Governance and Indian family businesses - Are Western models of governance the only option in the changing world?

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Family Governance in India: The Context of the Hindenburg Report

The Hindenburg Research, an investment research firm, issued a research report on the state of governance of Adani Group on 24th January 2023 and made various allegations against the Adani Group, an Indian multinational conglomerate.[1] On account of this report, by early March 2023, the market capitalisation of the 8 companies in the group fell by US$ 143.7 billion.

The Hindenburg report highlights governance risks and describes "Adani Group as a family business" with significant entrenchment by family members with all significant decisions and positions in the group in the hands of the family. This according to them is a key investment risk and a cause of grave concern.

Among other allegations of fraud and enrichment, one of the key reasons Hindenburg recommends short selling is due to the poor state of governance within family businesses in India. Without getting into the merits of all other allegations by Hindenburg, we will provide our perspective on the context of corporate governance in family businesses in India.

Corporate Governance at Family Firms: What is at the helm?

Indian businesses are characterised by being overwhelmingly dominated by the owners, where families often hold controlling ownership. As an example, among the top 1000 listed companies as on 31st March 2022, 849 companies are family businesses with average promoter/owners' holding of 55 per cent. The market capitalisation of these companies on 31 March 2022 is nearly US$ 3 trillion.[2] This is nearly the size of the Indian GDP in US dollar terms. The remainder of the top 1000 companies is government-owned or trans nationals with a sprinkling of companies with dispersed ownership including internet companies.

Family business groups in India and many other emerging countries represent a unique governance model different from the Anglo-Saxon model of corporate governance emulated in the West. Nearly 85 per cent of businesses are owned and managed by the family firm, making this a prevalent form of ownership in the Asia-Pacific region.[3] Similar is the case in Latin America, family businesses are dominant from small to large corporates contributing nearly 60 per cent of the GDP of the region.[4] While family businesses have their unique strengths and benefits, they also face unique challenges, particularly when it comes to corporate governance because of the unique dynamics that exist within these businesses.

The composition and prevalence of family businesses are deeply embedded in the social fabric of India or its caste systems, which nurtured and valued specialised persons who ran businesses for generations. They invest their own finances, when the capital was scarce, took the capital and personal risks and created value for the entire society by providing access to the trade of goods and services. In later years, as the caste system broke down and finances and expertise became available, more people from other castes or different social backgrounds formed businesses. A system of governance of a business cannot be seen in isolation but as a mirror of society, where family values and codes play a significant part in the conduct of business and societal dealings.

From another perspective, many of the country's leading corporations are owned and managed by business families like Reliance, Tata, Bajaj, Adani, Murugappa Chettiar, Birla Aditya and Mahindra and some of the groups are more than 100 years old being managing agents in the pre-independence era. The dominance and contribution of some of these business groups cannot be overemphasised as 22 business groups control over 110 of the top 1000 listed firms. These firms have a market capitalization of US$ 1.81 trillion which is nearly 52 per cent of the market capitalisation of all the listed firms in India.[5]

Family businesses, on the positive side, can provide stability to the business with patient capital and long-term commitment. They are more likely to reinvest profits in the business, take a long-term view of its strategic direction and build are successful in building sustained value for their stakeholders.

Family businesses, however, are often characterized by complex ownership structures and a blurring of lines between ownership and management. High ownership concentration poses a corporate governance challenge through the agency conflict between principal-principal (dominant and minority shareholders).[6] Controlling shareholders by virtue of voting and control powers may be involved in expropriation, taking decisions in their own interests but jeopardising corporate performance and the interests of minority owners as a consequence. It may create an uneven playing field for minority shareholders and can lead to a lack of transparency and accountability in the governance of the business.

Entrenchment also stems from a sense of entitlement among family members, and a high degree of emotional attachment to the business leading to disagreements and conflicts over the direction of the business. High ownership concentration along with weak protection of minority shareholders poses a significant corporate governance problem in India and not necessarily answering the fundamental question – what is the best for all shareholders? *Does India have checks and balances to effectively check the overreach of family owners?*

The Governance Regulatory Framework – Are they Adequate and Aligned?

Like in any society, many business families or owners were not ethical and had a low moral compass, causing losses to banks, employees, creditors, government with impunity while getting unjustly rich at the cost of common citizens. The issue of governance needs to be seen from a holistic perspective and not from a fear of misgovernance that controlling ownership can result in or have done in the past.

India ranks 13th position in providing minority rights to shareholders on the Ease of Doing Business Index 2020 of the World Bank. Both the Companies Act, 2013 and Listing Obligations and Disclosure Requirements (LODR) for listed companies by the Securities and Exchange Board of India (SEBI) provide provisions and oversight responsibilities for the officers, board, independent directors, auditors and other gatekeepers to rebalance equity and fairness in corporate dealings and grave failures have punitive criminal consequences.

Laws require the appointment of independent directors and audit committees, with a majority of independent directors in such committees for all listed companies. The board affirms statements about their responsibilities on presenting fair financial statements, oversight of internal controls, fraud prevention and overall safeguarding of the assets of the company. They become liable if later such statements become untrue especially when a material fraud is uncovered.

The related party transactions (RPTs) pose a significant governance challenge and regulators, businesses and government have extensively deliberated and over a period created safeguards for the protection of the minority shareholders. Laws require companies to disclose a board-approved RPT policy and all such transactions be approved by the audit committee and Board of Directors as being on arm's length and done in the ordinary course of business. If RPT exceeds a threshold limit approval of shareholders through resolution is required and such transactions have to be approved exclusively by the minority shareholders. Additionally, minority shareholders have the right to question RPTs and can also approach the Company Law Tribunal if they believe that RPTs are prejudicial to their or the interests of the company.[7]

Transparency and accountability are also essential for effective corporate governance in family businesses. Family members may be tempted to make decisions based on personal interests rather than the company's well-being. Regular audits and reviews by independent external auditors under the regulations, such as Manufacturing and Other Companies (Auditors Report) Order, 1988 in line with the Companies 2013 set the accountability and liability of independent auditors similar to many jurisdictions where such laws are enacted. Adoption of related party accounting standards (AAS, 18) had been significant in improving corporate transparency, particularly group affiliates.

The disclosure and transparency norms are framed with reference to best global practices for the protection of minority shareholders, investors and other stakeholders. Listed companies through a quarterly and annual corporate governance report inform all stakeholders of the firm structure, functioning and financial and non-financial aspects of the business.

Insolvency laws have seen owners losing control over their businesses which are poorly run, which earlier got bailed out by the bank and in case of any fraudulent practices such owners were also framed under criminal laws. In earlier days, *there was a saying that there are no owners but just poor companies!* This has been a wake-up call for business owners to perform for the business or lose it.

Enforcement of the law, when any dereliction of duties by key players is observed, is fundamental to maintaining the rule of law. The SEBI, the market regulator in India, in its legislative capacity, can conduct investigations, substantially pass orders, seek information from any person or entity, and put strict sanctions for breaches of securities laws. Annual report of the SEBI show speed in their enforcement actions where 541 companies being suspended from participation in the capital markets, 4961 promoters/ promoter group entities have dematerialised share trading account frozen and Rs. 663 crores of fines levied on companies for irregularities and non-compliance in the last five years from 2017 -2022.[8]

Conclusion and Way Forward

Family businesses will always be an integral part of India and a Western model of evaluating governance on a model based on dispersed ownership and a large agency gap between owners and managers is not necessarily applicable to our context. Even in the USA, founders especially in technology companies like Apple, Microsoft, and Cisco to name a few have run their companies for decades. Hence, there is no one size that fits all.

Indian businesses are continually evolving as the world gets globalised and their increasing focus on transparency, accountability and good management practices helps balance family interests with the needs of the company and its stakeholders. Indian laws acknowledge the reality of concentrated ownership and have created oversight within the company through a series of gatekeepers and regulators to be effective and deliberate in dealing with infractions.

To address governance issues and gain the trust of stakeholders, family businesses need to strengthen their corporate governance both in spirit and in law. This possibly takes India to the global leader board for protecting minority rights in the face of an overwhelming majority of owners of businesses. By focusing on long-term sustainability rather than short-term profits, family businesses can build a strong foundation for future growth and success.

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[1] Hindenburg Research (2023, January 23). Adani Group: How The World's 3rd Richest Man Is Pulling The Largest Con In Corporate History. https://hindenburgresearch.com/adani/

[2] Based on the Prowess database of the Centre for Monitoring Indian Economy (CMIE)

[3] Phúóng Uyên Tràn (2019, April 30). Lessons Learned from Growing A Family Business. https://phuonguyentran.com/lessons-learned-from-growing-a-family-business/

[4] Vazquez, P., & Botero, I., Arzubiaga, U., Memili, E. & Gómez-Mejía, L. & Duran, P. (2020). Family business in Latin America. Journal of Family Business Strategy. 11. 100413. 10.1016/j.jfbs.2020.100413.

[5] Based on the Prowess database of the Centre for Monitoring Indian Economy (CMIE)

[6] Young, M. N., Peng, M. W., Ahlstrom, D., Bruton, G. D., & Jiang, Y. (2008). Corporate governance in emerging economies: A review of the principal-principal perspective. Journal of Management Studies, 45(1): 196–220.

[7] The Companies Act, 2013

[8] The SEBI Annual Report, 2017 to 2022