Perspectives on Corporate Governance

Prashant Saran
Wholetime Member
Securities & Exchange Board of India

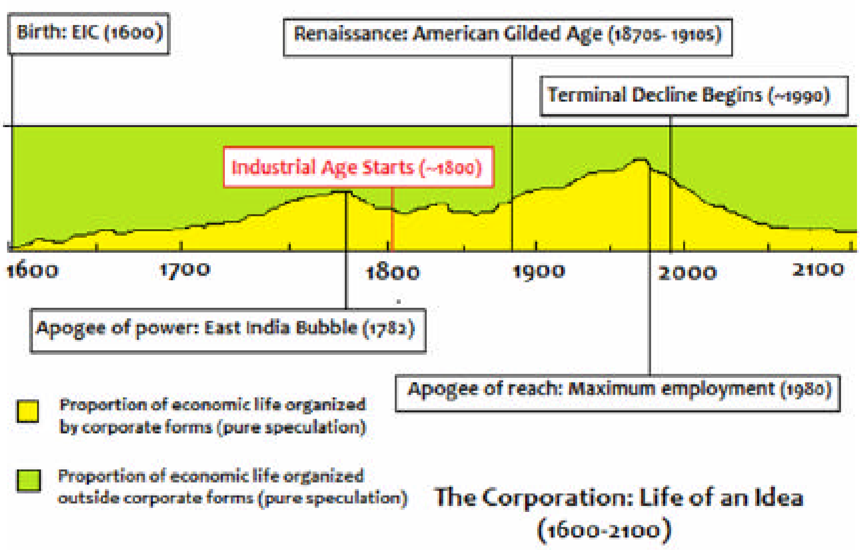
1. It is a favourite pastime among Indians to speculate why the thriving Indian economy of the seventeenth century was relegated to oblivion while the European nations ascended to the zenith. Some think that it was the spirit of renaissance as compared to dominance of religious orthodoxy in India that led the great expansion of Europe as against economic stagnation in India. Some others credit the scientific and industrial revolution for giving Europe the necessary fillip. However, most historians do agree that perhaps the greatest push that toppled India (and China as well) from its position of pre-eminence was the birth of East India Company in 1600. This led to the proliferation of corporations which ultimately dominated the world. The concept of corporation spawned two great ideas that made it ultimately the dominant form of business in the modern world. One was limited liability of shareholders and the other was perpetual succession.
2. The British Parliament passed the Limited Liability Act in 1855, which established the principle that any corporation could enjoy limited legal liability on both contract and tort claims simply by registering as a "limited" company with the appropriate government agency. The power of the concept was not appreciated in the beginning. The Economist wrote in 1855 that "*never, perhaps, was a change so vehemently and generally demanded, of which the importance was so much overrated*." The glaring inaccuracy of the second part of this judgment was recognized by the same magazine more than 70 years later, when it claimed that, "*[t]he economic historian of the future. . . may be inclined to assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution."* Another advantage of corporate form is that the assets and structure of the corporation continue beyond the lifetimes of its shareholders and bondholders. This allows stability and the accumulation of capital, which is thus available for investment in larger and longer-lasting projects than if the corporate assets were subject to dissolution and distribution. The company could sue and be sued in its own name. This made accretion and long term liabilities possible and made long gestation projects possible. These and other myriad of advantages led to proliferation of the corporation as the dominant business form which reached its apogee in the late twentieth century when in 1980, the number of employees in corporations were the maximum. The twenty first century brought home to attention some major shortcomings of the corporate form of business. Something that started with Enron and WorldCom finally led to the Global Financial Crisis. Failure of corporate governance has been blamed for the state of affairs.
3. The framework of corporate governance can be seen from four theoretical angles, the most common being that of Agency Theory. There is separation between ownership and control in corporations most of the time. Managers are the agents who may not always act in the best interest of the shareholders. Independent directors working through committee structures and mandated disclosures seek to resolve this conflict of interest. Strong regulatory enforcement and competitive environment help in ensuring better corporate governance. Then there is Resource Dependence theory which views the Board and independent directors as a valuable resource to the company. They bring a rich resource of knowledge and business connections to the board thus enhancing the value of the company. The Stakeholders theory brings in ethical dimension to the issue of corporate governance. If a company cares for all the stakeholders viz. employees, debt holders, shareholders and public at large through concerns for financial stability, environment and equitable society, it will increase its intangible capital and better stock performance. Finally, there is Institutional Theory which propounds that the presence of effective institutions ensures better corporate governance. It assumes that the businesses are well regulated and the institutions reward firms with good governance while denying resources to badly governed ones.
4. The attempts at creating structures for better corporate governance basically draw inspiration from one of these theories. However, there are basic problems with each of these solutions. For example, the entire agency theory solutions depend upon independent directors. But where can we find independent directors. The job of finding and inducting independent directors is left to the Boards and their nomination committees. Whosoever holds sway over the Board, whether it is the professional management or the promoters, will willy-nilly appoint persons with whom they are comfortable. They are more likely to be old friends and classmates. There is little chance that a person so inducted will go publicly against the person who gave him the position and in case of severe misconduct by the management; she is more likely to tender resignation on personal grounds rather than confronting. Better known corporations might induct retired bureaucrats or other persons of eminence to the

Boards. While doing so, they will take care not to recruit any person who is known to be prickly or thought to be a stickler.

5. Now suppose, that by sheer chance, the management does recruit a person who is really independent. Even such a person finds it an uphill task to differ from the management stance because of severe information asymmetry. She can form his opinion only on the information that is in the public domain or been supplied by the management who will take care to control such information.
6. Now further suppose that such a person is a near genius and is able to connect the dots provided by the scanty information at his disposal, there is a question is why she should devote all the time and effort. Is she being compensated to do so? If she is being paid nominal honoraria, it is very unlikely that she will devote any substantial time to the Board matters. On the other hand if she is paid substantially, where is independence?
7. The second issue thrown up by agency theory is the managerial remuneration. Pay them fixed, they become too lazy and conservative and are least bothered with the interests of the shareholders. If you incentivize them through stock options, what you have is risky behavior because they get the upside when the bet goes well and if it does not they just quit leaving others to pay the bill.
8. The policy options thrown by others theories also have major problems and conflicts. According to Resource Dependence Theory, the directors bring in is knowledge and connections to the corporation. If followed for any length of time, then ultimately we may end up with a tycoons club instead of a Board. The managing director of another company will be a very good resource person as a director because he has both knowledge and connections. You can be director in my company if you let me be a director in your company. If direct interchange is too obvious, we can always have a chain. Actually, this type of board culture was very prevalent in the past century. It is only recently that cozy clubs are being frowned upon.
9. The stakeholder theory is the most promising one as it takes a very broad view of a company where the maximization of the welfare of all the stakeholders is seen to increase the value of the company. As we shall discuss later, this theory might address issues thrown open by knowledge companies. Yet one cannot think that even this theory might not have to struggle with the resolution of conflicts of interest. For example, the interests of the equity and debt holders are diagonally opposite as far as risk appetite is concerned. The debt holders might like to minimize all risks so as to ensure repayment of their debts even if means sacrificing future growth prospects.
10. Finally, the institutional theory depends upon the actions of the Institutions in ensuring better governance. The problem here is to create credible institutions for which there does not seem to be a sure recipe. And even when we have succeeded in creating efficient and credible institutions, the tools in their hands have a doubtful efficacy. Disclosure is considered to be a universal tool for enhancing corporate governance but it is easy to subvert it by inundating the users with information which is mandated, is accurate and is perfectly useless. The idea behind these paragraphs is not to belittle the importance of corporate governance but to recognize the difficulties in enforcing it and preparing the stage for some out of the box thinking. In the following paragraphs, we shall examine some such newer ways of thinking.
11. Though lip service is paid to the employees being an important stakeholder yet most of the companies have not yet understood and internalized their real position in a knowledge society. In the traditional model, the shareholders are the true owners of the business while the companies use land, machinery and labour which is acquired through the capital provided by the shareholders with an ultimate aim to enhance the value of the shares. This presumes that labour is a commodity and is perfectly replaceable. It was perhaps true of nineteenth century mills where raw labour could be inducted into factories with a perfunctory training. The crux of business lay in the factory building and the machinery which was of course the possession of the shareholders. Twenty first century companies are actually nothing but knowledge employees who run the business. Most of the times, the owners actually do not a have a clue how the business is run. The knowledge worker today is a far cry from commoditized labour in the nineteenth century. It is true today that companies like Google and the Facebook don't exist outside their employees and will be true tomorrow for all companies as manufacturing moves to 3-D printing from today's factories. Capital is more of a commodity today than is labour. Capital is replaceable but the knowledge worker is not. If this is the situation then we have to move our theoretical framework for corporate governance where the focus is mainly on the shareholders and other stakeholders are peripheral players. We do need to redefine corporate governance in the context of knowledge economy where the workers gain the centre stage hitherto occupied by the shareholders. This will require deep rethinking on the issue followed by necessary regulatory and legislative changes. It would not be a bad idea to carry out the exercise because the corporate form cannot remain stagnant in the face of tectonic changes in the business environment.
10. The corporate form of business evolved in the context of relatively fewer numbers of shareholders. Annual General Meetings and Extra-ordinary meetings of shareholders were a reasonable place to gauge the general views of the shareholders. The shareholders were concentrated in the main financial centres where the shares

were listed. This is no longer the case. Even when held in football stadiums, Annual General Meetings are not representative when the number of shareholders runs into millions who are spread over the entire world. There is a further movement towards crowdfunding where financing is done in extremely small amounts. USA has even gone ahead with a Crowdfunding Act. We will have to evolve new paradigms if crowd-governance is the issue. Many forms have been suggested. Electronic Town Hall meetings have been suggested where the General Body meeting is actually conducted entirely in the virtual space. Similarly, direct interaction of the Board of Directors with the dispersed shareholders could be achieved through internet forums. These internet forums will act as channel of two way communication rather than the one way channel that exists currently.

11. Finally, a time has come to examine the corporate form of business organization itself. Venkatesh Rao in his blog has speculated on the rise and fall of the corporate form of business in the following diagram.



12. The scenario built above, might not be totally outrageous. If the 3-D printing technology matures, it is possible that the manufacturing might be totally metamorphosed obviating the need of present form of business structure. What newer forms of business organizations might evolve or what existing forms might be refurbished is difficult to speculate. But we will do well to remember that mutations routinely happen in the way businesses are organized. The age old proprietorship model has been refurbished into One Person Companies (OPCs). With the pre-dominance of knowledge the means of production and electronic distribution, who knows that OPCs may be the pointer to the future? Partnership form has been used extensively in the financial services area in the avatar of Limited Liability Partnerships (LLPs). Trusts have also found a great revival though they are right now limited to specialized areas such as securitization or collective investment. There is no reason why LLPs and Trusts might not become the dominant form of business tomorrow. They can move out of their financial services niche into the business mainstream. Even cooperatives have been a huge business success both in India and abroad; we have to only recall Rabo Bank and Amul. Then there are forgotten ways of organizing business such as guilds and regulated companies. In the middle ages, guilds were the dominant way of organizing manufacturing and "regulated companies" were an extension of guilds, where the guilds retained their individuality but agreed to work within a given framework. The guilds held several advantages for their members as well as the consumers. To the members they afforded advantages like protection from excessive taxes imposed by the lords and land owners, limiting competition between members, protection of trade secrets, sickness protection, insurance and regulated working hours and conditions. To the consumers, they assured reasonable pricing and assured quality. Even a preliminary look at the above characteristics will make one wonder whether knowledge based activities like graphic design and animation could be organized in a guild structure.

13. The central message here is not to advocate any of the antiquated forms of business organization, but to bring home the point that corporate form of business itself can be under competitive threat and unless it puts its house in order by way of better corporate governance, the very idea of a company might be antiquated by the end of the current century.