Conflicts of Interest: Real Issues and Challenges

Sharad Jaipuria
President
PHD Chamber of Commerce & Industry

Corporate world continues to suffer from the much prevalent disputes between shareholders. It definitely is not a phenomenon specific to India but is & has always been a universal problem. Allegations by the minority shareholders against the majority reverberate in courtrooms throughout the world. Indian law provides for various reliefs for operation and mismanagement but how effective they are is a point of debate.

India has often been criticized for poor corporate Governance and lack of enough regulations to protect minority shareholders' interest. On the extreme side, there have been cases when promoters' greed has broken all boundaries leading to a scam big enough to set an example and inspire new codes in place. But mostly, the promoters follow their whims with least regard to interests of minority shareholders. The root of the problem in such cases is lack of enough shareholder activism.

Historically, minority shareholders in most Indian companies have been practically at the mercy of the entities controlling the companies (aka promoters). Minority shareholders have had little or no power to influence strategic decisions of the companies in which they invest. Even at annual general meetings (AGMs) and extraordinary general meetings (EGMs) of shareholders, minority shareholders are usually treated by company management with scant respect.

While a high promoter stake increases confidence in a company, many a times the promoter has taken the rights of minority shareholders for granted in the name of shareholder democracy. This event just highlights the need of a formal procedure to make sure that no decisions by the majority stakeholders are in conflict with that of the minority.

There are two entities that need to work together to achieve this - the regulator and market participants. The latter includes investors, both retail and institutional. While enough has been covered on the role and loopholes on the part of regulator, it is time for financial institutions, fund managers and retail investors to wake up to their responsibilities and power.

Unfortunately, investors wake up and question only when the stock price or financials start suffering as a result of poor management decisions. By that time, the damage is done and it is too late to make amends. Ideally, investors should give enough weightage to the transparency and management quality and track record. Before investing in a company, they should apply 'management discount' wherever the management falls short on the required parameters. This will also ensure some self discipline among the management.

Minority shareholders are usually unable to block or veto key resolutions at the AGMs and EGMs, which they believe to be against their interest, even if they vote together. They are in no position to oppose, among other things, hefty salaries and perks paid by promoters to themselves. They are also unable to oppose "related-party transactions," wherein promoters carry out business transactions with entities in which they enjoy significant ownership stakes, and where such transactions are not "arm's length transactions."

Democratic decisions are made in accordance with the majority decision and are deemed to be fair and justified while overshadowing the minority concerns. If a majority does not want to take action, for example, because the wrong doing director(s) gets the majority of votes, a minority of shareholders must show that the facts fall within an exception to the rule. The exceptions are rigid. The law in this field is complex and obscure, and this may well deter minority shareholders from bringing such proceedings. Thus the attempt to provide an alternative procedure for minority shareholders' actions by statute has not been successful.

Despite the fact provisions have been in place under the Companies Act 1956 to protect the interest of the minority shareholders, the minority has been incapable or unwilling due to lack of time, recourse or capability-financial or otherwise. This has resulted in the minority to either let the majority dominate and suppress them or squeeze them out of the decision making process of the company and eventually the company.

Under the Companies Act 2013, the picture is about to change. Companies Act 2013 has sought to invariably provide for protection of minority shareholders rights and can be regarded as a game changer in the tussle between the majority and minority shareholders.

As per section 188 of the Companies Act 2013, promoters, who are majority shareholders, are barred from voting on special resolutions in cases of "related-party transactions."

Under the previous Companies Act, company promoters or management teams did not require approval from minority shareholders for entering into related-party transactions. This often led to transactions which were

not transparent, and which were not in the interest of minority shareholders. Henceforth, under the new act, any related-party transaction which is not done in the ordinary course of business, and which is not at arm's length, will need approval of minority shareholders by way of a special resolution. All related-party approvals will be scrutinized by audit committees, a majority of the members of which must be independent directors.

The new provisions could level the playing field between majority shareholders and minority shareholders, by providing the latter with checks and balances, and giving them a say in key special resolutions, to protect their own interests.

However, these new powers can potentially be abused by unscrupulous minority shareholders, who might be acting with ulterior motives. Such unscrupulous minority shareholders could seek favors from the majority shareholders, in exchange for voting in favor of, or against, certain special resolutions. It is also possible that majority shareholders might be unable to carry out even genuine, reasonable business transactions, if minority shareholders decide to oppose them, with ulterior motives.

India's stock market regulator, SEBI, has mandated that the e-voting facility be provided to all shareholders, in respect of resolutions that are passed at general meetings, or through postal ballots. While e-voting might lead to increased participation by minority shareholders in the company's key decisions, SEBI may effectively have done away with discussions by shareholders at AGMs and EGMs, by making the e-voting facility mandatory. It is possible that many companies might choose to eliminate debate and discussions at AGMs and EGMs, and opt for e-voting, while also ensuring compliance with the regulations.

In the case of listed companies with more than 1,000 shareholders, resolutions cannot henceforth be passed at AGMs and EGMs through a show of hands. While in a show of hands, the principle of "one hand, one vote" applies, in both e-voting and in a poll, the principle is "one share, one vote."

The mandatory e-voting is a mixed bag, since it could, on the one hand, unwittingly lead many minority shareholders to vote on key resolutions, which is not the case currently, as most minority shareholders do not make it a point to attend AGMs and EGMs. On the other, e-voting could well go against those minority shareholders who do attend meetings, since they will not be able to discuss such resolutions with management team members, or amongst themselves.

There needs to be a complete revamp of sorts. The small investor today is hostage to big institutional investors, market-makers and promoters. They, therefore, end up investing in mutual funds to take care of their interests rather than being a market participant directly. If the market needs a broader participation of the retail investor in the India equity story, it has to start trusting the system.

The first step here is to educate the investor, have regular interactions with them (as a group), and maintain significant transparency in the management of the companies. The need is to establish a platform where experts, shareholders, auditors, employees share their opinions, expectations, experiences about the company, and relate that to a score which determines the corporate governance score of the company.