JJ Irani: Concept to Reality

The Supreme Court in the USA, on 31 May 2005 overturned the 2002 obstruction of justice verdict against Arthur Andersen, the accounting firm whose criminal conviction in Enron's aftermath put thousands of people out of work. This also helped fuel the corporate governance movement, now codified in Sarbanes Oxley Act and its variants in other countries, including India, where it inspired the recent amendments to Clause 49 and Naresh Chandra Committee Report.

JJ Irani Committee issued its 'Report on Company Law' on the same day with recommendations for overhauling the Companies Act and bringing in a new philosophy of corporate governance with inspiration drawn in many areas from Sarbanes-Oxley Act. Somewhat ironic, that these two events, on the same day, redefine issues of corporate governance and legislation in two of the largest democracies in the world.

JJ Irani Committee Report is a well thought through report of 177 pages with recommendations in many areas which are fairly path breaking. The basic focus of the report is embodied by Mr. Irani's comment, "We have given full liberty to shareholders and promoters to run companies. But in case of violations, penalties will be stringent". Mr. Naresh Chandra, in a CII conference recently made a similar comment about "deal with the Big Fish approach".

The fundamental governance principles that the Committee has followed is embodied in its chapter titled "Approach to Company Law" – the principles of having a single corporate law for all companies, the principles of responsibilities of corporates to function as economic persons contributing to the well being of the country and complying with the applicable laws. The other premises include having one framework for an early resolution of corporate issues and moving towards one regulator.

The shackles of limitations on the number of subsidiaries a company could have been a retrograde step in earlier concepts, which the Committee recommends to resolve. In turn, they suggest a structure to disclose inter-group transactions, widely thought to be the conduit for corporate frauds. Global businesses form linkages with enterprises outside of one's geographic boundaries through joint ventures. Several courts in India have held that the Companies Act supercedes the restrictive covenants of a joint venture agreement if such clauses are not included in the articles of association. This conflict needs to be resolved and the Committee has recommended inclusion of suitable provisions in the new law.

The use of technology in bringing in governance, ease of redressal and reducing the costs of compliance has been highlighted in the report. The future lies in finding technological solutions to legal compliance to be more efficient and effective which some states like Andhra Pradesh, Karnataka have demonstrated by reforming archaic land records etc.

Another area where large scale changes have been made is regarding mergers and acquisitions. The study recognises the need to grow through inorganic process leading to shift in the scale of economics. Modern businesses are similar to any economic asset, capable of being bought or sold. The report propagates a simple window concept of having one agency for approving mergers in an effective time bound manner and 'deemed approval' concept from regulators. The report suggests ease of mergers within a group and suggests roadmaps for cross border mergers.

Approvals from regulators will be assumed, if within a specified period, they do not intimate their comments to the relevant approving authority. The other changes are in liquidation, insolvency, limited liability partnerships etc., which are progressive suggestions in view of changing business dynamics in a globally competitive business environment.

Minority Interest is a topic which has been successively handled with kid gloves, very much like the country handles trade unions who represent a tiny proportion of India's work force. An investment in equity shares by an investor, to a great extent is an act of speculation – though one may be able to determine the levels of risk associated to one's investment. The Committee very clearly puts their position on minority interest by stating that the fundamental principle defining operations of shareholders' democracy is that "the rule of majority shall prevail.

However, it is also necessary that this power of majority is placed within reasonable bounds and does not result in oppression of the minority and mis-management of the company". The recommendation to protect minority is by having a substantive definition of the term 'minority', protection through oversight by independent directors and information through correct disclosures. The frame-work of protection would also include setting up of tribunals for redressal. Only those shareholders having a significant minor stake as prescribed by law will have a right to object to a merger or amalgamation.

If knowledge is power, then the minority – retail investor is always at a disadvantage. Companies discriminate amongst various classes of shareholders and large investors like mutual funds, FIs' etc., are always given specific information which others are not privy to. This creates an imbalance in the knowledge by a smaller investor who is continually at a disadvantage. It should be incumbent on a company to disclose to the public whether through their websites or through any other means, any information of interest released to any class of investors. This is the backbone of corporate governance; equality of shareholder information is not merely getting the annual report in a timely manner.

In the areas of governance, the Committee has followed the well trodden path flowing from Sarbanes-Oxley Act, which was the basis of Naresh Chandra Committee Report and Narayan Murthy Committee Report.

Sarbanes Oxley Act in the USA is a reactive legislation – reacting to the short comings following from the corporate failures like Enron, World Com etc., and was directed to reforming the various constituents of the US capital markets. The stock markets are the biggest source of public money in the USA.

In India, public interest entities not only are listed companies and government owned companies, but all companies which borrow from government owned banks, financial institutions, government, etc., going beyond merely public departments. The cost of large loan loss provisions by government banks and financial institutions, euphemistically called Non Performing Assets (NPAs), arising from loans given to companies who grossly and at times even fraudulently mismanaged the affairs is borne by the citizens of this country.

The norms of corporate governance that are applicable to other public interest entities are not applicable to such companies that borrow from government owned lenders, till they go public. The principles of governance should extend to all entities using public money beyond a threshold and they should necessarily have systems and governance to protect such assets. The report also does not deal with governance issues in the public sector where the largest amount of capital of the country is locked.

The pendulum on independent directors swings from one end of inaction in the Enron days to leaving the operations of a company in the hands of such directors who did not have a deep knowledge about the business, following the aftermath. Many believe that the term “independent directors” is an oxymoron. The true test of independence would lie in getting the dissent of such directors recorded in the board meeting, as suggested by the report, in family run enterprises. The Committee’s recommendation of having one third of the directors of the board to be independent is in line with leaving the “running of business to its shareholders”, which is a practical solution to the scramble by companies to fill up positions of independent directors.

Asian culture, from Japan to India is based on family values and respect for authority and age. Dissenting to elders and authority is not our natural behaviour. In most of Asia, for this reason, delivering corporate governance through independent directors have not been very successful.

The report, coming in the wake of the aftermath of corporate excesses around the world including India, in its deliberations, has shown courage in its thought process. It leaves the directors with the authority to regulate the affairs of the company collectively as a Board, The duties of good faith and fair dealings are owed by each director individually. The framework shifts from a government based approval system to shareholder approval and disclosure based regime. The era of self regulation for corporate India is being ushered.

The regimes of self regulation can function only if the penalties for non-compliance is punitive. The report effectively deals with this issue. The tone of self regulation is carried through to limited liability partnerships, one person companies, appointment of auditors etc. The issue of rotation of auditors has now been settled. With our decades of experience with rotation of auditors in public sector, we have little to provide as empirical evidence of a positive correlation between quality of audit and rotation of auditors. In countries like Italy where auditors’ rotation has been in place, no such linkage has been determined either.

The report brings in concepts which are both progressive and visionary. There lie uphill challenges in traversing the distance from such concepts to the reality of legislating such ideas into a legal framework. In corporate India, many such good ideas were quietly put to rest in the past. Let us hope this report sees the light of a brand new day.

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