

# JUDGING THE REMEDY: AN ANALYSIS OF THE METHODS EMPLOYED TO SOLVE CORPORATE GOVERNANCE PROBLEMS

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## ABSTRACT

Corporate governance aims to make corporations responsible, but a debate rages as to whom should such duties be owed to. Some scholars say it should be the shareholders while others contend that it ought to be the stakeholders. This article is going to trace the evolution of corporations and investigate the problems which corporate governance tries to fix and the tools used by different models of corporate governance to solve such problems. The dominant contemporary theory of Anglo-American corporate governance jurisprudence claims that non-executive directors, performance related pay for executives and market for corporate control are the solutions to most corporate governance problems. This article would examine such claims and provide a critical analysis in order to ascertain if such an assertion is true.

## INTRODUCTION

In order to determine whether problems of corporate governance can be resolved by the use of non-executive directors<sup>1</sup>, performance related pay for executives and a ‘market for corporate control’<sup>2</sup> mechanism; it is imperative to understand the evolution of corporations and the associated development of corporate governance.

The dominant form of commercial ventures in the eighteenth and early nineteenth century was in the form of partnerships,<sup>3</sup> wherein the investors of capital were also the managers of the concern.<sup>4</sup> However, during the latter half of the Industrial Revolution in England when capital-intensive ventures like the railways, insurance, canal construction etc. began to emerge,<sup>5</sup> it wasn’t possible for a few wealthy individuals to raise the

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1 Hereinafter NEDs.

2 Hereinafter MCC.

3 David Sugarman, *Simple Images and Complex Realities: English Lawyers and their Relationship to Business and Politics, 1750-1950*, 11 LAW & HIST. REV. 257, 274 (1993).

4 See generally Steven Tadelis and Jonathan Levin, *A Theory of Partnerships*, STANFORD LAW AND ECONOMICS OLIN WORKING PAPER No. 244, October 2002 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=311159](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311159) (last visited Apr. 28, 2011).

5 Paddy Ireland, Ian Grigg-Spall and Dave Kelly, *The Conceptual Foundations of Modern Company Law*, 14 J.L. & SOC’Y 149, 159 (1987); See also Paddy Ireland, *Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality* 17 J.L. of LEG. HIST. 40, 49 (1996). It is to be noted that the first JSCs in English legal system originated in the 14th century, however incorporating a company needed Royal Charter and were thus few in number compared to the number of JSCs in the aftermath of passing of Companies Acts of 1844-62. See BRIAN R. CHEFFINS, *CORPORATE OWNERSHIP AND CONTROL BRITISH BUSINESS TRANSFORMED* (2008).

required funds alone.<sup>6</sup> This gave rise to the concept of a Joint Stock Company<sup>7</sup> wherein many investors would pool their resources.<sup>8</sup> The major advantages of a JSC over a partnership are that the liability of shareholders is limited to the extent of their unpaid share capital,<sup>9</sup> and the company has a distinct and continuous legal identity insofar as it can take and grant property in addition to being able to sue and be sued in its own name.<sup>10</sup> However, the greatest advantage of a company was the free transferability of its shares.<sup>11</sup> Thus unlike partnerships, where sale of equity by individual partners was almost impossible without the assent of others partners, a JSC shareholder would be able to sell the shares without much restriction in the share market.<sup>12</sup>

Due to the free transferability of shares and the high capital requirement of JSCs, the number of shareholders increased rapidly.<sup>13</sup> Commenting on the rush to purchase shares of railway companies in the mid 19<sup>th</sup> century, poet William Wordsworth observed, “From Edinburgh to Inverness the whole people are mad about railways. The country is an asylum of railway lunatics.”<sup>14</sup> One of the fallouts of such dispersed and diffused shareholding was the emergence of professional managers who had little shareholding in the company and yet would dominate the board of directors in effect running the company ‘on behalf of the shareholders’.<sup>15</sup> Emergence of these professional directors as managers of company’s assets widened the distance between shareholder ownership and control of the company, effectively morphing shareholders into ‘sleeping partners’ or ‘rentier investors’ whose main objective was to gain maximum profit from their investment.<sup>16</sup> With the advent of institutional investors along with rapid financialization

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6 See generally Richard Brown, *Genesis of Company Law in England and Scotland*, 13 JURID. REV. 185 (1901).

7 Hereinafter JSC.

8 James C. Finney, *Corporations*, 10 U. DET. BI-MONTHLY L. REV. 107, 109 (1926-1927).

9 Thus in case the company goes bankrupt and needs to satisfy its creditors, the shareholders would be legally obliged to pay only to the extent of unpaid share. See section 3 of Companies Act 2006. While in partnership every partner in firm is liable jointly and severally with the other partners for all debts and obligations of the firm incurred while he is a partner. See § 9 of Partnership Act 1890.

10 See *Salomon v A Salomon & Co Ltd* [1897] AC 22 for position in UK and *Berkey v. Third Avenue Railway Co* 244 N.Y. 602 (1927) for position in USA. In a partnership the firm does not exist as a separate legal entity acts of a partner binds the firm and through it the other partners. See §§ 5 and 6 of Partnership Act 1890. Further unlike companies which have continuous and perpetual existence, a partnership firm would dissolve merely if one of the partners dies unless there is an agreement to the contrary. See § 33 of Partnership Act 1890.

11 See *Avord v Smith* 5 Pickering 232 (1827) as cited in Hugh L. Sowards and James S. Mofsky, *Factors Affecting the Development of Corporation Law*, 23 U. MIAMI L. REV. 476, 477 (1968-1969) for position in USA. For historical overview of change of character of share in UK see Ireland (1996), *supra* note 5.

12 Finney, *supra* note 8, at 110.

13 Paddy Ireland, *Property and Contract in Contemporary Corporate Theory*, 23 LEG STUD 453, 461-462 (2003); See P. L. DAVIES, *GOWER'S PRINCIPLES OF MODERN COMPANY LAW* (8th ed 2008) ch 2, 3; J. H. FARRAR & B. HANNIGAN, *FARRAR'S COMPANY LAW* (4th ed. 1998).

14 As quoted in CHEFFINS, *supra* note 5, at 160.

15 Christopher A. Riley, *Understanding and Regulating the Corporation*, 58 MOD. L. REV. 595, 595, 609 (1995).

16 See generally ADOLF BERLE & G. C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (2d revised ed. 1991); Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Edwin M. Dodd, *For whom are*

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in the last quarter of the 20<sup>th</sup> century, in addition to the ascendancy of a neoliberal economic ideology in the 1970s, the main thrust of the directors of companies was removed from increasing overall productive output to increasing the market capitalisation of the company.<sup>17</sup> At present, neoliberal shareholder oriented corporations are the dominant form of companies in the Anglo-American business sphere.<sup>18</sup>

Corporate governance as academic discourse arose due to the widening rift between the shareholders and the management of the company.<sup>19</sup> Richard Eells in 1960 coined the term ‘corporate governance’ and described it as ‘the structure and functioning of the corporate polity.’<sup>20</sup> Since then the focus and function of corporate governance has varied according to the legal, economic or political philosophy and outlook of the scholar. Christine A. Mallin differentiates the competing definitions of ‘corporate governance’ on the basis of “whether the company itself operates within a shareholder framework, focusing primarily on the maintenance or enhancement of shareholder values as its main objective, or whether it takes a broader stakeholder approach, emphasising the interests of diverse groups such as employees, providers of credit, suppliers, customers, and the local community.”<sup>21</sup> Thus there are two major opposing frameworks which dominate the corporate governance viewpoint – shareholder primacy and the stakeholder theory.<sup>22</sup>

Mallin explains the stakeholder theory in the context of a company, which ‘takes account of a wider group of constituents rather than focussing on shareholders.’<sup>23</sup> She adds ‘where there is an emphasis on stakeholders, then the governance structure of company may provide for some direct representation of the stakeholder groups.’<sup>24</sup> The philosophical underpinnings of the stakeholder theory lie in the complete separation of the control and ownership of a company.<sup>25</sup> The supporters of this theory try to prove that shareholders no longer own or control the company economically or legally.<sup>26</sup> The logical conclusion to such an assertion would be a ‘socially responsible corporation’, which is not just aligned to the interests of the shareholder but would also ‘use the power

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*Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf Berle, *For whom Corporate Managers are Trustees: A note*, 45 HARV. L. REV. 1365.

17 See DAVID HARVEY, *A BRIEF HISTORY OF NEOLIBERALISM* (2005); FINANCIALIZATION AND THE WORLD ECONOMY (Gerald A. Epstein ed., 2005); Ismail Erturk et al, *General introduction: Financialization, coupon pool and conjuncture*, in FINANCIALIZATION AT WORK (Ismail Erturk et al ed. 2008).

18 Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law* 89 GEO. L. J. 439 (2000).

19 See John H. Farrar, *A Brief Thematic History of Corporate Governance*, 11 (2) BOND L. REV. 259 (1999), available at <http://epublications.bond.edu.au/blr/vol11/iss2/9> (last visited April 28, 2011).

20 RICHARD EELLS, *THE MEANING OF MODERN BUSINESS: AN INTRODUCTION TO THE PHILOSOPHY OF LARGE CORPORATE ENTERPRISE* (1960) 108 as cited in UDO C. BRAENDLE AND ALEXANDER N. KOSTYUK, *DEVELOPMENTS IN CORPORATE GOVERNANCE* (2007).

21 CHRISTINE A. MALLIN, *CORPORATE GOVERNANCE* 13 (3d ed, 2010).

22 ROBERT WEARING, *CASES IN CORPORATE GOVERNANCE* (2005).

23 Mallin, *supra* note 21, at 18.

24 *Id.* at 21.

25 See BERLE & MEANS (1932), *supra* note 16; Ireland (1996), *supra* note 5.

26 See Berle-Dodd debate, *supra* note 16.

of business to solve social or environmental problems.<sup>27</sup> The proponents of the stakeholder theory argue that a socially responsible corporation would achieve long-term profitability<sup>28</sup> instead of short-term myopic gain.<sup>29</sup>

On the other hand, the shareholder primacy theory rests the foundation of its argument on the agency theory. Under this theory the corporation is viewed as a nexus of contracts,<sup>30</sup> wherein as per the contractual relationship, the shareholders are principals while the managers are their agents whose sole aim is to increase the corporation's profits.<sup>31</sup> Therefore, under the agency theory, managers (agents) should act in the best interest of their principal (shareholders).<sup>32</sup>

Upon this understanding of the different models of corporate governance, let us revisit the original question raised in the beginning of this article as to whether the use of NEDs, performance related pay for executives and 'market for corporate control' would solve corporate governance problems effectively. In order to resolve this query, in Part II of this article the author would discuss separately the problems of corporate governance, which the two different models seek to solve. For the shareholder primacy model the identified governance, shortcomings would be agency problems like misuse of power by managers, mismanagement of company, oppression of minority shareholder etc. Under the Stakeholder model the risk of losing human capital, short term versus long-term profitability, effect of corporations on the community at large etc. would be the problems discussed. In Part III, the solutions to the governance problems identified under the shareholder primacy model as per the Anglo-American corporate governance framework and OECD Principles of Corporate Governance, namely the use of NEDs, performance related pay for executives, and the operations of market for corporate control would be explained and examined. In Part IV, solutions like dual board, employee participation etc., evolved by scholars and institutions under the stakeholder model will be discussed with specific reference to the Indian context. Finally, in Part V, the effectiveness of the Anglo-American solutions to corporate governance problems would be critically analysed in order to ascertain if they solve any and/or all forms of corporate governance problems.

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27 Rakhi I. Patel, *Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act* 23 ST. THOMAS L. REV. 135, 137 (2010).

28 David Novick, 'Cost-Benefit Analysis in the Socially Responsible Corporation', in *MANAGING THE SOCIALLY RESPONSIBLE CORPORATION* (Melvin C. Ahnson ed., 1974) as cited in Robert B. Reich, *Corporate Accountability and Regulatory Reform*, 8 HOFSTRA L. REV. 5, 31 (1979-1980).

29 M. M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 13 (1995).

30 M. C. Jensen and W. H. Meckling, *Theory of the Firm: Managerial behaviour, Agency costs and ownership structures*, 3 J. OF FIN. ECO. 305 (1976).

31 Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, THE N.Y. TIMES MAGAZINE, Sep. 13, 1970.

32 MALLIN, *supra* note 21 at 14-15.

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**I. PROBLEMS IDENTIFIED BY CORPORATE GOVERNANCE FRAMEWORK**

**A. SHAREHOLDER PRIMACY MODEL**

The main governance problems identified in the shareholder primacy corporate governance framework is that of agency and the related agency costs.<sup>33</sup> In his seminal book “The Wealth of Nations” Adam Smith laid the foundational setting of the agency problem as:

*[B]eing the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. [...] Without an exclusive privilege, they have commonly mismanaged the trade. With an exclusive privilege, they have both mismanaged and confined it.<sup>34</sup>*

Based on this ideological setting Micheal Jensen and William Meckling<sup>35</sup> identified the ‘relationship between the stockholders and managers of a corporation’ as “a pure agency relationship.”<sup>36</sup> However, to curtail the self-seeking motive of agents, every agency relationship would entail some ‘agency costs’, which Jensen and Meckling expounded as: the monitoring expenditure by the principal, the bonding expenditures by the agent, and the residual loss.<sup>37</sup>

Therefore, in an agency setting the problems of a widening rift between ownership and control is an irrelevant concept.<sup>38</sup> What matters is the reduction of the agency problem by making the managers fully accountable to shareholders.<sup>39</sup> Thus the aim of corporate governance based on the ‘agency theory’ motif is to ensure that the agents seek to maximise the welfare of the principal, rather than their own.<sup>40</sup> This can be ensured ‘through incentives that seek to align the agent’s interests with those of the principal, and through monitoring that enforces the principal’s interests.’<sup>41</sup>

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33 Stuart Chan, *Corporate Agency Costs - An Unresolved Problem*, 7 INTER ALIA 102 (2010).

34 See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776) Book V, Ch.1, Para 18 of the Expenses of the Sovereign or Commonwealth.

35 See Jensen and Meckling, *supra* note 30.

36 *Id.* at 319.

37 *Id.*

38 In an agency model it is expected that there would be a ownership-control gap between the principal (shareholder) and their agent (managers). See Eugene Fama, *Agency Problems and the theory of the firm*, 88 J. OF POL. ECO. 288, 304 (1980).

39 Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 108 (2010-2011).

40 John Roberts, *Trust and control in Anglo-American systems of corporate governance: The individualizing and socializing effects of processes of accountability* 54 (12) HUMAN RELATIONS 1547, 1548 (2001).

41 *Id.*

## B. STAKEHOLDER MODEL

In contrast to the shareholder primacy model whose sole focus is on shareholder value maximisation, the stakeholder model addresses ‘who or what really counts’.<sup>42</sup> It thus encompasses the interests of a wide range of stakeholder groups like investors, employees, suppliers, customers and managers – but cannot be equated with any one of them.<sup>43</sup> Thus, the stakeholder model is based on a trusteeship model,<sup>44</sup> wherein ‘businesses are defined as a nexus of long established trust relationships’<sup>45</sup> and managers act as trustees to sustain assets of the corporation to benefit all stakeholders. The theoretical backing to this model derives itself from the assertion that assets of the corporation include not just the capital provided by shareholders but also the ‘skills of its employees, the expectations of customers and suppliers, and the company’s reputation in the community.’<sup>46</sup>

Thus, the problems, which the stakeholder model seeks to solve, are multifaceted and diverse owing to the divergent and sometimes competing interests of the stakeholders. They may range from low employment morale, management apathy, undesirable effects on community, non-standardised multiple products to predatory business practices, tax avoidance, opaque policy objectives, adverse consequence on the environment, collusion with oppressive government regimes which do not respect human rights of their citizens etc.

The stakeholder model aims to solve these problems through a cooperative relationship involving the participation and consultation of all the interested stakeholders.<sup>47</sup> It also emphasises on intergenerational equity where the interests of future customers and employees are taken into consideration in the long-term development of the capabilities of the business.<sup>48</sup> Thus the stakeholder model seeks to implement responsible management behaviour in order to maximise the welfare of its stakeholders even at the cost of adopting certain constraints to profits.<sup>49</sup>

However, unlike the shareholder profit maximisation theory, which has a clear objective for managers to aim solely at providing maximum returns on shareholder investment, in stakeholder welfare maximisation there is confusion as to how to best balance the competing needs of stakeholders. As Easterbrook and Fischel observed:

*[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other. Agency costs rise and social wealth falls.<sup>50</sup>*

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42 R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984).

43 John Kay, *The Stakeholder Corporation* in STAKEHOLDER CAPITALISM 126 (Gavin Kelly et al. ed., 1997).

44 *Id.* at 134.

45 *Id.* at 135.

46 *Id.*

47 Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE W. RES. L. REV. 1043 (2007-2008).

48 Kay, *supra* note 43 at 136.

49 John Parkinson, *Company Law and Stakeholder Governance* in STAKEHOLDER CAPITALISM 148 (Gavin Kelly et al. eds., 1997).

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However such a criticism may be resolved if the stakeholder model, similar to the shareholder model, insists that the corporation maintain a transparent record of its financial, legal and business decisions. But unlike the shareholder model which uses transparency to make managers accountable to shareholders, the stakeholder model may use transparency to make managers accountable to all stakeholders.

## II. SOLUTIONS UNDER SHAREHOLDER PRIMACY MODEL

As has been discussed earlier, once a corporation has been reduced to a nexus of contracts under the shareholder model and the relationship between shareholders and managers is classified as a principal-agent relationship, the solution to the problems of corporate governance is condensed into ‘how best to align the interest of managers with that of shareholders’, which is understood to be maximum return on invested capital.<sup>51</sup> The Anglo-American corporate governance model, which has evolved under the umbrella of the shareholder primacy theory, provides for use of NEDs, performance related pay for executives, and the operations of market for corporate control as ideal corporate governance platforms.<sup>52</sup>

### A. NON EXECUTIVE DIRECTORS

Under the Anglo-American corporate governance model, companies have a unitary board structure where the executive directors,<sup>53</sup> elected by shareholders, take decisions on how to run the company. However in order to ensure that executive directors work in the best interest of the shareholders, the Anglo-American model puts in a separate set of independent NEDs<sup>54</sup> to oversee the functioning of the executive directors. The most

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50 FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 38 (1991) as cited in Ho, *supra* note 39.

51 See generally Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. OF COR. L. 63 (2006).

52 See generally Ismail Erturk et al, *Corporate Governance and impossibilism* 1 (2) J. OF CUL. ECO. 109 (2008); Thomas Clarke, *A critique of Anglo-American model of Corporate Governance* (2009) 5 (3) CLPE RESEARCH PAPER 15; for acritical background history of growth of Anglo-American Corporate Governance model see Mark Roe, *A Political Theory of American Corporate Finance* 91 COLUM. L. REV. 10 (1991).

53 UK Companies Act 2006 does not differentiate between executive and NEDs, section 250 of the Act defines directors as ‘any person occupying the position of director, by whatever name called.’ However an executive director can be described as a ‘director [who] will normally have some day-to-day responsibility for the running of the company’s business. The term ‘executive’ has no precise legal meaning but is derived from the idea that the director has some specific executive tasks and authorities delegated to him or her by the board of directors. Executive directors will normally be employees of the company and benefit from service contracts. The director’s rights and obligations under a service contract have a largely separate existence from his or her legal rights and obligations as a director. If a director resigns or is dismissed as a director, the terms of a service contract will continue to apply until it expires or is terminated.’ Neil Harvey and Ian Yeo, *Duties and Liabilities of Directors of a Private Limited Company under English Law*, INT’L BUS. L.J. 749, 750 (1996).

54 ‘The listing rules of the Stock Exchange of Hong Kong Ltd. define the independent NEDs as: first, an independent non-executive director does not have the administrative or management responsibilities in a company, that is, he/she does not participate in the routine operation of the company; nor does he/she participate in the management. Second, an independent non-executive director must be independent of

common grounds for use of NEDs are to ‘give access to relevant external information, provide an independent appraisal and check on management, strengthen the board, give new perspective on the company direction etc.’<sup>55</sup> As per the Cadbury Report, NEDs are supposed to bring ‘independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.’<sup>56</sup> To ensure that NEDs are truly *independent*, the Cadbury Report suggested that NEDs should not have ‘any business or other relationship with the company concerned, which could materially interfere with the exercise of their independent judgement.’<sup>57</sup> However, the report was ambivalent as to the remuneration of NEDs.<sup>58</sup> The Cadbury Report has since formed the basis of every corporate governance reform, which followed the Anglo-American path, around the world.<sup>59</sup>

Eleven years after the Cadbury Report, in 2003 the Department of Trade and Industry, UK promulgated a review on the role and effectiveness of NEDs, which came to be known popularly as the Higgs Report.<sup>60</sup> It divided the role of NEDs into four broad focus areas: 1) to contribute to the development of strategy of the company (strategy), 2) to scrutinise the performance of the management in meeting agreed goals and objective (performance), 3) to inspect and audit the financial reports and verify that the risk management system is robust (risk) and lastly 4) to contribute to the appointment of senior management, succession planning, determine remuneration of executive directors etc. (people).<sup>61</sup> The Higgs Report concluded that there was “no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director.”<sup>62</sup> It also laid down objective criteria for determination of the independence of NEDs which included requirements along the lines of the person not representing a significant shareholder, holding cross-directorships, or receiving additional remuneration from the company etc.<sup>63</sup> The Higgs Report also proposed that NEDs

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the management, without any direct relations with the management. For instance if a person has relatives in the management of a company, such person is not qualified to be an independent non-executive director of the company. Third, an independent non-executive director does not have any interests other than the remuneration paid by the company.’ Moses Mo-Chi, *Role of Independent Non-Executive Directors* available at <http://www.cipe.org/regional/asia/china/role.htm> (last visited May 1, 2011).

55 Bob Tricker, *The Independent Director* in MANAGEMENT ACCOUNTABILITY AND CORPORATE GOVERNANCE: SELECTED READINGS 30 (K Midgley ed, 1982).

56 CADBURY REPORT (1992) ¶ 4.11

57 *Id.* at ¶ 4.12.

58 *Id.* at ¶¶ 4.13-4.14; It does not provide any cap or limit to remuneration and thus fails to delink remuneration from independence.

59 Clause 49 of the SEBI Listing Agreement which forms the basis of corporate governance in India, Listing rules of the Stock Exchange of Hong Kong Ltd. which forms the basis of corporate governance in Hong Kong is greatly influenced by Cadbury and subsequent Reports.

60 DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (2003) available at [www.dti.gov.uk/files/file23012.pdf](http://www.dti.gov.uk/files/file23012.pdf) (last visited Apr. 30, 2011).

61 *Id.* at 27.

62 *Id.*

63 *Id.* at 37.



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were to be appointed by the board after recommendations from a nomination committee which would consist of a majority of NEDs.<sup>64</sup> It further dealt with the remuneration structure of NEDs; and recommended that the remuneration of NEDs should follow an objective and transparent standard.<sup>65</sup>

Some of these recommendations do find a place in the OECD Principles of Corporate Governance (2004)<sup>66</sup> and the UK Corporate Governance Code (2010).<sup>67</sup> The issue of NEDs finds a prominent mention in Indian law by virtue of Clause 49 of the SEBI Listing Agreement, which lays down mandatory corporate governance guidelines for listed companies in India.<sup>68</sup> These guidelines also introduce a new class of NEDs called independent directors who are at arm's length from the company.<sup>69</sup>

As per clause 49 (IA), the board of directors should comprise of NEDs which constitute no less than half its number. Clause 49 (IIA) stipulates that two-thirds of the members of the audit committees should be independent directors (also complemented by section 292A of the Companies Act, 1956). Annexure ID (2) (ii) of Clause 49 states that the remuneration committee should be comprised entirely of NEDs (complemented by Part II, Schedule XIII of Companies Act, 1956)<sup>70</sup>. Thus, at present the Anglo-American Corporate Governance model generally accepts the view that the role and duty of the non-executive director is to make sure that the board of directors exercise an objective independent judgment, nominate other board members rationally, ensure the integrity of financial reporting of the company etc.<sup>71</sup> thereby making sure that the executive directors and the management do not divert from the best interests of the shareholders.

## **B. PERFORMANCE RELATED PAY FOR EXECUTIVES**

Performance related pay for executives is thought to be an internal incentive based control mechanism to best align the interests of the executives to the interests of the shareholders, which is understood to be to the maximization of return on the equity investment.<sup>72</sup> Jensen and Murphy regarded performance related pay for CEOs as a

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64 *Id.* at 40-41.

65 *Id.* at 56.

66 Part One, VI(E)(1).

67 ¶ A.4.

68 SEBI, LISTING AGREEMENT (2005) Clause 49, available at <http://www.primedirectors.com/pdf/Revised%20Clause%2049.pdf> (last visited Jul. 10, 2011).

69 *Id.* at (IA)(iii).

70 Remuneration Committee means in respect of a listed company, a committee which consists of at least three non-executive independent directors including nominee directors (Inserted to Companies Act, 1956 vide Notification no. G.S.R. 70(E), Feb. 8, 2011).

71 OECD, *supra* note 66; see also Jillian Segal, *Corporate Governance: Substance over Form*, 25 U.N.S.W.L.J. 320 (2002).

72 Basariah Salim and Wan Nordin Wan-Hussin, *Remuneration committee, ownership structure and pay for performance: Evidence from Malaysia* (2009) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1515166](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1515166) (last visited May 1, 2011); Murali Jagannathan, *Internal Control Mechanisms and Forced CEO Turnover: An Empirical Investigation* PhD dissertation (1996) extract available at <http://scholar.lib.vt.edu/theses/public/etd-183513359611541/etd.pdf>.

solution to the agency problems of the corporation and believed that a ‘compensation policy should be designed to give the manager incentives to select and implement actions that increase shareholder wealth.’<sup>73</sup>

As per Murphy the performance related pay for executives may take varied and heterogeneous forms, but is usually comprise of ‘annual bonuses tied to accounting performance, stock options, long-term incentive plans (including restricted stock plans and multi-year accounting-based performance plans)’<sup>74</sup> and special benefits like supplemental executive retirement plans.<sup>75</sup> An annual executive bonus plan would consist of a set performance measures (consisting of financial performances like revenues, net income, pre-tax income, operating profits etc. and non-financial performances like customer satisfaction, operational and/or strategic objectives, plant safety etc.).<sup>76</sup> Based on this standard, the performance of an executive will be judged and bonus paid at the end of the financial year. Murphy notes that the common payout plan under the annual bonus model is the ‘80/120’ plan where ‘no bonus is paid unless performance exceeds 80% of the performance standard and bonuses are capped once performance exceeds 120% of the performance standard.’

Stock options allow executives of a corporation to buy shares of the company at a fixed price and on completion of certain loyalty conditions (for example if they stay with the company for a fixed period of time) or on a share value trigger (where the share price reaches a particular pre agreed value) on the happening of which the executives can exercise the option (capitalise the share).<sup>77</sup> Stock options therefore provide a direct link between managerial rewards and share-price appreciation.<sup>78</sup> Other incentive plans may comprise of long term incentive plans (payouts based on performance over a period of time usually three to five years), restricted stock (similar to stock options but the period of restriction on capitalisation is longer), retirement plans (payouts to executives on their retirement may be fixed or variable based on performance or their years of service).<sup>79</sup>

OECD Principles of Corporate Governance (2004) support performance related pay for executives. Under the annotations to Article VI(D)(4) in Part Two<sup>80</sup> it clarifies that executive and board remunerations should be aligned to the long term interests of

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73 Michael C. Jensen and Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 (2) J. OF POL. ECO. 225, (1990) page 1 of preprint available at [http://www.stockoptions.org.il/Admin/App\\_Upload/Performance%20Pay%20and%20Top-Management%20Incentives.pdf](http://www.stockoptions.org.il/Admin/App_Upload/Performance%20Pay%20and%20Top-Management%20Incentives.pdf) (last visited May 1, 2011).

74 Kevin J. Murphy, *Executive Compensation* (1998), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=163914](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=163914) (last visited May 1, 2011).

75 *Id.*

76 *Id.* at 11, 12.

77 *Id.* at 16.

78 *Id.* at 17.

79 *Id.* at 23.

80 OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004).

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the shareholder and the company and this may be achieved by allowing key executives to hold and trade stock of the company. The UK Corporate Governance Code (2010) also strongly encourages the performance related remuneration of directors. Under section D.1 it states “[a] significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.”<sup>81</sup> It further lays down guidelines as to how to design performance related remuneration for executive directors.<sup>82</sup>

The 2009 Corporate Governance Voluntary Guidelines<sup>83</sup> drafted by Ministry of Corporate Affairs, Government of India explicitly espouses performance related pay for directors. They state that “The performance-related elements of remuneration should form a significant proportion of the total remuneration package of Executive Directors and should be designed to align their interests with those of shareholders and to give these Directors keen incentives to perform at the highest levels.”<sup>84</sup> These Guidelines also state that NEDs can also be remunerated by stock options,<sup>85</sup> presumably to also link their interests to those of shareholders. Though Clause 49 of the SEBI Listing Agreement does not directly encourage performance linked pay, it lays down disclosure requirements which states that the “details of the fixed component and performance linked incentives, along with the performance criteria, [...] Stock options<sup>86</sup> etc. of director’s remuneration should be included in the Annual Report.” Further, the Companies Act, 1956 also complements such performance linked payment overtures by allowing for Employee Stock Option Schemes and Employee Stock Purchase Plans.<sup>87</sup>

Thus from an Anglo-American corporate governance perspective, performance related pay for executives are geared up to align the interests of perceived ‘risk-averse self-interested’ executives with those of the shareholders,<sup>88</sup> in order to maximise the market value of stocks.

### C. MARKET FOR CORPORATE CONTROL

Market for corporate control is an external control mechanism in the Anglo-American corporate governance model.<sup>89</sup> The term market for corporate control was

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81 UK CORPORATE GOVERNANCE CODE 22 (2010).

82 *Id.* at 27.

83 Ministry of Corporate Affairs, Government of India, CORPORATE GOVERNANCE VOLUNTARY GUIDELINES (2009) available at [http://www.ecgi.org/codes/documents/cg\\_voluntary\\_guidelines\\_2009\\_india\\_24dec2009\\_en.pdf](http://www.ecgi.org/codes/documents/cg_voluntary_guidelines_2009_india_24dec2009_en.pdf) (last visited Jul. 20, 2011).

84 *Id.* at C.1.1.iii.

85 *Id.* at C.1.2.iv.

86 SEBI, *supra* note 68.

87 Clause 5(i)(a) General Instruction for preparation of statement of profit and loss, Schedule VI, Companies Act 1956.

88 Murphy, *supra* note 73 at 26.

89 Richard S Ruback, *An Economic View of the Market for Corporate Control*, 9 DEL. J. CORP. L. 613, 623 (1984); see also Vanessa Finch, *Company Directors: Who Cares about Skill and Care*, 55 MOD. L. REV. 179 (1992).

first conceived in 1965 by Henry Manne.<sup>90</sup> This idea presupposes the ‘existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company.’<sup>91</sup> Based on this premise Manne expounded that if a company is being mismanaged then its share prices are bound to decline in comparison to other companies in the same sector or the market as a whole. The share price thus directly reflects managerial efficiency and is a “measure of the potential capital gain inherent in the corporate stock.”<sup>92</sup> This lower share price also facilitates efforts to take over the company, wherein the primary motivation of the purchaser is the belief that they can run the target company more efficiently and thus revitalise the company, which was hitherto poorly run.<sup>93</sup> Manne concludes that only market for corporate control can provide ‘some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders.’<sup>94</sup>

OECD also subscribes to this idea of market for corporate control as a corporate governance tool to oust inefficient managers. In its online Glossary for statistical terms, OECD states that “share prices of companies publicly listed on the stock exchange are often viewed as a “barometer” indicating the extent to which the management is efficiently operating the corporation and maximizing shareholder wealth.”<sup>95</sup> It is thus unsurprising that OECD promotes market for corporate control. In its Principles of Corporate Governance (2004), OECD urges that it is in exercise of shareholders rights that “markets for corporate control should be allowed to function in an efficient and transparent manner.”<sup>96</sup> It advocates clear and fair rules of takeover and advises against takeover defences.<sup>97</sup> In the Indian context, market for corporate control was proposed in ‘Desirable Corporate Governance – A Code’<sup>98</sup> drafted in 1998 by the Confederation of Indian Industry. This code recommended simpler takeover and merger regulations with easier

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90 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 (2) J. OF POLL. ECO. 110 (1965); see also Henry G. Manne, *The Higher Criticism of the Modern Corporation*, LXII COLUM. L. REV. 399 (1962); HARRY G. JOHNSON, *THE CANADIAN QUANDARY* (1963).

91 *Id.* at 112.

92 *Id.* at 113.

93 *Id.*

94 *Id.*

95 GLOSSARY OF INDUSTRIAL ORGANISATION ECONOMICS AND COMPETITION LAW, compiled by R. S. Khemani and D. M. Shapiro, commissioned by the Directorate for Financial, Fiscal and Enterprise Affairs, OECD, 1993 available at <http://stats.oecd.org/glossary/detail.asp?ID=3255> (last visited May 1, 2011).

96 Article II(E) Principles of Corporate Governance (2004), 19.

97 *Id.* at 19, 36 (annotations); the extract is as follows: “1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. 2. Anti-take-over devices should not be used to shield management and the board from accountability.”

98 Confederation of Indian Industry, *Desirable Corporate Governance – A code* (1998), available at [http://www.ecgi.org/codes/documents/desirable\\_corporate\\_governance240902.pdf](http://www.ecgi.org/codes/documents/desirable_corporate_governance240902.pdf) (last visited Jul. 15, 2011).

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access to funding<sup>99</sup> based on the rationale that market for corporate control ‘imposes a credible threat on management to perform for the shareholders and enhances shareholder value in the short and medium term.’<sup>100</sup>

Thus, market for corporate control tries to ensure that positions of management would be secure only so long as they can maintain a high market capitalisation of the firm and thereby promote efficiency and maximise shareholder wealth.

### III. SOLUTIONS UNDER THE STAKEHOLDER WELFARE MODEL

There are two major justifications for stakeholder welfare oriented corporate governance: First is the reward for risk justification provided by Margaret Blair,<sup>101</sup> wherein she argues that the notion of shareholder oriented corporate governance, on the economic justification that shareholders incur risk and should hence be rewarded with residual profit is flawed. She states that under the doctrine of limited liability, the risk undertaken by shareholders is also limited; nevertheless, there are other categories of persons related to the company who may incur unlimited risk. She gives the example of employees who develop firm-specific skills, which are useless if they get unemployed. Similarly if a company which is a market leader fails then the market segment as a whole may lose investor confidence leading to a slowdown of growth in that sector causing a ripple effect throughout the economy. Thus, she claims that “in any given firm there are likely to be a number of parties who have made firm specific investments that are at risk in the same way equity capital is at risk. Therefore the Management should focus on maximising the total wealth-creating potential of the firm, not just on the stake held by shareholders.”<sup>102</sup> The second justification for stakeholder welfare model is the performance argument – stake holding gives managers the freedom to incorporate ideas for the long-term growth of the company, to invest in research and development and to increase the motivation of all stakeholders etc.<sup>103</sup>

Therefore the aim of stakeholder oriented corporate governance would be to increase the welfare of all stakeholders of the company and the probable solution would be to ensure ways in which managers can be motivated to keep the interests of all stakeholders in mind and act under a fiduciary trusteeship model. This has been achieved in a formal manner through the dual board or co-determinism structure as in Germany where the Co-determination law (*Mitbestimmung*) stipulates that all companies with more

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99 *Id.* at Recommendation 13.

100 *Id.* at 8.

101 See MARGARET M. BLAIR (ed.), WEALTH CREATION AND WEALTH SHARING: A COLLOQUIUM ON CORPORATE GOVERNANCE AND INVESTMENT IN HUMAN CAPITAL (1996).

102 *Id.* at 13 as quoted in Ciaran Driver and Grahame Thompson, *Corporate Governance and Democracy: The Stakeholder Debate Revisited*, J. OF MAN. AND GOV. 111-130 (2002) available at <http://www.dcu.ie/~jacobsd/StakeholderTheory1.pdf>.

103 *Id.*

than 2000 employees will have a supervisory board, which will have an equal number of representatives from shareholders and employees. This supervisory board will have the power of supervising the management, approving the balance sheets, making proposals for distribution of profit etc.<sup>104</sup> The same function is performed through worker councils in social market economies like in France.<sup>105</sup> Stakeholding can also realise in an informal manner like in Japan where the notion of trust between the employees and the management triumphs over all other considerations.<sup>106</sup> In addition informal recognition of employee interests have operated through life-time employment systems, hierarchical promotion structures, ‘consensus’ decision making within the firm, and the like.<sup>107</sup> Thus solutions to the problems of corporate governance under the stakeholder welfare maximisation model, attempts to include all stakeholders in the decision-making matrix of the company, in such a manner that the stakeholders can guide the company with a long-term view in mind.<sup>108</sup>

#### IV. DO THE ANGLO-AMERICAN SHAREHOLDER PRIMACY SOLUTIONS WORK?

We understand that the shareholder primacy based Anglo-American corporate governance model bares a marked ideological similarity to the worldwide movement for harmonisation of corporate governance structures led by the OECD, and both encouraging the adoption of NEDs, performance related pay for executives and the operation of market for corporate control. However, these solutions are at the vanguard of the clash for dominance between the shareholder primacy and the stakeholder primacy model.<sup>109</sup> Let us now analyse if NEDs, performance related pay for executive and MCC provide the ultimate solution to the problems of corporate governance.

##### A. NON EXECUTIVE DIRECTORS

The use of NEDs it was believed would bring an independent supervisory mechanism inside the board. Thus, NEDs could tackle contentious issues like executive pay packages, succession plans, standards of conduct as well as verification of audit statements as well as provide non-partisan checks and balances on the management of the company.

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104 J. W. Lorsch, *The Workings of Codetermination*, 4 HARV. BUS. REV. 107-108 (1991); For major criticisms of German co-determinism see JEAN JACQUES DU PLESSIS, ANIL HARGOVAN AND MIRKO BAGARIC PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE (2d ed. 2011) 342-351.

105 See N. BARRY BUSINESS ETHICS (1998) .

106 C. E. Metcalfe, *The Stakeholder Corporation*, Business Ethics: A European Review 30-36 (1998).

107 Driver and Thompson, *supra* note 102 at 20.

108 See ANDREW L. FRIEDMAN AND SAMANTHA MILES, STAKEHOLDERS: THEORY AND PRACTICE (2006).

109 See generally Kellye Y. Testy, *Convergence as Movement: Toward a Counter-Hegemonic Approach to Corporate Governance*, 24 LAW & POLY 433 (2002); Samik Chakraborty and Shaswata Dutta, *Market and the Boardroom - The Indian Experience*, 1 NUJS L. REV. 93 (2008); Alan Dignam and Michael Galanis, *Governing the World: The Development of the OECD's Corporate Governance Principles*, 10 EUR. BUS. L. REV. 396 (1999); Arthur R. Pinto, *Globalization and the Study of Comparative Corporate Governance*, 23 WISCONSIN INT'L L.J. 477 (2005); Paddy Ireland, *Shareholder Primacy and the Distribution of Wealth*, 68 MOD. L. REV. 49 (2005).

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However, reality offers a different perspective. Empirical studies in the 1990s have shown that monitoring despite the proportion of NEDs on a board and remuneration committees had limited effect on the level of top management pay.<sup>110</sup> Similar studies by Main and Johnston,<sup>111</sup> Daily,<sup>112</sup> Klein<sup>113</sup> also concluded the fact that NEDs do not affect the absolute level of CEO pay. Studies by Boyd<sup>114</sup>, Crystal<sup>115</sup>, Traversky and Kahneman<sup>116</sup> etc. have shown that there might in fact be a direct correlation between high pay for NEDs and higher pay for CEOs. Thus, the Anglo-American corporate governance logic that NEDs provide an independent review of board activities in terms of CEO pay seems to lack empirical favour.

On the other hand empirical evidence from a 2007 study conducted by Julie Froud reveals that NEDs in the FTSE 100 and the FTSE 250 are drawn from a small pool of active FTSE managers, who having retired from active business commitments held more than one NED post creating a NED hegemony.<sup>117</sup> Froud, does not directly answer the question as to whether recycling of past and present FTSE executives as NEDs would influence corporate behaviour. However, he does analyze a few takeover scenarios and concludes that exchange of personnel between top firms in the form of NEDs leads to greater financialisation with the attraction of lucrative roles in private equity for NEDs and EDs post-retirement.<sup>118</sup>

Shortcomings of the use of NEDs were fully exposed by the Satyam scandal, which shook corporate India to its core in 2009. Satyam was India's fourth largest information technology company.<sup>119</sup> It won many accolades for 'stellar corporate governance practices' including the Golden Peacock Global Award for Excellence in Corporate Governance in 2008 by the London based World Council for Corporate

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110 M Conyon and S. Peck, *Board Control, Remuneration Committees and Top Management Compensation*, 41 (2) ACAD. OF MAN. J. 146 (1998) as cited in R. T. EVANS AND J. T. EVANS, THE INFLUENCE OF NON-EXECUTIVE DIRECTOR CONTROL AND REWARDS ON CEO REMUNERATION: AUSTRALIAN EVIDENCE 5 (2002), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=263050&](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=263050&) (last visited May 2, 2011).

111 B Main. and J. Johnston, *Remuneration Committees and Corporate Governance.*, 23 (91A) ACC. & BUS. RES. 351 (1993) as cited in Evans, *supra* note 110.

112 C. M Daily et al, *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 (2) ACAD. OF MAN. J. 209 (1998) as cited in Evans, *supra* note 110.

113 A Klein, *Firm Performance and Board Committee Structure* (1996) as cited in Evans *supra* note 110.

114 B.K Boyd, *Board Control and CEO Compensation*, 15 STR. MAN. J. 335 (1994) as cited in Evans, *supra* note 110.

115 G CRYSTAL, IN SEARCH OF EXCESS 228 (1991) as cited in Evans, *supra* note 110.

116 A Traversky and D Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453 (1981) as cited in Evans, *supra* note 110.

117 Julie Froud et al, *Everything for sale: How NEDs make a difference*, (2008) CRESC Working Paper Number: 46 available at <http://www.cresc.ac.uk/sites/default/files/wp46.pdf> (last visited May 2, 2011).

118 *Id.* 12, 20.

119 Manjeet Kripalani, *India's Madoff? Satyam Scandal Rocks Outsourcing Industry* BUSINESSWEEK, Jan. 7, 2009, available at [http://www.businessweek.com/globalbiz/content/jan2009/gb2009017\\_807784.htm](http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_807784.htm) (last visited May 2, 2011).

Governance.<sup>120</sup> In January 2009, the Chairman of Satyam sent an email to board members admitting that he had falsified accounts from 2002-2008 and had shown inflated profits to the tune of US\$ 1.04 billion.<sup>121</sup> Satyam had six independent NEDs in its ten-member board of directors. The NEDs in the board comprised of luminaries from the field of business and management, Harvard Law School professor, the Dean of the Indian School of Business, the Managing Partner of IndoUS Capital-a venture capital firm in the US, the Chairman of the Naval Research Board of Defence Research and Development Organisation among others.<sup>122</sup> In spite of such a vast accumulation of experience, the NEDs failed to detect the fraud. Quite strikingly each of these independent NEDs was paid approximately US\$ 200,000 per annum as remuneration for their service to the company.<sup>123</sup>

Such oversight can be attributed to the confusion in the minds of NEDs in India as regards their exact role in the company's affairs and their prospective liabilities.<sup>124</sup> It has been clearly laid down by the Bombay High Court in *Jagjivan Hirallal Doshi and others v. Registrar of Companies*<sup>125</sup> that where a liability has been fixed under the statute no distinction can be drawn on the basis of full-time or part-time performance of the duties by the Director, if such director was in charge of the day-today affairs of the company.<sup>126</sup> However even after the clear requirement of 'being in-charge of the day to day affairs' being laid down by the law independent directors are frequently sought to be prosecuted for criminal liability. A case in point would be the prosecution of Nimesh Kampani in relation to his services as an independent director at Nagarjuna Finance.<sup>127</sup> Nimesh Kampani, a respected Indian banker, served as an independent director at the board of Nagarjuna Finance from 1998 to 1999. Later in 2001-2002 Nagarjuna Finance failed to repay its creditors. The law provided for harsh punishment for the management in case

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120 Harichandan Arakali, *Satyam Chairman Resigns After Falsifying Accounts*, BLOOMBERG Jan. 7, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahRPVLeBamxk> (last visited May 2, 2011).

121 Available at [http://www2.accaglobal.com/pubs/economy/analysis/acca/technical\\_papers/tech\\_1a.pd](http://www2.accaglobal.com/pubs/economy/analysis/acca/technical_papers/tech_1a.pd) (last visited May 2, 2011).

122 *Three more directors resign from Satyam board*, INDIAN EXPRESS, December 30, 2008 online edition available at <http://www.indianexpress.com/news/three-more-directors-resign-from-satyam-board/404441/2> (last visited May 2, 2011).<sup>123</sup>SATYAM FINANCIAL YEAR 2007-2008 ANNUAL REPORT available at <http://www.corpfiling.co.in/CompanyFilings/CompanyFilings.aspx?companyId=SATCOMSE> (last visited May 2, 2011).

124 Vikramaditya Khanna and Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence*, 22 NLSI REV. 35 (2010), available at <http://ssrn.com/abstract=1690581> last visited Jan. 10, 2011).

125 [1989] 65 Comp Cas 553 (Bom).

126 Apart from judicial pronouncements CII Task Force on Corporate Governance chaired by former Cabinet Secretary Naresh Chandra recommended in November 2009 that NEDs should not be subject to trial for noncompliance with statutory provisions unless a prima facie case can be established demonstrating that the non-executive director was liable for the non-compliance on the part of the company, i.e., that the director had knowledge of such noncompliance on the part of the company. Khanna and Mathew, *supra* note 124 at 58.

127 *Id* at 36.



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of default, and in 2008-2009 the state started prosecuting Mr. Kampani as he was on the board during the period in which the loan was taken. After a long ordeal, in which Mr. Kampani remained abroad to evade arrest and jail, a court stayed proceedings against him. Although Mr. Kampani did get relief towards the end, the blatant illegality of the proceedings against the independent director shook the confidence of NEDs in other boards across India as was well documented by Vikramaditya Khanna and Shaun J. Mathew who lamented that it led to a massive ‘exodus of independent directors from the boards of Indian companies in 2009.’<sup>128</sup>

Various empirical studies and the evidences in form of the Satyam and Enron scandals show that NEDs do not play any path-altering role in providing solutions to any form of corporate governance problems. NEDs act more like a rubber stamp on the board of directors, who hailing from similar business backgrounds and deriving pecuniary benefits, may be wary to rock the boat in its present form, thereby tending to not help either the shareholders or the stakeholders. Given the present scenario it seems that Tim Rowland was prophetic when he cynically observed that boardrooms contained potted plants and non-executives - and in his experience potted plants were often more useful.<sup>129</sup>

However, with a little re-structuring, NEDs can become an important tool to uphold corporate governance standards under the stakeholder welfare model. Instead of the board of directors nominating and appointing NEDs, it is suggested that the stakeholders elect/select NEDs who would represent them in the board. Thus employees of the company may elect one amongst themselves to serve as an NED, consumer advocacy groups may propose their own NED, even market regulators may select noted academicians with a business or legal background to sit on the board as NEDs. Furthermore, keeping in mind that NEDs come from many different professions and may not be adequately adept in financial/management/strategic oversight, there should be regular training sessions for NEDs to acquaint them with the fundamentals of these areas and enable them to get a clear idea as regards their objectives and strategic goals. Although this proposed system does not guarantee assured welfare maximisation for stakeholders, it would certainly bring independent ideas to the board and better the prospects of long-term growth for the company.

## **B. PERFORMANCE RELATED PAY FOR EXECUTIVES**

The use of performance related pay for executives under the ‘shareholder wealth maximisation’ model is premised on a two-legged fallacy – first that top executives will take decisions in the interest of the shareholder if it also serves their own personal interests and second that everyone is better off if share value is maximised.

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128 *Id.* at 40.

129 Simon Caulkin, *Are They Just Bums on Seats?*, THE OBSERVER, January 20, 2002, available at <http://www.guardian.co.uk/business/2002/jan/20/madeleinebunting.theobserver> (last visited May 2, 2011).

To argue that executives would only work for benefit of others if their interest is linked to such an endeavour attributes a pessimistic conception to the motives of an executive.<sup>130</sup> There has been substantial academic research to find out if there exists a basis for such a conclusion, and the answer is in negative.<sup>131</sup> This view is aptly supported by empirical studies, which have found little correlation between pay and executive performance.<sup>132</sup> On the other hand, it is felt that performance linked pay for executives induces executives to influence the standard against which the performance is to be judged. Murphy suggests that ‘budget-based performance standards, for example, create an incentive to “sandbag” the budget process leading to an avoidance of actions in the present year that might have an undesirable effect on next year’s budget.’<sup>133</sup> Furthermore, the performance related pay has a perverse effect on R&D as managers try to cut costs on long-term investments if they affect the current performance outcome.<sup>134</sup> In addition empirical studies discredit the notion that stock options tie managers to the interests of the shareholders - options reward stock appreciation not growth in terms of dividends thus executives holding options would try to reduce dividends and favour share repurchases.<sup>135</sup> Since the value of options increase with stock-price volatility, executives with options have an incentive to engage in riskier investments<sup>136</sup> with the safety of knowing that the management can always re-price the option if the share price falls too low for the option to be exercised.<sup>137</sup> These empirical findings, which claim that performance related pay does not in any way, reflect on the performance of the management or the company got further credence from the accounting/financial post mortem of the Enron Scandal and the Eurotunnel mismanagement.<sup>138</sup> Enron’s top executives indulged in insider trading when they offloaded their stock but encouraged others to keep buying thus keeping the share prices high, amassing huge private gains.<sup>139</sup>

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130 See Roberts, *supra* note 40 at 1548.

131 C. PERROW, *COMPLEX ORGANIZATIONS: A CRITICAL ESSAY* (3d ed 1986) as cited in Roberts *supra* note 37 at 1548; K. Eisenhardt, *Agency theory: An assessment and review*, 14 (1) *ACAD. OF MAN. REV.* 57 (1989) as cited in Roberts, *supra* note 40 at 1548.

132 Martin J Conyon and Dennis Leech, *Top Pay, Company Performance And Corporate Governance*, 56 (3) *OX. BULLETIN OF ECO. & STAT.* 229, 24 4 (1994); Gregg et al, *The Disappearing Relationship Between Directors Pay And Corporate Performance*, 31 *BRIT. J. OF INDUS. REL.* 1 as cited in Conyon *supra* note 110 at 229; Gregg et al, *Compensation Of Top Directors In UK Companies*, Harvard University mimeograph (1993) as cited in Conyon, *supra* note 110 at 229; see also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

133 See Murphy, *supra* note 73 at 15.

134 *Id*

135 Lambert et al, *Executive Stock Option Plans and Corporate Dividend Policy*, 24 (4) *J. OF FIN. AND QUANTITATIVE ANALYSIS* 409 (1989) as cited in Murphy, *supra* note 73 at 19.

136 Defusco et al., *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 (2) *J. OF FIN.* 617 (1990) as cited in Murphy *supra* note 73 at 19.

137 D. Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements* 52 (2) *J. OF FIN.* 449 (1997) as cited in Murphy, *supra* note 73 at 19.

138 Wearing, *supra* note 22 at 118.

139 Enron directors got following proceeds from their share sale in the last year of Enron Fastow (US\$ 33 million), Lay (US\$ 184 million), Skilling (US\$ 70 million), Causey (US\$ 13 million) and McMohan (US\$ 2 million) Wearing, *supra* note 22 at 70.

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Moreover, performance related pay for executives have greatly widened the remuneration gap between workers and top executives. In 1981, average CEO compensation, with a stock option grant of 35 percent, was forty-two times the earnings of an average factory worker. By 2001, total CEO compensation, with stock options of around 85 percent, was four hundred times the earnings of the average worker.<sup>140</sup>

Now let us analyse if everyone is better off if the share price is maximised. Conventional wisdom suggests that shareholders who take risk by investing in a venture must be rewarded if the enterprise succeeds.<sup>141</sup> However, it is not just the shareholders who undertake a risk, employees invest their human capital, creditors risk their asset, consumers commit their trust etc. Thus, the society as a whole entrusts the corporation with the responsibility to undertake a long-term sustainable approach to growth in order to justify the social, political and economic risks undertaken.<sup>142</sup> Increase in the market price of stock does not benefit the employees, creditors or other stakeholders. Employees (at least in the lower rungs) get paid a steady salary, creditors are repaid at a fixed invariable rate of return and consumers pay a certain sum in lieu of the product; hence none of the above transactions would change fundamentally if the share price varies.<sup>143</sup> However, it has been suggested that under correct conditions share prices can be linked with stakeholder welfare - stock linked employee's pension funds link employee benefits with the market price of company share,<sup>144</sup> secondary markets for trading of debt instruments allow creditors to reap benefits from higher equity price<sup>145</sup> and other societal stakeholders can also indirectly partake in the high share price pie through the continued existence of the firm.<sup>146</sup> However to sustain this model the growth of the share price must be steady and long term.<sup>147</sup> Extensive empirical studies have shown that share prices vary according to the vagaries of the market<sup>148</sup> and managers mostly take a short-term view of the situation to influence share prices.<sup>149</sup> Thus to link stakeholder fate with stock price is nothing short of a catastrophe, and this view was given further credence to, in the aftermath of the

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140 Margaret M. Blair, *Shareholder Value, Corporate Governance and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom*, in CORPORATE GOVERNANCE AND CAPITAL FLOWS ON A GLOBAL ECONOMY 61 (Peter K. Cornelius and Bruce Kogut, eds., 2003).

141 See generally Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998); Friedman, *supra* note 31.

142 See generally Margaret M. Blair, *Team Production Theory and Corporate Law*, GEO. L. AND ECO. RESEARCH PAPER No. 281818 and Georgetown Public Law Research Paper No. 281818 (2001) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=281818](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=281818) (last visited May 3, 2011).

143 See generally Blair, *supra* note 140.

144 Eric Zeller and Maxence Manzo, *International Employee Share Purchase Plans, Stock-Option Plans, and Free Share Plans*, INT'L BUS. L.J. 125 (2007).

145 Andrea Sironi and Giampaolo Gabbi, *Which Factors Affect Corporate Bond Pricing? Evidence from Eurobonds Primary Market Spreads*, BOCCONI U, NEWFIN RESEARCH CENTER WORKING PAPER (2002) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=308299](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=308299) (last visited May 3, 2011).

146 M. C. Jensen, *Value maximisation, stakeholder theory and the corporate objective functions*, (2001) TBS WORKING PAPER NO. 01-09 as cited in Blair, *supra* note 140 at 58.

147 Blair, *supra* note 140 at 59.

148 E. F. Fama, *Efficient capital markets: A review of theory and empirical work*, 25 JOUR. OF FIN. 383 (1970).

149 See Blair, *supra* note 29.

Enron, where employees who had invested in pension plans linked to the company shares, found that after the crash their pension fund worth at least US\$ 1 billion had vanished.<sup>150</sup> Ergo, it is disastrous to suggest that stakeholder welfare should be solely dependent on a volatile and high-risk share market.

From the analyses above we find that performance related pay for executives does not solve the agency problem under the shareholder primacy model. It fosters income inequality thus paving the way for social conflict and further fails to shore up the idea that high share prices would benefit all. Thus, the notion that performance related pay is a solution to the corporate governance problem is utterly unfounded and is potentially harmful.

### C. MARKET FOR CORPORATE CONTROL

MCC works on the principle that stock prices reflect the true underlying value of the company, and thus it assumes that capital markets are fully efficient wherein shareholders would vote with their feet, if they are unhappy with the management's performance. It also presupposes that the sum total of the transaction loss in a takeover or merger is less than the efficiency output of the new entity. This school of thought gains strong empirical backing from Ruback and Jensen who observed that the 'evidence indicates that corporate takeovers generate positive gains, that target firm shareholders benefit, and that the bidding firm shareholders do not lose.'<sup>151</sup>

Before we try to find out if takeovers are 'efficient' let us first try to find out if stock prices are in any way connected to the true worth of the company. There is irrefutable evidence to show that stock markets go through cycles of rise and depressions and the share prices vary according to this cycle irrespective of their underlying performance.<sup>152</sup> Adding to this periodical change in the nature of the stock exchange, we have the behavioural pattern or herd mentality of stock buyers<sup>153</sup> leading to a highly volatile and inefficient capital market.<sup>154</sup>

A quick study<sup>155</sup> on the comparison of dividends declared and fluctuations of share price over a 52 week period in 5 random FTSE 100 companies shows that the

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150 *Enron Timeline* available at [http://news.bbc.co.uk/hi/english/static/in\\_depth/business/2002/enron/timeline/12c.stm](http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/12c.stm) (last visited May 3, 2011).

151 Richard S. Ruback and Michael C. Jensen, *The Market for Corporate Control: The Scientific Evidence*, 11 J.L. OF FIN.ECO. 5, available at [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=244158](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=244158) (last visited May 3, 2011).; see also Easterbrook and Fischel, *supra* note 50.

152 R SCHILLER, *IRRATIONAL EXUBERANCE* (2000) as cited in Blair *supra* note 140 at 59; L. A. Stout, *Are Takeover Premiums Really Premiums? Market Price Fair Value And Corporate Law*, 99 YALE L.J. 1235 (1990) as cited in Blair, *supra* note 140 at 59; L. A. Stout, *Stock Prices And Social Wealth* (2000) as cited in Blair, *supra* note 140 at 59.

153 *Id.* at 144. 'Buyers are susceptible to fads and bandwagon thinking that may allow stock prices to get badly out of line with reality before enough investors will act to sell an overpriced stock or buy an underpriced one to cause the stock to move back into line'; Blair *supra* note 140 at 59.

154 See generally Joseph E Stiglitz and Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECO. REV. 393 (1981)

155 Available at [www.iii.co.uk/investment/detail?code=cotn:BSY.L&it=le](http://www.iii.co.uk/investment/detail?code=cotn:BSY.L&it=le); [www.iii.co.uk/investment/detail?code=cotn:IPR.L&it=le](http://www.iii.co.uk/investment/detail?code=cotn:IPR.L&it=le); [www.iii.co.uk/investment/detail?code=cotn:LGEN.L&it=le](http://www.iii.co.uk/investment/detail?code=cotn:LGEN.L&it=le); [www.iii.co.uk/investment/](http://www.iii.co.uk/investment/)

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fluctuations in share prices greatly outweigh the percentage of dividend declared. This indicates a system where short term financialisation is potentially rewarded over long term growth.

These empirical evidences show that capital market may not be the best judge of the underlying value of the company but is rather a fickle and whimsical punter. Assuming, *arguendo* that the markets are perfectly efficient, let us investigate if takeovers leave all the

LSE Code	52 wk high (in £)	52 wk low (in £)	Difference 52 wk low	% change on share (%)	Div. Per
BSY	849	533.5	315.5	59.13	19.4
IPR	451.50	280.2	171.3	61.13	10.91
LGEN	124.29	72.10	52.19	72.38	1.33
SGE	305	221.9	83.1	37.45	7.8
ULVR	2009	1662	347	20.88	81.9

parties better off. A takeover bid is invariably going to raise the price of the share as the acquiring company would offer a premium over the current market price of the share,<sup>156</sup> however once the takeover is complete the only way to push up the share price of the company would be asset stripping,<sup>157</sup> layoffs,<sup>158</sup> reductions in wages<sup>159</sup> and benefits.<sup>160</sup> Thus in a takeover although the temporary market capitalisation increases (increasing shareholder wealth), the sum total of productive capacity decreases (leaving the stakeholders worse off).

This opens an interesting debate as to whether developing countries should adopt the shareholder primacy model with a free rein given to MCC. A developing country

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detail?code=cotn:SGE.L&it=le; <http://www.iii.co.uk/investment/detail?code=cotn:ULVR.L&it=le>; Data correct as of May 4, 2011.

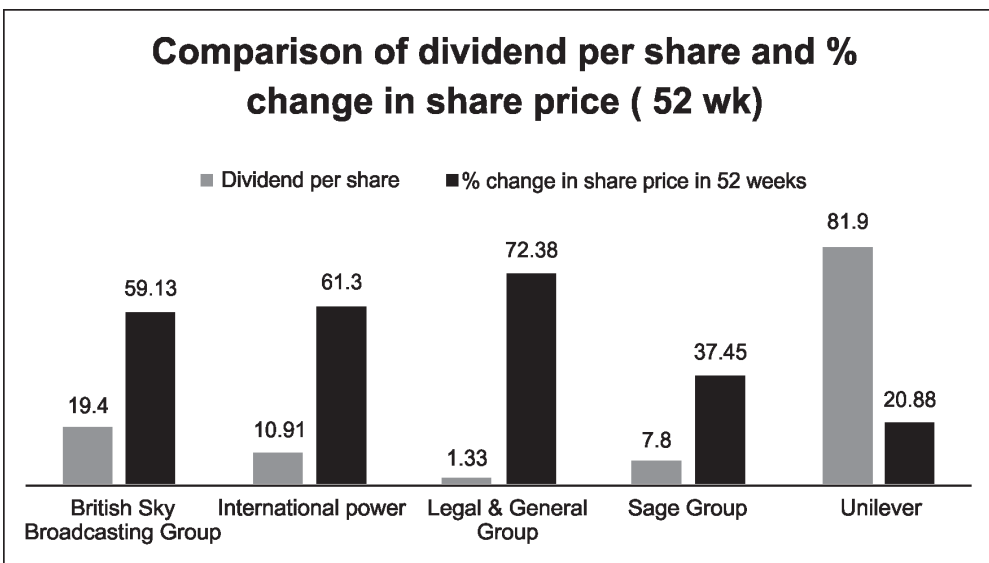
156 See Ruback, *supra* note 151.

157 Bhagat et al, *Hostile Takeover In The 1980s: The Return To Corporate Specialisation*, BROOKINGS PAPER ON ECONOMIC ACTIVITY: MICROECONOMICS 1 (1990).

158 A Shliefer and L H Summers, *The Breach Of Trust In Hostile Takeover*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (A. J. Auerbach ed. 1988) as cited in Blair, *supra* note 140 at 63.

159 D Neumark, *Rents And Quasi Rents In Wage Structure: Evidence From Hostile Takeovers*, 35 INDUS. REL. 145 (1996) as cited in Blair, *supra* note 140 at 63.

160 J Pontiff et al., *Reversion Of Excess Pension Assets After Takeovers*, 21 RAND J. OF ECO. 600 (1990) as cited in Blair, *supra* note 140 at 63.



needs long term capital investments, which would build infrastructure and promote sustainable industrial growth.<sup>161</sup> Thus, a fast in fast out shareholder regime would rarely help in the development of emerging economies.<sup>162</sup> Consequently the author proposes that shares traded in markets of developing countries should have a mandatory lock in period,<sup>163</sup> and a shareholder who habitually abstains from voting should be penalised (for example a higher dividend tax) etc.<sup>164</sup>

At this juncture it is also pertinent to note that MCC forms the genesis of unregulated financial innovations which were the main cause of the Financial Crisis of 2007.<sup>165</sup> However, the scope of this paper does not entail a further discussion in this regard. Thus, MCC is a weak instrument as far as it attempts to solve corporate governance

161 See generally HA JOON CHANG, *BAD SAMARITANS: RICH NATIONS, POOR POLICIES AND THE THREAT TO THE DEVELOPING WORLD* (2007).

162 See generally Harvey, *supra* note 17.

163 Interestingly in India promoters of a company cannot sell their shares for five years after an IPO available at <http://www.indiamarkets.com/imo/finanavenues/Tree2/html/2t6.html> (last visited May 3, 2011).

164 Even more drastic measure can be taken like fixing the price of the share at the par value and let the company issue bonus shares to its shareholders along with dividend, this would eliminate speculative rise or fall of share prices however allows stable growth of shareholder wealth. If the shareholder wants to offload the shares then he would get the par value multiplied by total number of his shares (original share + bonus share) issued to him. Such an arrangement would make the shareholders look for capacity gain rather than capital gain which would lead to sustainable long term growth.

165 See generally TURNER REVIEW (2009) 'THE TURNER REVIEW – A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS', FINANCIAL SERVICES AUTHORITY, United Kingdom; UNITED NATIONS, 'REPORT OF THE COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UNITED NATIONS GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM', (2009) available at [www.un.org/ga/econcrisissummit/docs/Final\\_Report\\_CoE.pdf](http://www.un.org/ga/econcrisissummit/docs/Final_Report_CoE.pdf) (also known as the Stiglitz Report) (last visited May 4, 2011).

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problems. Though it may lead to short spurts of capital gains through takeovers, it rarely reflects the true worth of a company and therefore can never lead to long-term growth or development.

## **V. CONCLUSION**

This essay finds that the use of NEDs, performance related pay for executives and operation of market for corporate control does not solve the problems of corporate governance. Non-executive directors do not provide fail-safe neutrality or independence, performance related pay for executives do not guarantee shareholder wealth maximisation and the capital markets are never perfectly efficient as stock prices rarely show the true value of the underlying company. We find that instead of solving corporate governance problems some of these solutions further exacerbate the situation. Performance related pay for executives increase income inequality, and may even incentivise corrupt practices like insider trading, fudging of accounts. Market for corporate control similarly promotes rapid unregulated financialisation, which is believed to have caused the Financial Crisis of 2007.

Thus, there is a need to suitably amend the corporate governance mechanism to offer a strategy for long-term sustainable growth, which maximises the welfare of all stakeholders, rather than focus merely on the short-term myopic growth of share prices. This can be achieved by a simple tweaking of the existing Anglo-American corporate governance structure and orienting it towards a stakeholder welfare regime. To involve stakeholders in the decision-making process NEDs can be elected/selected by the stakeholders themselves. Thus, organisations representing consumers, employee unions, investor lobby groups, representatives of the local bodies etc. can have equal representation in the selection of NEDs. As NEDs usually undertake supervision over the executive board and form remuneration, audit committees etc.; once elected by stakeholders they would focus on long-term goals of the company rather than on short-term gains.

A criticism of NEDs under the Anglo-American system is that they do not pay much attention to their obligations and act as mere rubber stamps to the executive directors. However, once NEDs are selected by diverse interest groups they would always look after the interest of their constituents, which in most cases would mean a thrust towards long-term growth and development of the company. Another criticism of the NEDs is that they give little time to companies they look after. This is usually because under the present scenario one person can be a non-executive director in more than one company. Such a criticism can be easily addressed by stipulating by way of legislation that a person can be a non executive director in not more than one company at given point in time. Similarly, emphasis should be withdrawn from the financialisation of company and impetus should be given to increasing its productivity. This is particularly so in light of empirical studies which show that market for corporate control and

performance related pay for executives have little correlation to the absolute increase in the productive capacity of the company, though profitability of the firm may increase in the short term (which is usually achieved by retrenchment of labour, off shoring of production etc.).

Thus instead of focussing solely on market linked indicators of health of a company, efforts should be undertaken to educate the shareholders to understand the long-term indicators of growth. This would put less pressure on the management to artificially inflate the market price of shares and at the same time encourage shareholders to be long-term investors in the company. As for performance linked pay, the performance should be determined not by any absolute financial criterion but by a mixture of productivity and financial linked indexes. Furthermore, not only should the executives benefit from such a scheme but also it should be open to all the employees of the company. This would greatly help in mitigating the widening income gap between the floor shop employees and higher executives.

If these recommendations are judiciously implemented then the problems of corporate governance will be solved to a large extent and corporations will aim for long-term sustainable and inclusive growth for the welfare of all its stakeholders rather than solely focus on enriching only its shareholders.