317188.html;May>; (22, 2012);

Firstpost.Business: When will Pranab stop the loot of oil companies?

⁸⁰Supra, Refer Note 78.

The stranglehold of the Gol in the pricing of petroleum products affects not only the oil marketing companies but the upstream companies as well. In a report on Oil and Natural Gas Corporation (ONGC), Investment banker Goldman Sachs pointed towards corporate governance issues saying the government of India (who owned 74% stake in ONGC) took \$20 billion in cash from 2003-04 onwards from the company without consulting minority shareholders⁸¹. Though this charge was strongly refuted by ONGC⁸² it has, nonetheless, stuck.

Such a situation, characterized by the lack of a coherent and consistent government policy for the oil sector, has resulted in decisions being taken which are ostensibly not in the interest of the minority shareholders and have significantly impacted how the investors perceive the oil companies; the damage done to the stocks of the oil companies has been considerable and, more important; the signaling effect has been distinctly negative.

And this has happened at the cost of the minority shareholders who occupy a not so insignificant share in the ownership of the oil companies.

Non government shareholding in Oil Companies*

<u>Serial No.</u>	<u>Oil Company</u>	<u>% of non government shareholding</u>
1	Indian Oil Corporation	21.08 %
2	Hindustan Petroleum Corporation	48.89 %
3	Bharat Petroleum Corporation Ltd.	45.07 %
4	Oil India Limited	21.57 %
5	Oil & Natural Gas Corporation	30.77 %
6	Gas Authority of India Ltd.	42.66 %

* Source: NSE website <http://www.nseindia.com/>

The anecdotal evidence as regards corporate mis- governance in Gol controlled SOEs is not good.

⁸¹ <http://www.rediff.com/money/2009/mar/05goldman-sachs-raises-corporate-governance-issues-with-ongc.htm>. In its research report dated 5 March 2009 Goldman Sachs reiterated a 'sell' on the ONGC stock and cited corporate governance issues with cash withdrawals by promoters as a concern. Goldman report added that despite repeated objections raised by investors and most recently by independent directors on ONGC's board, there has not been headway on this issue 'Despite repeated objections raised by investors and more recently by independent directors on ONGC's board, there has not been headway on this issue,' Goldman Sachs said in its report. 'The market appears to have got used to this practice by ONGC promoters, while similar issues in privately run companies would likely cause serious concern' and went on to add, 'We believe minority shareholders are likely to suffer in a situation where their interests are poorly protected. Moreover, such ad-hoc cash withdrawals hurt ONGC even more since it has a poor production profile and revenues are effectively a function of their oil realization.'

⁸² An 8th March 2009 press release from ONGC firmly stated that Corporate Governance remains highest priority for the management at all times and that more than adequate disclosures are made on all operational as well as non-operational issues. Furthermore, in the absence of production sharing/ profit sharing agreement with Gol, the subsidy discount is the sharing of the upside(s) on the crude oil prices.

Available at http://www.ongcindia.com/press_release1.asp?fold=press&file=press385.txt

In a hard hitting article, R Jagannathan has pointed out that apart from Coal India; here are nine other public sector undertakings whose shareholders should sue their boards and the government of India as promoter for lack of corporate governance⁸³.

In fact, the sensitivity shown by ministers of Gol towards corporate governance in SOEs under their charge has been shocking and they have not hesitated to publicly voice their belief in using the SOEs to pursue the policy objectives of the government at the cost of the interest of the minority shareholders. A few months back, Gol's Coal Minister Sriprakash Jaiswal was happily offering Coal India's surplus cash to fund a proposed plan from the Gol for food security. The minister said⁸⁴ that he would not hesitate to help the government meet its social responsibilities with Coal India's cash reserves as the state-run firm's wealth really belonged to the people of India. "Cash-rich companies like Coal India Ltd can lend to the government whenever the government is in need of funds. For example, enactment of the food security bill would require huge funds. Coal India belongs to the people of this country and an amount of Rs 25,000 crore can easily be given to the government for implementing social schemes. We, however, have not discussed anything with the finance ministry yet."

Such statements clearly show that corporate governance in SOEs in India has to traverse a long way before minority shareholders can expect a fair treatment and the stated intent promising equitable treatment of all shareholders is, more often than not, not reflected in actions on the ground.

⁸³ <http://www.firstpost.com/business/why-only-cil-here-are-9-other-psu-boards-investors-can-sue-241950.html>; (Mar 13, 2012): Firstpost.Business.Why only CIL? Here are 9 other PSU boards investors can sue. R. Jagannathan points out that first there is ONGC whose profits are used to illegally subsidise the oil marketing companies and ONGC is not compensated for this loss. In fact, the government has arbitrarily even raised the level of subsidies payable by ONGC. Second, there is GAIL: whose profits too are used to subsidise the oil marketing companies. Third there is Oil India which is in the same boat as ONGC and GAIL. Fourth there is Indian Oil where despite being forced to sell everything from petrol, diesel, kerosene and cooking gas below cost, the government has not been compensating them. Fifth is BPCL which is in the same situation as Indian Oil. Petrol is supposed to be deregulated, but government has forced the oil marketing companies to hold back on price increase due to the political reasons such as state elections. Sixth is HPCL which is in the same situation as IOC and BPCL. Additionally, IOC, BPCL and HPCL shareholders can also sue their boards and the government for deciding that airlines can import fuel directly – at their cost. Aviation fuel is not subsidised, but even this profitable product can now be imported directly, reducing the business opportunities for oil marketing companies. Seventh is NTPC which is being forced to keep supplying power to bankrupt state electricity boards and distribution companies at a huge cost to itself in terms of unpaid receivables. Eighth is MTNL who along with its unlisted sister BSNL, was forced to take up costly spectrum during the 3G auction and not allowed to expand in other territories beyond Mumbai and Delhi. The company is now more or less a basket case. Ninth is LIC where policyholders should sue the board, which is neither independent nor alert. In the recent ONGC share auction, the insurer was forced both to buy ONGC shares before the auction and during the auction to bail out the government's disinvestment programme.

⁸⁴ The Economic Times; (Oct 19, 2011);Corruption, inefficiency eat 25% of CIL output: Interview of the Union Minister of Coal Shri Sriprakash Jaiswal is available at: http://articles.economictimes.indiatimes.com/2011-10-19/news/30297602_1_coal-shortage-coal-output-coal-india.

6. Conclusion

The privatization of the Indian SOEs has seen the emergence of a new class of external shareholders, domestic and foreign, who have invested in the SOEs and the resultant need for the evolution of a transparent set of corporate governance norms in Indian SOEs that would ensure an equitable treatment for all shareholders.

While the Department of Public Enterprises, which is the nodal agency over viewing SOEs in India, has undertaken significant initiative in formulating a very set of processes and procedures that would ensure a fair and equitable treatment to all shareholders, the anecdotal evidence shows a significant gap between intent and action and points to the fact that most of the good intent remain confined to paper and is not reflected in the executive actions that the GoI, as the significantly dominating shareholder, takes in managing the SOEs.

As SOEs gradually get privatized, external investors would come in with the expectation to make money by investing in them just as they would make by investing in other organizations. However, having come in and bought into the State sector, the external investors start declaring that once the government divests equity in a company to mobilize resources for its budget, then the company can no more act under instructions from the state. In what amounted to a threat, Oscar Veldhuijzen, a partner at TCIF (minority investor in Coal India) reportedly told the Financial Times⁸⁵: "Coal India have to understand that if they mess around and treat their company like a 100 per cent government-owned entity, it will have major implications for the future of Indian capital markets."

However, SOEs like Coal India are highly profitable because the GoI has granted them various rights (coal exploration rights, mining rights, acquisition of land and surface rights, and many other rights) at throwaway prices and, if Coal India were required to pay market prices for these rights, their super profits could turn into losses in no time. Therefore, minority shareholders in a SOE should not complain about the majority shareholder's interference with free market forces, without willing to sacrifice the profits sourced from that very interference – this is an argument that could cut both ways!

Just like a minority shareholder in an SOE has a valid desire to fight for its interests and maximize its returns, the majority shareholder (government) does not have to surrender its rights and obligations to please the "minority". On issues where there is a "national" interest and a "minority" interest, the larger government shareholder has a legitimate right to pursue that "national" interest.

⁸⁵ Financial Times;(March 13,2012);TCI in legal threat against Coal India; available at:
<http://www.ft.com/intl/cms/s/0/7e70ca02-6d12-11e1-ab1a-00144feab49a.html#axzz1ygEFtOLj>

While the government is unlikely to be cowed down by any threat from the minority shareholders, since it holds too large a stake and has given the minority investors in SOEs the right to exit if they are not happy with the functioning of the company, improvement in corporate governance practices in SOEs are needed to be undertaken to ensure that the current stirrings of protests from minority shareholders do not snowball into a agitation against government domination in SOEs and derail the government efforts to raise resources through a privatization program.

The challenge, therefore, is to find the right governance model for privatized SOEs which will be just and equitable for all shareholders.

Drawing upon his research and work with SOEs in a number of jurisdictions, Wong⁸⁶ has recommended following an integrated approach to improve the corporate governance of SOEs based on three critical foundations – clear objectives, political insulation, and transparency. These principles reinforce each other and are part of an integrated package. However, when governments adopt these reforms partially, such as establishing a clear mandate without sufficient transparency, the results are usually disappointing. Although these reforms may require tremendous political commitment to implement and a system of professional oversight that includes checks and balances, they constitute the best recipe for countries and should form the basis on which SOEs need to be managed for best results.

First of all, governments must set clear objectives for SOEs. If improved financial performance is the goal, then state overseers must set specific targets. Given that an SOE may have multiple objectives, the performance measure doesn't necessarily have to match what might be achievable in the private sector, where profit maximization usually tends to be the only objective. Nonetheless, performance targets must ensure that an SOE will, when the costs of any non-commercial objectives are excluded, recover its cost of capital. Only when the government is confident that an SOE is viable from a financial perspective should it ask the company to pursue non-commercial objectives, such as employment stability, cultural preservation, and so forth. Any other approach risks the SOE's long-term viability.

Transparency is a cornerstone of any governance reform in SOEs. Open access to information provides a basis for government accountability and raises the barriers against capricious, self-serving intervention. Without accurate and detailed information it is difficult to assess company and board performance, set targets and allocate capital efficiently. Information should be provided not only on performance but the objectives of each enterprise (especially non-commercial, social goals), the costs of pursuing non-commercial objectives and any subsidies granted by the government. Increased scrutiny by the public, press and non-governmental organizations raises accountability, both for SOE management and government overseers

Lastly, insulation from political interference can be strengthened by vesting real authority in the board of the SOE. While the government, as the shareholder of SOEs, has a legitimate right to influence the SOEs within its portfolio, its sphere of influence should be limited. Appropriate roles for the government includes setting objectives and performance targets (for example, ROE, dividends), appointing directors, monitoring the performance of the enterprise and its board, and stepping in when things go wrong, such as a major scandal. Aside from these

⁸⁶ Simon C.Y. Wong; Improving Corporate Governance in SOEs: An Integrated Approach: Corporate Governance International, Volume 7, Issue 2, June 2004

intervention rights – which should be clearly articulated and publicly disclosed – the remaining authority should reside in a professional board and management.

Additionally, any effort to reform the governance of state companies needs public support which is best achieved by open and constructive debate; otherwise, labor unions and other interest groups can derail the process.

Once the right governance framework based on – clarity of objectives, transparency and insulation from political interference – has been implemented the SOE is well positioned to follow a system that would respect the rights of the minority shareholders and ensure, thereby, that their interests are not expropriated.

With a supporting environment in place, some specific areas for improvement for protecting the rights of the minority shareholders are as follows:

- The process for appointment of Independent Directors in SOEs needs to be strengthened so as to ensure that the point of view of minority shareholders is adequately represented on the Boards of SOEs.
- Greater transparency in key decisions and wider consultation with shareholders /even stakeholders would help in evolving consensus on key decisions as the focus of an enterprise should be on creating more value for all stakeholders and necessary processes need to be instituted for the same.
- Creating/Setting up a professionally managed separate entity to hold all SOE shares and manage the government interface with the SOE , unlike the current practice which has the Administrative Ministry in a central role in running the SOE, may sharpen the distinction between owners and managers and improve corporate governance.
- The common shareholding entity envisaged as a holding company for all SOEs can play a broader role for temporary warehousing of Indian SOEs in distress and even to manage the Sovereign Fund to acquire assets overseas.
- Incorporate best practices from abroad. What?

As a result of the recent financial crisis in the western economies the government has also emerged as a significant shareholder in business and there has been considerable discussion in the role that government should play in such businesses where it became the dominating shareholder.

Appearing before a congressional subcommittee set up to discuss principles for the government's exercise of its shareholder rights in companies like AIG, Citigroup, GM, and Chrysler, purchased under the Troubled Asset Relief Program (TARP,) established by the Emergency Economic Stabilization Act of 2008, Eckbo testified that while the

Obama Administration has begun to formulate principles for managing government shareholdings in enterprises these principles lacked detail and should be broadened⁸⁷.

In his testimony Eckbo argued⁸⁸ that the government ought to adopt a pro-active stance in terms of exercising voting rights because given the strong protection accorded to minority shareholders under U.S.corporation laws, the emergence of a large block holder would be generally a positive development for the entire shareholder base and the minority shareholders would benefit from the presence of a large block holder because only the latter has the economic incentive to exercise voting rights in an efficient manner.

Eckbo suggested⁸⁹ that by taking a pro-active stance on share-voting in accordance with the value-maximizing principle and existing best governance practices, the US government is now in a unique position to improve inefficient governance practices and provided some guidance on actions that the US government, as a shareholder, ought to do:

- (1) Play a proactive role in developing best corporate governance practices,
- (2) Support a policy of maximizing shareholder value,
- (3) Promote transparency and a focus on minority shareholder rights protection,
- (4) Organize the management of its ownership positions in an independent entity,
- (5) Support director election reform,
- (6) Support the elimination of staggered boards,
- (7) Support a separation of the positions of CEO and board chairmanship,
- (8) Support compensation policies that based on sophisticated empirical analysis of CEO value added.

Eckbo's prescriptions for the US government have universal applicability and would also apply to the role of the Indian government in SOEs in India.

Lastly a question arises on whether, in the wake of the current signs on protest on the treatment of minority shareholders, would shares in the Indian SOE be shunned by investors? There is little possibility for that happening and while investors would continue to invest in the shares of SOEs based on an evaluation of their expected returns from such investments. However, such shares would - and should - trade at a discount to their private-sector peers (in case the SOE is in a competitive field) or would be valued below their full potential (in case the SOE is in a monopolistic field).

⁸⁷ The Government as Active Shareholder. Espen Eckbo; (December 16, 2009); Testimony to the Congressional Domestic Policy Subcommittee of the Oversight and Governance Reform Committee; available at:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1529010 .

The congressional subcommittee was set up by the Obama administration to find the road map to manage the government ownership stake in a hands-off, commercial manner and to help the government to exercise its shareholder vote on core governance issues, such as director election and major corporate events or transactions. Such a road map would be consistent with US government's position as a reluctant "owner of last resort" and its desire that its shareholdings will be privatized at the earliest possible time.

⁸⁸ Id.

⁸⁹ Id.

India, like any other Emerging Nation, would continue to be a great place to invest - if investors know where to invest and what price to pay for the investments they make.

The extent of discount of the SOE share price to the price of its private sector peer or to its full potential price would, however, depend on how the Gov, as a dominant shareholder, treats the minority shareholders in the SOE!