Private Sector Opinion

Culture and Corporate Governance Principles in India: Reconcilable Clashes?

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The structures, institutions, and legal framework of corporate governance are developed and administered by individuals whose behaviors are shaped by cultural and personal concepts of hope, ambition, greed, fear, uncertainty, and hubris, as well as by the social ethos. A problem arises when these influences do not conform with the regulatory prescriptions of corporate governance. This *Private Sector Opinion* explores the dynamics of culture and corporate governance in India by calling attention to three areas where the clashes are strongest: related-party transactions, the promoter's or large shareholder's actions, and the board's nominations, deliberations, and effectiveness.

Foreword

An estimated $1.5 billion (Rs 7600 crore) may have disappeared in the fraud confessed to in 2009 by the now-jailed chairman of Satyam Computer Services Ltd.[1] Satyam's failures were many and systemic—from a weak auditing process to ineffective board oversight to a leader intent on committing fraud. For corporate leaders, regulators, and politicians in India, as well as for foreign investors, this "Enron moment"[2] demanded a reassessment of the country's progress in corporate governance. The resignations of an unprecedented 620 independent directors over the following year added to the mounting concerns.[3]

As a consequence, India's ranking in the CLSA[4] *Corporate Governance Watch 2010* slid from third to seventh in Asia. The CLSA report stated that India "has failed to adequately address key local governance challenges

[1] Joe Leahy (January 7, 2009). "1 bn Fraud at India IT Group," *Financial Times*. http://www.ft.com/cms/s/0/32ea8364-dc85-11dd-a2a9-000077b07658.html#ixzz1Nb42NUgP.

[2] A reference to the 2001–2002 bankruptcy scandal of American energy company Enron Corporation.

[3] Vikramaditya Khanna and Shaun J. Mathew (2010). "The Role of Independent Directors in Controlled Firms in India: Preliminary Evidence," *National Law School of India Review* 22: 35. Http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers/aspx.

[4] CLSA is a leading brokerage, investment banking, and private equity group in the Asia-Pacific markets.

Global Corporate Governance Forum

IFC International Finance Corporation World Bank Group

The Global Corporate Governance Forum is the leading knowledge and capacity-building platform dedicated to corporate governance reform in emerging markets and developing countries. The Forum offers a unique collection of expertise, experiences, and solutions to key corporate governance issues from developed and developing countries.

The Forum's mandate is to promote the private sector as an engine of growth, reduce the vulnerability of developing and emerging markets to financial crisis, and provide incentives for corporations to invest and perform efficiently in a transparent, sustainable, and socially responsible manner. In doing so, the Forum partners with international, regional, and local institutions, drawing on its network of global private sector leaders.

The Forum is a multi-donor trust fund facility located within IFC, co-founded in 1999 by the World Bank and the Organisation for Economic Co-operation and Development (OECD).

such as the accountability of promoters (controlling shareholders), the reputation of related-party transactions, and the governance of the audit profession."[5]

The ensuing debate over reform approaches has raised such questions as, "How well are India's companies being governed?" "Why the failures?" "Where were the regulators?" "What must be done to ensure that directors abide by best practice?"

Forming answers to these questions—answers that will guide reforms—requires an understanding of how India's legal traditions, cultural heritage, and social structure have influenced the evolution and practice of corporate governance. Pratip Kar's insights are useful and timely in helping us to see how culture drives a country's divergence from global best practice. His analysis rightly centers on the key areas of related-party transactions, the promoter's or large shareholder's actions, and the board's nominations, deliberations, and effectiveness.

Kar writes that this sensitive issue of culture is overlooked, if not avoided altogether, when implementing corporate governance best practice, partly because these traditions run deep and, hence, are difficult to address, let alone change.

"Culture is a little like dropping an Alka-Seltzer into a glass—you don't see it, but somehow it does something."
Hans Magnus Enzensberger

At Hermes Equity Ownership Services Ltd., we do address these issues. We place great emphasis on understanding and maintaining local norms, but we also realize that these norms should not compromise a company's adherence to high standards. People in India and other emerging markets, for example, place great importance on respect for elders and their views. But, as a minority shareholder, we need to ensure that this cultural norm does not keep board directors from challenging one another's opinions, exposing problems, or vigilantly protecting shareholders' rights and interests.

In dealing with another local norm—deference to individuals related to the families that own businesses—Hermes EOS recognizes that family members are likely to be promoted to leadership positions over nonfamily employees. The commitment, loyalty, stability, and pride of family members are valuable traits for effective leadership, and, as managers, family members tend to have long-term relationships with stakeholders, including capital providers. But, we stress that individuals should be appointed and promoted based on merit. This approach helps ensure that a company has the leaders it needs to prosper.

5 CLSA (September 2010). *Corporate Governance Watch 2010:* 65.

Further, procedures must be in place for a regular evaluation of the directors' caliber and credibility, with no preferential treatment for family members. Investors should raise red flags about potential directors who hold seats on the boards of other companies tied to the controlling family. Also, in succession planning, we encourage family-owned companies to assess the opportunities that an "outsider" could bring to enhance performance and broaden a company's vision. We also emphasize that family conflicts should not be allowed to hold the business back.

It requires deep engagement on the part of investors to address the issues related to achieving responsible behavior by boards and management. But, in India, shareholder engagement is still a relatively new concept. Often, "investor dialogue" is used as a mechanism to convince investors or to allay their concerns, rather than being seen as an opportunity to enter into a genuine discussion that welcomes alternative perspectives.

Domestic mutual funds also have a role in improving corporate governance by probing further than just the quarterly results. With the clout these funds wield through their share votes, they can influence the quality of a company's governance. But, these investors are unlikely to intervene and actively vote their shares, partly because of the cultural dynamics discussed by Kar. Until these investors start sharing their perspectives with boards and management as a way to address corporate governance weaknesses, foreign shareholders alone are unlikely to exert sufficient influence.

Another important consideration is sustainability, which is viewed mistakenly by many in India as corporate philanthropy. Companies must make sound assessments of the long-term environmental and social risks they face. For example, India has the world's fourth-largest population suffering from AIDS, resulting in part from labor migration and low levels of literacy. In response to this need, companies should ensure that they have the right amenities available for their workforce, such as providing housing to employees' families in rural areas where extractive industries are located. Here again, culture has a bearing on these issues.

In India, there is also growing interest in such environmental issues as clearances for land acquisitions. Companies involved in these projects must ensure that they conduct feasibility studies that exceed state requirements. And, they must assume full ownership throughout the project approval process, including the management of stakeholder relationships. Mismanagement of social and environmental risks can lead to severe reputational damage for companies, including lower valuations, a weaker competitive position, and burdensome, costly litigation.

Interestingly, more of India's companies now appear to be ready to acknowledge and discuss a previously sensitive issue—corruption. Transparency International has ranked India 88th in efforts to reduce corruption. The majority of corruption cases involve state companies, where salaries are generally low. Hermes EOS has recently lobbied regulators to support having base salaries that are high enough to attract and retain talent, making it more likely that individuals would resist pressures to supplement their salaries through unethical means. Without directly tackling the root cause of this issue, it will be difficult to reach a long-term solution.

The driver for successful corporate governance is the board's desire to cultivate a culture imbued with the true spirit of corporate governance reform. Kar's study is a welcome contribution to a better understanding of the influence of cultural factors on corporate governance—and the challenges involved in addressing them.

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Culture and Corporate Governance Principles in India: Reconcilable Clashes?

By Pratip Kar[6]

In India, the evolution of corporate governance is a complex narrative about how a uniquely diverse society, home to many distinct cultures, comes to terms with global standards as part of its economic transformation. To establish a context for this narrative, consider the views of several thinkers on the concept of culture.

For example, University of Michigan professor Richard E. Nisbett observes that organizations have certain structures that function under certain rules and procedures. But you need people to run them, and people are a part of society. Hence, organizations are social units, where social norms and structures, cultural practices, philosophies, and value systems influence them.[7] When an organization is moved from one society to another, it finds itself in an alien environment, and the clash of cultures often gives rise to conflicts, as is frequently seen in multinational corporations and in cross-border mergers and acquisitions.

Culture, which originally meant the cultivation of the soul or mind, through the ages has acquired different meanings in the social and anthropological contexts. According to Hofstede, culture is defined as "the collective programming of the mind which distinguishes members of one category of people from another. In this sense culture is a system of collectively held values."[8] Edgar Schein defines culture as "the deeper level of basic assumptions and beliefs that are shared by members of an organization, that operate unconsciously and define in a basic 'taken for granted' fashion an organization's view of its self and its environment."[9]

The commonality underlying all the definitions and meanings is that culture can be identified by four elements—norms, values, beliefs, and symbols of expression—to reflect patterns of human activities. Social and cultural norms govern individual and collective behaviors and hence organizational behaviors. It is likely that these cultural differences will have an influence on governance structures also.[10] Finally, Jiatao Li and Richard Harrison, in their multicultural study on corporate governance, found that national culture has a

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6 The author thanks James D. Spellman, a consultant with the Global Corporate Governance Forum, for his numerous and invaluable contributions to the preparation of this *Private Sector Opinion*. He brought his extensive expertise and experience in corporate governance, capital markets, and communications to inform the research, analysis, and drafting of this publication.

7 Richard E. Nisbett (2003). *The Geography of Thought*, New York: Free Press.

8 Geert Hofstede (1980). *Culture's Consequences*, Beverly Hills: Sage Publications.

9 Edgar Schein (1994). *Organizational Culture and Leadership*, San Francisco: Jossey-Bass Psychology Series.

10 Geert Hofstede (1991). *Cultures and Organizations: Software of the Mind*, Maidenhead, UK: McGraw-Hill.

dominant influence on corporate governance structure. They recommend emphasizing the importance of national culture and taking it into consideration in future cross-national organizational research.[11]

So, the structures, institutions, and legal framework of corporate governance are developed and administered by individuals whose behaviors are shaped by social and personal concepts of hope, ambition, greed, fear, uncertainty, and hubris, as well as by the social ethos. This makes national cultures a dominant influence on corporate governance.

Another dominant influence is the presence of family-specific cultures. According to Nigel Nicholson, a London Business School professor, and Grant Gordon, director general of the United Kingdom's Institute for Family Business, "Within a family, culture resides in the behaviors and attitudes that are taken for granted. [Some of these have] to do with feeling—especially around love, control and identification. Family climate also has a thinking and an acting dimension."[12]

"[Culture is] the collective programming of the mind which distinguishes members of one category of people from another. In this sense culture is a system of collectively held values."

Geert Hofstede

The problem arises when these national and family cultural influences do not conform with the regulatory prescriptions of corporate governance. This is why understanding cultural imperatives—and the opportunities and challenges they generate—is essential for boards, senior management, stock exchanges, and governments, as well as others involved in implementing and enforcing best practice. These insights also are invaluable to investors in evaluating a company as an investment opportunity.

India's experiences can help other societies and companies advance corporate governance. These experiences illustrate how perceptions, nuances, and human interactions—as shaped by a culture—influence the way corporate governance is understood and implemented. According to Gordon and Nicholson, "In family conflicts, the focus is often over inequality . . . but more often than not it is over what is seen as bad faith."[13] Core concepts of corporate governance—equity, transparency, faith, and accountability—all have deep moorings in values, a component of culture. How human beings handle guilt and shame in a society, for example, determines in part the content, application, and enforcement of accountability standards.[14]

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[11] Jiatao Li and J. Richard Harrison (2008). "Corporate Governance and National Culture: A Multi-country Study," *Corporate Governance: International Journal of Business in Society*, 8(5): 607–621.

[12] Grant Gordon and Nigel Nicholson (2008). *Family Wars: Classic Conflicts in Family Business and How to Deal with Them*, London: Kogan Page. http://up.m-e-c.biz/up/Mohcine/Book/0749446307.pdf.

[13] *Ibid.*

[14] S. Velayutham and M. H. B. Perera (2004). "The Influence of Emotions and Culture on Accountability and Governance," *Corporate Governance*, 4 (1): 52–64.

As a case study, India's history illustrates the complexities involved when a country adopts a set of principles or practices, as articulated by the OECD (Organisation for Economic Co-operation and Development), without adapting them to local cultures.

The Seeds of Corporate Governance

> *"A nation's culture resides in the hearts and in the soul of its people."*
> *Mohandas Gandhi*

The concept and underlying principles of corporate governance are deeply rooted in India's history, ethos, philosophy, economic achievements, and amalgam of diverse faiths and social classes. British historian E. P. Thompson's frequently quoted comment about India still applies: "All the convergent influences of the world run through this society: Hindu, Muslim, Christian, secular; Stalinist, liberal, Maoist, democratic socialist, Gandhian. There is not a thought that is being thought in the West or East that is not active in some Indian mind."[15]

In the third century BC in the city of Pataliputra (now Patna in the state of Bihar), the Indian statesman and philosopher Kautilya wrote his celebrated treatise on statecraft, Arthaśāstra, meaning the "science of political economy," according to one translator.[16] Kautilya viewed the state as an economic entity ruled by a king. His treatise describes those qualities and disciplines that make a king wise and virtuous:

Praja sukhe, sukham ragyam,
Prajanan ca hite hitam,
Naatman priyam hitam ragyan,
Parajanan tu priyam hitam.

It is translated as:

In the happiness and well-being of the subjects,
Is the well-being of the king,
In the welfare of the subjects,
Is the welfare of the king,
What is desirable and beneficial to the subjects and
Not for his personal desires and ambitions
Should be desirable and beneficial to the king.

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[15] As quoted by Amartya Sen (2005) in *The Argumentative Indian*, New York: Farrar, Straus and Giroux.

[16] Roger Boesche (January 2003). "Kautilya's Arthaśāstra on War and Diplomacy in Ancient India," *The Journal of Military History* 67 (1): 9–37.

Essentially, Kautilya described the underlying concept of the king's role as that of trusteeship. In his subjects' welfare lies the king's welfare; good comes from pleasing the subjects. A king endears himself to his people by enriching them and doing good for their benefit. He must be ever vigilant in promoting his people's security and welfare.

If we equate the state to a corporation, the king to a corporation's chief executive officer or board, and the subjects to the shareholders, we could interpret Kautilya's words to mean that a corporation's resources are to be used only for the well-being of the corporation and its shareholders—not for the personal benefit of the chief executive officer, the board directors, and managers. Is not sustainability—and its benefits for economic development and equitable distribution of the corporation's wealth—the fundamental objective of corporate governance? Kautilya's writing embodies this broad concept: "fruitful" economic activity brings prosperity.

Principles that are well-integrated into Indian culture have much in common with corporate governance fundamentals, but Western culture, law, and thought have shaped approaches adopted by India's companies, stock exchanges, and regulators.

Some 18 centuries after Kautilya, the Moghul Emperor Akbar, upholding reason over blind faith, established the "foundations of a non-denominational, secular state which was yet to be born in India or for that matter anywhere else," predicated on the same principles.[17]

Although principles that are well-integrated into Indian culture have much in common with corporate governance's fundamentals, it is Western culture, law, and thought that have shaped the approaches formally adopted by India's companies, stock exchanges, and regulators in modern times. According to D. M. Datta, "Nearly 200 years of British rule, the British system of education . . . , preaching by Christian missionaries, and the phenomenal achievements of the West in science and technology" are some explanations for the primacy of Western philosophy in India. [18]

From a corporate governance standpoint, the West's influence has advantages and disadvantages. For example, in an era of globalization when India's businesses seek to expand worldwide, their ability to pursue acquisitions overseas and attract foreign capital depends on their adoption of the West's approach. [19] The move toward global harmonization of regulatory standards and accounting principles has intensified the perceived need by India's business leaders to adopt Western best practice. Pragmatism and the pace of economic change are also helping expedite this process.

[17] *Ibid.*

[18] D. M. Datta (October 1956). "India's Debt to the West in Philosophy," *Philosophy East and West* 6 (3): 195–212.

[19] See Afra Afsharipour (2010). "The Promise and Challenges of India's Corporate Governance Reforms," *Indian Journal of Law and Economics* 1; and as UC Davis Legal Studies Research Paper No. 223. http://ssrn.com/abstract=1640249. "The needs of India's expanding economy, the increased presence of foreign and institutional investors (both domestic and foreign), and the growing desire of Indian companies to access global capital markets by gaining listing on stock exchanges outside of India, have spurred corporate governance reforms."

The disadvantages of Western influence arise from the fact that the founding principles of business are rooted in a country's *dharma*, or "life-path," and corporate governance includes moral values, ethics, and concepts that are largely defined by the cultural and personal contexts in which they exist. Concepts of equity, fairness, and stewardship have deep moorings. Within the West itself, such concepts explain in part the dichotomy between a "rules" and a "principles" approach to corporate governance.[20] In Confucian society, there is a high value to achieving harmony and consensus, but this tradition may severely restrict board deliberations and result in directors' mechanical deference, if not obeisance, to their board chairmen.

Generally, "cultural, historical, and institutional factors and contexts are critical influential factors to consider in developing better and more effective governance practice."[21] Different countries have assimilated the corporate form of organization, each in its own way. Hence, a "universal" code needs to be applied differently in some countries, a point that the OECD, the International Monetary Fund, and the World Bank all acknowledge. Implementation of corporate governance, then, may warrant country-specific adaptations.

The Family's Role

India's distinctive corporate governance issues originate from the high percentage of companies that are family-owned. As Harvard Business School professors Tarun Khanna and Krishna Palepu write, "concentrated ownership has been an important feature of India's private sector for the past seven decades. . . . Concentrated ownership exists . . . because of institutional voids, [such as] the absence of specialized intermediaries in capital markets." [22] Khanna and Palepu do not find any "intrinsic reason why concentrated ownership is inimical to competition." According to them, "in some Indian families, concentrated owners have consistently tried to use their business group structures to launch new ventures. In the process, they have either failed—hence the turnover in identity—or reinvented themselves."[23]

[20] See Anita I. Anand (2008). "Rules v. Principles as Approaches to Financial Market Regulation. Responding to John H. Walsh, Institution-Based Financial Regulation: A Third Paradigm," *Harvard International Law Journal* 49: 381; and Harvard International Law Journal Online (April 7, 2009). www.harvardilj.org/attach.php?id=172. "Generally, principles-based regulation refers to a broad set of standards that gesture in the direction of certain desired outcomes. These standards may be accompanied by guidelines about how to achieve the outcomes. By contrast, rules-based regulation is, as the name implies, based on a set of detailed rules that govern firms' behavior. Such rules enable firms to 'tick-the-box' to guarantee compliance with law."

[21] Güler Aras and David Crowther, eds. (2008). Culture and Corporate Governance, Social Responsibility Research Network Research Series: Issues in Corporate Behaviour and Sustainability. See also Amir N. Licht (2001). "The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems," *Delaware Journal of Corporate Law* 26 (1): 147–205. http://ssrn.com/abstract=266910.

[22] Tarun Khanna and Krishna Palepu, edited by Randall K. Morck (2005). *The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry*, University of Chicago Press; and as Working Paper 10613 (June 2004), National Bureau of Economic Research: Cambridge, MA. http://www.nber.org/chapters/c10272.

[23] *Ibid.*

One-third of Indian companies are controlled by one or more family members in concert with one another.[24] Even though its ownership share may be modest, the controlling family may dominate by using dual classes of ownership. The level of concentration is confirmed by Moody's Investor Service, which found that 17 of the 30 companies in the Bombay Stock Exchange's benchmark Sensex index were family-controlled in 2007. This ratio has changed only slightly since then. [25] The intensity of family ownership in India is comparable to that found throughout Asia, the Middle East, Italy, and Spain.

India's level of ownership concentration is not surprising, given that such concentration tends to be the norm in developing countries and emerging markets, and more specifically in countries where enforceable legal protection of minority property rights is relatively weak. [26] In India, the courts and other specialized tribunals are ineffective enforcement mechanisms. [27]

Figure 1: A Century of Concentrated Ownership in India, 1900–2000

	1900s	1950s	1960s	1990s
Period	Pre-independence	Post-independence	License Raj	Liberalization
Representative business group	Tata,* Birla	Goenka, Khaitan	Ambani	Wipro/Infosys Ranbxy/DRL
Factor underlying rise	Ethnic community	Transfer of assets	Playing the license game	Advent of markets

*Though the group and the companies of the group, bear the brand name of Tata, the principal shareholder of the Tata Group, Tata Sons, is owned by three public trusts, and the family's holding in the company is miniscule.

Source: Tarun Khanna and Krishna Palepu, "The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry," June 2004.

[24] Vrajlal K. Sapovadia and Kandarp Patel (February 22, 2009). "Is Blood Thicker than Water? Appraising Adequacy of Indian Corporate Governance for Family Based Companies: A Case Study of Satyam Computers," Working Paper Series, Social Science Electronic Publishing. http://ssrn.com/abstract=1347868.

[25] *Financial Times* (September 5, 2010). "India's Family Groups Groom Future Leaders."www.ft.com.

[26] For example, see World Bank (2011). *Doing Business 2011: Making a Difference for Entrepreneurs*. http://www.doingbusiness.org/reports/global-reports/doing-business-2011/.

[27] See Forum, *Resolving Corporate Governance Disputes*. www.gcgf.org.

Randel Carlock, the Berghmans Lhoist Chair professor in entrepreneurial leadership at the business school INSEAD, notes certain advantages of a family-owned enterprise, including committed owners, long-term strategies, industry knowledge accumulated over generations, and such values as trust, stewardship, and longevity. [28] The concentration of power may lead to quick decisions; information and transaction costs may be lower; and access to capital may be easier, when few external alternatives are available. But, Gita Piramal, chairman of Ergo, India's leading office furniture maker, suggests that the ultimate factor in determining success of family businesses may have to do with the legacy. According to Piramal, "Legacy—the conviction that one is not just building a business, but providing a stable and successful future for the next generation—is one of the most important aspects of the Indian family business."[29]

Researchers find that family groups involve "significant pyramiding and evidence of tunneling activity that transfers cash flow and value from minority to controlling shareholders."

From a corporate governance standpoint, however, Rajesh Chakrabarti, William Megginson, and Pradeep K. Yadav find that family business groups involve "significant pyramiding and evidence of tunneling activity that transfers cash flow and value from minority to controlling shareholders."[30] Related-party transactions may be the norm, with social dynamics constraining directors from challenging the patriarchs, matriarchs, and their offspring who run the companies. Prevalent are inbred, insular decision-making processes in which family issues are inextricably intertwined with business matters. Beverley Jackling and Shireenjit Johl identify another possible dominant factor as blind loyalty—an attitude that directors work for those who brought them onto the board.[31] These situations all run counter to corporate governance's foundations of transparency, accountability, and boards' effective stewardship—foundations that "go a long way in building trust of the shareholders."[32]

[28] Randel Carlock (2010). "When Family Businesses are Best," INSEAD Faculty and Research Working Paper 2010/42/EFE. http://www.insead.edu/facultyresearch/research/doc.cfm?did=44409. See also R. Chakrabarti (October 2005). "Corporate Governance in India—Evolution and Challenges," *ICFAI Journal of Corporate Governance*. papers.ssrn.com/sol3/papers.cfm?abstract_id=649857&rec=1&srcabs=1012222; Asian Corporate Governance Association (2010). *ACGA White Paper on Corporate Governance in India*. www.acga-asia.org/public/files/ACGA_India_White_Paper_Final_Jan19_2010.pdf; B. N. Balasubramanian, B. S. Black, and V. S. Khanna (2009). "Firm-Level Corporate Governance in Emerging Markets: A Case Study of India," Law Working Paper, 119/2009, European Corporate Governance Institute. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992529&rec=1&srcabs=914440; and V. S. Khanna and B. S. Black (2007). "Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India," *Journal of Empirical Legal Studies*. 2007: 4. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=914440&rec=1&srcabs=1012222.

[29] Gita Piramal (2009). "Satyam and the Indian Family Business," *Harvard Business Review Blog* (January 26). http://blogs.hbr.org/cs/2009/01/satyam_and_indian_family_busin.html.

[30] Rajesh Chakrabarti, William Megginson, and Pradeep K. Yadav (March 31, 2008). "Corporate Governance in India," *Journal of Applied Corporate Finance* 20 (1): 59–72. http://ssrn.com/abstract=1115534.

[31] Beverley Jackling and Shireenjit Johl (2009). "Board Structure and Firm Performance: Evidence from India's Top Companies," *Corporate Governance: An International Review* 17 (4): 492–509.

[32] Jaspreet Kaur (March 2011). "Corporate Governance in India: Issues for Consideration," *Indian Journal of Commerce and Management Studies* 2 (2).

Several studies draw close links in India between a company's adherence to good corporate governance practices and its performance. For example, University of Michigan Law School professor Vikramaditya S. Khanna and Northwestern University Law School professor Bernard S. Black conducted a study, in part supported by the Forum, that looked at share valuation trends and their correlations with corporate governance improvements in India.[33] Specifically, they examined India's new regulations (Clause 49 of the Listing Agreement, which stipulates corporate governance requirements for listed companies) and whether their imposition improved companies' share prices because investors believed the changes would boost performance and guard against corporate wrongdoing. They concluded that this was the case, particularly for faster-growing firms.

India is seeing change driven by companies themselves. As one observer noted, Infosys is "completely free of the influence of a dominant family or group, and [has] made the individual shareholder their central governance focus."[34] The CLSA study gave Infosys one of the highest scores in its ranking.[35] The value destruction from imploded family-owned companies is another powerful driver for reform. "The Birlas split after three generations, the Ambanis in the second generation, and the Bajajs in the third generation."[36] (See Figure 1.) Another factor: "Generation Next, or members of the millennial generation in their 20s and 30s, is moving in and moving up the corporate ladder."[37]

Family heritage and value systems can also have a significant positive influence on the companies' governance practices—influences that can transcend generations.

Family heritage and value systems can also have a significant positive influence on the companies' governance practices—influences that can transcend generations. Take the Tata Group for example. The crest of the Tata Group bears the legend, *Humata, Hukhta, Hvarshta,* which in the Avesta language means good thoughts, good words, and good deeds. This legend is integral to the Tata Code of Ethics and the group's value system, including its position on corporate social responsibility. The Purpose Statement says, "At the Tata Group we are committed to improving the quality of life of the communities we serve." The corporate credo, laid down by patriarch Jamshetji Tata, continues to inform the group's value system and its underlying business philosophy: "In a free enterprise, the community is not just another stakeholder in business, but is in fact, the very purpose of its existence."

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[33] Vikramaditya S. Khanna and Bernard S. Black (2007). "Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India," *Journal of Empirical Legal Studies* 4; also as ECGI-Finance Working Paper No. 159/2007; as University of Michigan Law and Economics, Olin Working Paper No. 07-002; as University of Texas Law, Law and Econ Research Paper No. 86; as 1st Annual Conference on Empirical Legal Studies; and as EFA 2007 Ljubljana Meetings Paper. http://ssrn.com/abstract=914440.

[34] Chakrabarti, et al. "Corporate Governance in India."

[35] CLSA, *Corporate Governance Watch* 2010: 65.

[36] Shishir Prasad, Shloka Nath, and N. S. Ramnath (2010). "Family Businesses And Splitting Heirs," Forbes (October 15). http://business.in.com/article/india-rich-list-10/family-businesses-and-splitting-heirs/18242/1#ixzz1OdJs6rHV. The Birla family businesses vary, from commodities and textiles to automobiles, information technology, and telecommunications. The Ambanis own Reliance Industries, a textile conglomerate. The Bajajs own the Bajaj Group, a conglomerate with holdings in the auto, home appliances, lighting, iron and steel, insurance, travel, and finance sectors.

[37] *India Knowledge@Wharton* (2010). "How 'Generation Next' is Moving Up the Corporate Ladder at India Inc." (October 7). http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4530.

Where Culture Clashes with Best Practice

Family bonding, custom and tradition (or, *riti-parampara*), personal or family trust, and relationships all have an impact on leadership styles, board composition, choice of independent directors, and succession planning, as well as on disclosure of related-party transactions, especially in family-owned businesses.

Family bonding is important, and the concept of the extended family is still very much prevalent. Often the entire business is considered to be a part of the extended family; the distinction between what belongs to the family legally and what belongs to the company is lost. *Riti-parampara* affect boardroom behavior. If custom demands deference to the elders and thus an unquestioning attitude toward the chairman if he is the eldest member of the family, so be it.

Traditionally, Indian businesses have always run on personal relationship and trust. The owner-manager often bestows his trust on a set of people, irrespective of their place in the organizational hierarchy. Independent directors are often chosen on the basis of whether the person would fit into the organization's culture and be agreeable to the family.

This *Private Sector Opinion* uses India as an example to explore the dynamics between culture and corporate governance by looking at three areas where the clashes in India are strongest: related-party transactions, the promoter's or large shareholder's actions, and the board's nominations, deliberations, and effectiveness.

Related-party transactions

Related-party transactions tend to take the form of "expenses" reimbursed to group companies or enterprises controlled by top management. These charges range from the leasing of premises to corporate advertising.[38] Such transactions may be a tool for managing earnings and operations results, achieving returns on equity or other targets, and serving deceptive and fraudulent purposes. Yet, these transactions cannot be classified solely as having fraudulent or deceptive purposes, because they may also fulfill sound economic needs and hence be unavoidable. If companies are prohibited from entering into such transactions, they may be unable to maximize shareholder value. As Pizzo points out, social factors "play an important role in the issue, making these exchanges and their implications peculiar in each nation."[39]

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[38] For general background on related-party transactions, see Michele Pizzo (July 30, 2009). "Related Party Transactions in Corporate Governance," Social Science Electronic Publishing. http://ssrn.com/abstract=1441173.

[39] *Ibid.*

It is now fairly widely understood by Indian business that a related-party transaction can present a potential or actual conflict of interest by advancing the self-interests of families holding a majority stake to the detriment of minority shareholders. The practice can lead to situations in which funds are tunneled out of the company into another entity, a "related party," or can result in a lost business opportunity.

> *"Indian companies need only obtain board approval for related-party transactions, even large ones, not broader shareholder approval. Stock exchange listing rules merely mandate audit committees to review related-party transactions and disclose them in the quarterly compliance reports and corporate-governance sections of annual reports of listed companies. Accounting Standard 18 also governs disclosure of such transactions—but not related transactions between state enterprises."*
>
> *Corporate Governance Watch 2010*

India's body of laws, regulations, and codes directly or indirectly lays down the "dos and don'ts" of related-party transactions.[40] In a broad sense, therefore, a coherent regulatory system exists in India, particularly in disclosure and board oversight. One study found that, from 2002 through 2006, Indian companies disclosed more than the minimum level of related-party disclosure required in the Indian accounting standard.[41] The fact remains, though, that board approval, not a shareholder vote, is all that is required, although Clause 166 of the Companies Bill 2009 authorizes shareholder votes (real-time polling service) on the sale, purchase, or supply of goods, services, and property; leasing property; and appointment of agents. The Securities Exchange Board of India is advocating reforms to prevent any shareholder who has an interest from voting on that transaction.[42]

In an economy where family-owned businesses dominate, the desire and opportunity to use a known party is great, particularly when trust is involved. Secrecy may also be a consideration to prevent competitors from learning about a business strategy. "But the line between using a familiar face and exploiting shareholders' resources for personal gain becomes very wide and very gray in family-owned businesses." [43] Cultural factors have raised the threshold for tolerance. The lack of timely disclosures prevents shareholders from questioning the deals.[44]

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[40] For example, certain passages in Indian law—namely, sections in the Indian Companies Act 1956, such as 297, 299, and 314(1A) (which have been in place since the enactment of Act in 1956); the Companies Audit Report Order; Section 44AB of the Income Tax Act; Clauses 32, 41, and 49 of the Listing Agreement between the stock exchanges and the listed companies—embody the concept of a related-party transaction, though none of these, save Clause 49 of the Listing Agreement, has any explicit reference to the term "related-party transaction."

[41] Bikram Chatterjee, Monir Zaman Mir, and Omar Al Farooque (2009). "The Current Status of Related Party Disclosure in India: A Longitudinal Analysis," in Mathew Tsamenyi and Shahzad Uddin (eds.), *Accounting in Emerging Economies* (Research in Accounting in Emerging Economies, Volume 9), Emerald Group Publishing Limited: 287–319.

[42] *Economic Times* (February 8, 2011). "No Voting Rights for Interested Groups: Sebi." http://articles.economictimes.indiatimes.com/2011-02-08/news/28430399_1_satyam-maytas-related-party-transactions-transactions-with-group-subsidiaries.

[43] Pratip Kar (2010). "Fighting Abusive Related Party Transactions in Asia: Workshop on Implementation," Background document, OECD-Asian Roundtable on Corporate Governance. (October 25–26). http://www.gcgf.org/ifcext/cgf.nsf/Content/RTP_Publication

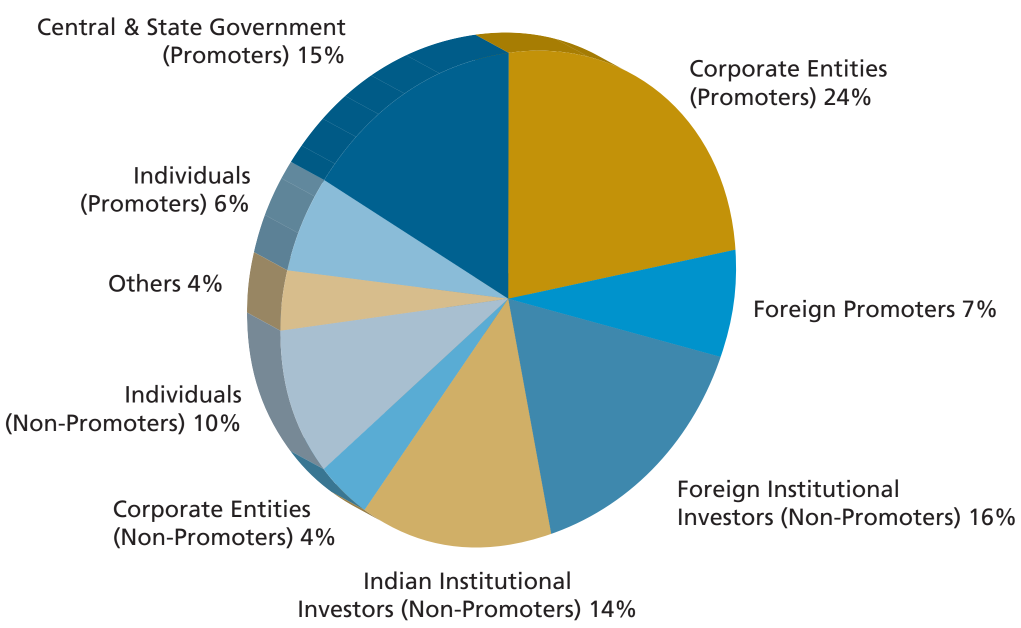
[44] *Business Standard* (May 27, 2011). "Poor Corporate Governance Leads to Higher Risk and Lower Returns: Study." http://www.business-standard.com/india/news/poor-corporate-governance-leads-to-higher-risklower-returns-study/436891/.

Promoter's or large shareholder's actions

A "promoter" generally means the entrepreneur—whether an individual, a corporate entity, or a government institution—that establishes and continues to exert control of the business. The status of "promoter" gets effectively transferred through sale of the business to a new owner.

According to one analysis, "a 2005 study of the shareholdings of some 2500 Indian listed manufacturing companies at the end of 2002 reported that promoters held roughly 48% of the shares, accounting for about 51% of the shares of the family group companies and 46% of the shares of the other, so-called 'stand-alone' firms. By comparison, the Indian public's share amounted to just 35% of the total sample, including 28% of the group companies and 38.5% of the stand-alone firms." [45] This concentration of ownership, however, is beginning to change. University of California (Davis) law professor Afsharipour notes that ". . . non-promoter institutional investors, both Indian and foreign, are making significant inroads in the ownership of large Indian firms." [46] (See Figure 2.)

Figure 2: Types of Promoters in the 500 Largest Companies in India



Source: Prowess

[45] Chakrabarti, et al. "Corporate Governance in India."

[46] Afsharipour. "The Promise and Challenges of India's Corporate Governance Reforms."

The Satyam case illustrates the perils of promoters. In December 2008, Satyam Chief Executive Officer B. Ramalinga Raju announced that the company would acquire a 100 percent stake in Maytas properties for $1.3 billion and a 51 percent stake in Maytas Infrastructure for $300 million. The Raju family owned roughly one-third of each takeover target. The maneuver was seen as a way of diverting cash from Satyam's shareholders to the Raju family through these acquisitions at highly overvalued prices. Because the Raju family's ownership of Satyam was a minority share (8.75 percent), the deal required shareholder approval and was eventually rejected. In January 2009, Raju confessed that this scramble for acquisitions was an effort to cover up fraud amounting to $1 billion, or 94 percent of the company's cash. The "independent" directors were not truly independent, and the auditors often acted in collusion to perpetrate the corruption.

Companies now need to provide details of shares pledged by promoters. In November 2008, the Securities and Exchange Board of India tightened rules on the disclosure of share transactions by directors and controlling shareholders (from four to two working days). In 2009, SEBI amended the listing rules to direct companies to provide details of any shares pledged by promoters in the listed entities. Disclosures must now be made when the shares are pledged, and periodic disclosures must be made in the quarterly statements submitted to the stock exchanges.

Board nominations, deliberations, and effectiveness

The presence of controlling shareholders on a board weighs heavily on how directors interact with one another and make decisions. The family's "groupthink" may prevail. Familial ties may create a division between "insiders" and "outsiders" regarding influence and perceptions of what constitutes the best interests of the company and shareholders. Opinions and decisions during board meetings may reflect "family convocations" held outside the boardroom. Objectivity may be skewed by family priorities, disputes, interpersonal relationships, and shared understandings. Further, "it is not easy to give up power, particularly if you have been the object of so much adulation," as N. R. Narayana Murthy noted in his last letter to shareholders as Infosys chairman.

In Indian society, respect for elders is paramount; it is customary to demonstrate deference to their views. This cultural trait often influences the selection of directors and boardroom dynamics. Business leaders and politicians also tend to retire late in India. For example, the chairman of family-owned conglomerate Mahindra & Mahindra is 86 years old—and has been at the helm since 1963.

If the selection of directors is made by proxy, families will invariably determine the choice, because their votes likely constitute the majority. According to National University of Singapore law professor Umakanth Varottil, "The absolute dominance of controlling shareholders in this process creates a level of allegiance that independent directors owe towards controlling shareholders. If controlling shareholders cease to be pleased with the efforts of an independent director, such a director can be certain that his or her term will not be renewed, even if such director is spared the more disastrous consequence of being removed from the board." [47]

"If controlling shareholders cease to be pleased with the efforts of an independent director, such a director can be certain that his or her term will not be renewed."

Umakanth Varottil

Even though 65 percent of India's population is below 35 years of age, a *Economic Times* survey of Bombay Stock Exchange-listed 500 companies in April 2011 shows that a majority of full-time directors on the boards are either in the 46–60 age group (42 percent) or the 61–80 age group (35 percent). [48] Experience and vision are seen as coming with age, with the one exception being promoters' children, who take board seats relatively early. "Getting someone in their 40s on the board might just be about bringing in a peer of the chief executive officer," said K. Sudarshan, a managing partner at EMA Partners International. "But she or he may not be someone people look up to, for advice."[49]

Cultural changes also lead to exits, as Frank Hancock, managing director and head of M&As, India at Barclays Capital, observes. "The new generation is much less focused on the family business," he writes. "They're not necessarily beholden to daddy. They're eager to strike out on their own." [50] Examples include the apparel exporter Gokaldas, which was sold to the Blackstone Group in August 2010, and brothers Malvinder and Shivinder Singh who, after years of running the drug maker Ranbaxy Laboratories that their grandfather founded, sold out to Japan's Daiichi Sankyo in August 2010.

The succession of the Tata chairmanship is a closely watched case, because long-time patriarch Ratan Tata plans to step down in 2012 when he turns 75 years old. Through his leadership over two decades, the group he inherited from his uncle grew gross revenues from $5 billion to $70 billion through global operations. A search committee formed in August 2010 had yet to name a successor as of June (it had set a March deadline). The selection process is also complicated by pressure from the diminishing minority Parsi community, to which the Tata family belongs, which wants the successor to be one of their own. The outcome will set a precedent for other family-owned businesses.

[47] Umakanth Varottil (2010). "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," *Hastings Business Law Journal* 6: 281.

[48] Shreya Biswas and Mahima Puri (2011). "India Inc. Vouches for Senior Executives at Board Levels; GenNext Can Wait," *Economic Times* (April 27). http://articles.economictimes.indiatimes.com/2011-04-27/news/29479221_1_corporate-governance-directors-amit-burman.

[49] *Ibid.*

[50] *Arab Times* (August 13, 2010). "Indian Family Firms Businesses Decline." http://www.arabtimesonline.com/NewsDetails/tabid/96/smid/414/ArticleID/158226/reftab/36/t/Indian-family-firms-businesses-decline/Default.aspx.

Conclusion

We have seen how traditions and culture interact with the establishment of corporate governance best practice, shaping the "universal" model to reflect India-specific conditions. Although this observation argues for adaptation, it also reveals the complexities and challenges of understanding core concepts that drive corporate governance, concepts that have deep roots in the culture. India's diversity illustrates well the need for company leaders to involve a broad group of stakeholders rather than acting unilaterally. The implementation of corporate governance at a national or company-specific level is a trust-building endeavor demonstrating the value of understanding mutual expectations and concerns.

Change is under way as a new generation of family heirs begins to succeed elder family members and as companies face more intense competition for exports.

Change is under way as a new generation of family heirs begins to succeed elder family members (or, to go their own way, making room for nonfamily successors) and as companies face more intense competition for exports. In the end, it is India that must find its own way to adhere to best practice, supported by expertise from those countries that have undergone or are starting their own transitions. It remains to be seen whether these shifts will moderate cultural clashes, intensify them, or just make them different. But, India's history, diversity, and rapid emergence as a major player in the world economy makes it a potential bellwether—and certainly worth keeping an eye on.

About the Author

Pratip Kar, a member of the Forum's India Advisory Council and a consultant to the Forum and the World Bank, has been associated with India's financial sector for three decades. His other roles include being a member of the Board of Governors of the National Institute of Securities Markets of the Securities and Exchange Board of India; member of the Working Group of the Reserve Bank of India on Non Banking Finance Companies; senior advisor to Deloitte, Touche, Tohmatshu (India); director of the Tata AIG Life Insurance Company (India); and member of CII's National Council on Corporate Governance.

Kar joined SEBI at its inception in 1988, later serving as its executive director (1992–2006). During his 18 years with SEBI, he was closely involved with India's economic reforms and the reforms of the Indian securities market. He was involved in forming the regulatory framework and policy for the securities market, and helped implement the regulations covering all aspects of the securities market. He also drafted the SEBI reports on corporate governance and framed Clause 49 of the Listing Agreement, which lays down the requirements of corporate governance in India. During his tenure in SEBI, Kar was closely associated with the International Organization of Securities Commissions and the OECD.

In 2006, Kar moved into academics, serving until 2009 as the dean of finance and corporate governance at the Tata Management Training Centre, Pune, the learning arm of the Tata Group. He is a visiting faculty member at the Indian Institute of Management, Kolkata, and director and strategic advisor of the Globsyn Business School, Kolkata. He is also a consultant for a number of companies and professional firms. Kar has several publications in the fields of capital markets and corporate governance, and he writes a monthly column, "Capital Concerns," for the *Business Standard* newspaper in India, available at http://www.business-standard.com/india/news. He holds an MBA degree from INSEAD and a master's degree in solid state physics from the Calcutta University.

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