The Role Of Judiciary In Corporate Governance In India

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Abstracts: The author aims to examine the role of judiciary in corporate governance. Further to see whether there is need to interfere by the judiciary in the self governance of the corporation and what is the position in India? The judiciary plays a central role in corporate governance even when they appear to be merely interpreting statutes. At many places where the situation requires the judiciary has laid down certain guidelines to be followed to enhance the good governance in the corporation. The author has formulated the following questions and has tried to find out the answer- Whether judiciary plays any important role in corporate governance. Is there any effect on the rights and remedies of shareholders, directors, stakeholders etc. because of judiciary's intervention? What are the positions in India regarding the role of judiciary in corporate governance?
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I. Introduction:

The aim of this paper is to analyze the concept of Corporate Governance and show that this concept is an increasingly complex mixture of legal and self regulation. The reasons for such complexity are that the laws regarding the corporate governance have undergone changed over time and therefore the role of judiciary comes into front. Further, the author would like to focus on some recent corporate collapse which casts crucial doubts about the ultimate efficacy of self regulation. These developments raise the questions about the justifiability of modern corporate governance, whether there are any alternatives to the conventional adjudication and what should be the role of judges. It is pertinent to note here that the courts do two things, first it adjust mandatory provisions provided by the statutes and, secondly it evaluates the contractual innovations agreed by the parties against the backdrop of the fiduciary duties of care and loyalty owed by directors and the managers toward the shareholders. "When courts adjust the mandatory rules imposed by statutes, they employ a hypothetical bargaining approach that first determines what arrangement the parties themselves would have adopted ex ante and then requires that subsequent transactions conform to that hypothetical bargain. It is only in this way that mandatory rules can properly be labeled. It indicates that the only respectable academic approaches to corporate law are those that accord judge the central, decisive role in corporate life"[1]. Investors have certain expectations of the role of judiciary in the enforcement of fiduciary duties. The judicial intervention is a key ingredient in the overall corporate transaction among the four parties involved—the stockholders, directors, management, and state government. Since the court has power to interpret the law only, the author would see whether courts play a central role in corporate governance even by interpreting statutes. The author will focus important cases in which the courts have played an important role and also see that whether courts have a role to enforce self regulation and what is the use of self regulation in legal proceedings. The aim of corporate governance is to enhance the interests of shareholders and the role of courts is to see whether corporate action is such that enhance the shareholders interests.

II. The Concept of Corporate Governance:

The term 'corporate governance' is much in use these days. Everybody who has anything to do with corporate sector talks about corporate governance. The term 'Corporate Governance' was used, for the first time, in 1962, by *Richard Eells* of Columbia Business School in his book *The Government of Corporations*[2].The genesis of corporate governance arises from the great business scams and scandals which are all common in the recent past. The term 'corporate governance' can be defined as a set of systems, processes and principles which ensure that a corporation is governed to the best interests of all the

[1] Jonathan R. Macey, Courts and corporations: A comment on coffee,(1990) HeinOnline -- 89 Colum. L. Rev. 1693 1989.

[2] JH Farrar, *Corporate Governance in Australia and New Zealand* (2001), Chapter 1, p. 1.

stakeholders of the corporation[3]. Here a corporation includes generally five stakeholders, namely:

1) Shareholders,
2) Employees,
3) Customers,
4) Creditors, and
5) Community.

To serve the best interests of all the stakeholders, systems and processes have to be built keeping in the mind the interests of each of the above stake holders. Corporate Governance can be considered as the system by which companies are directed and controlled. It is a set of standards which aims at improving the corporations' image, efficiency, effectiveness and social responsibility. The concept of corporate governance primarily hinges (depend) on complete transparency, accountability and integrity of the management, with an increasing emphasis on investors' protection and public interest. Corporate Governance involves self imposed discipline by the corporate. According to Sir Adrian Cadbury, "Corporate Governance is concerned with holding the balance between economic and social goals and between individual and community goals. The aim is to align as nearly as possible the interests of individuals, corporations and the society". According to the OECD, "Corporate Governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders". In developing countries, Corporate Governance setting takes on additional importance. Good corporate governance is fundamental because of its role in attracting foreign investment. The extent of foreign investment shapes the prospects for economic growth for many developing countries While India's corporate governance structure is advanced for a developing country, it still should be radically improved. At the end we could say that a good corporate governance is based on the principles such as transparency, accountability, fairness and responsibility[4]. The main objectives behind the corporate governance are 'enhance the long term share holders value and to protect the interests of other stakeholders in the corporation, *viz*, bankers, creditors, customers, employees of the company, suppliers, Government and the community at large.

III. Why Corporate Governance:

Before making investment decision, Investors first of all consider two things, first, the rate of return on invested capital, and secondly, the risk coupled with the investment. In recent years, the attractiveness of developing nations as a destination for foreign capital has increased, partly because of the high likelihood of obtaining strong returns and partly because of the decreasing attractiveness of developed nations[5]. The attracting a high rate of return, however, does not, by itself, guarantee foreign investment, the risk attached with it weighs equally in the investors' decision-making calculus. Good corporate governance practices reduce this risk by ensuring accountability, transparency and enforceability in the marketplace. A strong corporate governance system ensures a long-term success of the country; while weak system often leads to many serious problems. In an open market, the firms which are more open and transparent, and thus well governed, are more likely to raise capital successfully because investors will have "the information and confidence necessary for them to lend funds directly" to such firms[6]. Moreover, the firms which are well-governed likely will obtain capital more cheaply than firms that have poor corporate governance practices because investors will require a lower risk premium for investing in well-governed firms. Thus, the investors will invest in those firms which are having good corporate governance because of the lower risks and the likely hood of higher return. Good corporate governance helps the developing countries in getting more benefits in a number of ways. Good corporate governance practices can decrease the likelihood of a domestic financial crisis and the severity if such a crisis does occur. Further, I would like to say that a good corporate governance practice would create an efficient corporate management. Finally, it has been seen that the well-governed firms are valued much higher than firms with poor corporate governance practices. Moreover, the good corporate governance plays a role of reducing corruption and the reduced corruption significantly enhance the development prospects of the country.

IV. Role of Judiciary in Corporate Governance:

The judiciary has to do two things, first it adjust mandatory provisions provided by the statutes and, secondly it evaluates the contractual innovations agreed by the parties against the backdrop of the

[3] L.V.V. Iyer, *Corporate Governance: Some thoughts, Corporate Law Cases,* 2000, Journal 1.

[4] Suresh Thakur Desai, *Its Meaning and Scope, SEBI and Corporate Law Magazine*, 2002, vol. 35, p. 95.

[5] Dr. Madan Bhasin, *Corporate Governance in India: Past, Present & suggestions for Future.* (http://www.manupatrafast.in/pers/viewdocMain.aspx)

[6] Ibid

fiduciary duties of care and loyalty owed by directors and the managers toward the shareholders. "When courts adjust the mandatory rules imposed by statutes, they employ a hypothetical bargaining approach that first determines what arrangement the parties themselves would have adopted ex ante and then requires that subsequent transactions conform to that hypothetical bargain. It is only in this way that mandatory rules can properly be labeled. It indicates that the only respectable academic approaches to corporate law are those that accord judge the central, decisive role in corporate life" [7]. The judiciary's central role in corporate law arises from the existence of the policymaker's dilemma, which renders legislative enactments unhelpful in a wide variety of contexts [8]. The author would like to give some examples on the basis of which the role of judiciary exist.

i. Judicial Removal of Directors:

In recent years, nearly 29 countries have adopted in their corporate law the provisions empowering courts to remove directors elected by shareholders, apparently under the assumption that sometimes shareholders would like to, but cannot, remove directors themselves[9]. This power of court is extraordinary in nature that it usurps the shareholders' inherent right. But unfortunately India is not a part of those countries having judicial removal of directors.

ii. Executive compensation:

Executive compensation is an important area of corporate governance which has received much attention. Executive compensation is financial compensation received by an officer of a corporation. It is usually determined by the Board of Directors of the company. Executive compensation generally includes a fixed base salary, a bonus scheme, perquisites (including pension plans, company cars, use of company aircraft, and other "perks"), and conditional promises of separation payments. There are two views in America, "one urges that American executive-compensation model is immoral, rewards greedy executives for company performance that is unrelated to an executive's performance, allows executives to essentially set their own compensation and to enrich themselves at the expense of shareholders, and causes significant economic harm. Others argue that American executive-compensation practices are efficient, reward talented individuals who compete in an extremely competitive market, and have contributed to economic growth."[10] The settlement payment comes from the corporation which would be against shareholders' interest. The court held in *SEC v. Bank of America Corp.*, that these settlements are frequently "neither fair, nor reasonable, nor adequate. Many executive-compensation problems will be significantly reduced or eliminated. In 2006, the SEC passed new rules requiring that a company must explain how much compensation its top executives received and why. With the intervention of the judiciary regarding executive compensation the Shareholder Bill of Rights Act, 2009 was passed by the American Government to have control on executive compensation.

iii. Shareholders' remedies and Judges:

Generally the right to seek remedies for the wrongs committed towards the company vested in the company. The decision of the House of Lords in *Ebrahimi v Westbourne Galleries Ltd*[11] produced a new approach which was the beginning of a more interest based approach which arose in interpretation of the just and equitable clause in winding up but was carried over to the reforms of the statutory shareholder remedy, now in section 232 of the Corporations Act 2001. Now the share holder could file a petition in respect of wrong done to company.

iv. Shahara Grop's Optionally Fully Convertible Debenture (OFCD) scheme case,

The Supreme Court Directing the market regulator SEBI to proceed with the probe into Sahara group's Optionally Fully Convertible Debentures (OFCD) scheme said that the investors may not be aware about these products and might feel cheated like in the Harshad Mehta scam. SC was of the view that on the question of OFCD, it requires decision of (market regulator) SEBI. Let SEBI hear and pass an order. While hearing the case the SC observed that investors were not aware of this investment scheme and later they might feel cheated as was the case with

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[7] Jonathan R. Macey, *Courts and corporations: A comment on coffee,(1990) HeinOnline* -- 89 Colum. L. Rev. 1693 1989.

[8] *Supra* note 1, p. 1699.

[9] Olga N. Sirodoeva Paxon, Judicial Removal of Directors: Denial of Directors' License to steal or Shareholders' freedom to vote?

[10] Mathew Farrell, *A Role for the Judiciary in Reforming Executive Compensation: The Implications of Securities and Exchange Commission v. Bank of America Corp,* available at http://legalworkshop.org/2010/11/03/november-3rd

[11] [1973] AC 360

Harshad Mehta securities scam that took place in 1990s.

V. Indian Scenario:

There are many provisions under the Companies Act, 1956 that make the role of judiciary in corporate governance. These are as follows:

1) *Reduction of share capital*: sections 100-105 provides that a company limited by shares, if so authorized by its articles, may by special resolution reduce its share capital. Here the resolution to reduce the share capital shall come into effect only after confirmation of court (now Tribunal)[12]. In case of *TN Newsprint and Paper Lt.*[13] the Madras HC allowed the company to reduce its capital which was found to be in excess of its needs by permitting it to pay the same to its creditors.

2) *Power regarding compromise or arrangements*: Sections 291-293 makes provisions regarding compromise and arrangements between company and its creditors, or between company and its members. Section 291 provides that where a compromise and arrangement is proposed between company and its creditors, or between company and its members, the court (now Tribunal) is empowered, on the application of company or any creditors or members as the case may be, to pass an order that a meeting of creditors or members be called and held in the manner directed by the court. The court has very wide powers in sanctioning or rejecting the scheme of compromise or arrangement. As per the provisions of Section 292[14] of the Companies Act 1956, the courts shall have the following powers-

a. Power to stay any suit or proceeding
b. Power to supervise or modify compromise or arrangement
c. Power to make an order for winding of a company.

3) *Winding up of company by court:* Section 425[15] of the Companies Act, 1956 makes provisions for the winding up of a company. Subsection (1) (a) makes provision for the winding up of company under the order of the court. The court may by its order wind up of the company under the circumstances enumerated in Section 433[16] of the Company Act, 1956.

4) *General Powers of court in case of winding up by court: The following are the general powers of the court:*

a. To stay winding up[sec. 466]
b. To settle list of contributories[sec. 467]
c. To deliver property to liquidator[sec. 468]
d. To set off claims[469]
e. To make calls[sec. 470]
f. To order deposit in Reserve Bank[sec. 471]
g. To exclude creditors[sec. 474]
h. To adjust rights of contributories[sec. 475]
i. To order costs[sec.476]
j. To order public examination of promoters, directors etc.[sec. 478]
k. To arrest absconding contributory[sec. 479]

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[12] Companies (Amendment) Act, 2002.

[13] (1995) 5 SCL 187 (Mad.)

[14] (1) Where a High Court makes an order under section 391 sanctioning a compromise or an arrangement in respect of a company, it (a) shall have power to supervise the carrying out of the compromise or arrangement ; and
(b) may, at the time of making such order or at any time thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary for the proper working of the compromise or arrangement.
(2) If the Court aforesaid is satisfied that a compromise or arrangement sanctioned under section 391 cannot be worked satisfactorily with or without modifications, it may, either on its own motion or on the application of any person interested in the affairs of the company, make an order winding up the company, and such an order shall be deemed to be an order made under section 433 of this Act.
(3) The provisions of this section shall, so far as may be, also apply to a company in respect of which an order has been made before the commencement of this Act under section 153 of the Indian Companies Act, 1913 (7 of 1913), sanctioning a compromise or an arrangement.

[15] Section 425 provides that the winding up of a company may be either -
(a) by the Court (compulsory); or
(b) voluntary ; or
(c) subject to the supervision of the Court.
(2) The provisions of this Act with respect to winding up apply, unless the contrary appears, to the winding up of a company in any of those modes.

[16] Sec 433 provides that a company may be wound up by the Court,
(a) if the company has, by special resolution, resolved that the company be wound up by the Court ;
(b) if default is made in delivering the statutory report to the Registrar or in holding the statutory meeting ;
(c) if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year
(d) if the number of members is reduced, in the case of a public company, below seven, and in the case of a private company, below two ;
(e) if the company is unable to pay its debts ;
(f) if the Court is of opinion that it is just and equitable that the company should be wound up.

5) Power of Court to Appoint and Remove Liquidator: Section 515[17] of the Companies Act, 1956 provides that if from any cause, whatever, there is no liquidator acting, the court may appoint the official liquidator or any other person as liquidator. This section further provides that the Court may, on cause shown, remove a liquidator and appoint the Official Liquidator or any other person as a liquidator in place of the removed liquidator.

6) Power of court to assess damages against delinquent directors, etc.: Section 543[18] empowers the court to assess damages and require the delinquent directors and other officers of the company to pay the amount to the company.

7) Power of court to declare dissolution of company void: As per the provisions of Section 559[19] of the Companies Act, 1956 where a company has been dissolved in pursuance of the provisions of this Act, the court may at any time within 2 years of the date of dissolution, on the application of the interested person, make an order upon such terms and conditions as the court may think fit, declaring the dissolution to have been void.

Conclusion

The author would like to conclude this paper by stating that the judiciary has an important role to play in corporate governance. It is found that the court fills the missing terms in the contract by interpreting it as to enhance the shareholders' wealth. The corporate governance is the complex amalgamation of self regulation. The boundary of self regulation raises new challenges for the court to interfere. The court comes into front when the policy making body leaves some lacuna in the law. Only judiciary has power to interpret the law and thereby has the valid reason to interfere with the self regulation of the corporation.

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[17]Section 515 provides, (1) If from any cause whatever, there is no liquidator acting, the Court may appoint the Official Liquidator or any other person as a liquidator.

(2) The Court may, on cause shown, remove a liquidator and appoint the Official Liquidator or any other person as a liquidator in place of the removed liquidator.

(3) The Court may also appoint or remove a liquidator on the application made the Registrar in this behalf.

(4) If the Official Liquidator is appointed as liquidator under the proviso to sub-section (2) of section 502 or under this section, the remuneration to be paid to him shall be fixed by the Court and shall be credited to the Central Government.

[18] Section 543 provides, If in the course of winding up a company, it appears that any person who has taken part in the promotion or formation of the company, or any past or present director, manager, liquidator or officer of the company -

(a) has misapplied, or retained, or become liable or accountable for, any money or property of the company; or

(b) has been guilty of any misfeasance or breach of trust in relation to the company;

the Court may, on the application of the Official Liquidator, of the liquidator, or of any creditor or contributory, made within the time specified in that behalf in sub-section (2), examine into the conduct of the person, director, manager, liquidator or officer aforesaid, and compel him to repay or restore the money or property or any part thereof respectively, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Court thinks just.

[19] Section 559 provides, Where a company has been dissolved, whether in pursuance of this Part or of section 394 or otherwise, the Court may at any time within two years of the date of the dissolution, on application by the liquidator of the company or by any other person who appears to the Court to be interested, make an order, upon such terms as the Court thinks fit, declaring the dissolution to have been void; and thereupon such proceedings may be taken as might have been taken if the company had not been dissolved.

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