Strengthening the minority shareholder

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Today's business climate has amplified more than ever the importance of reliable corporate compliance initiatives. The recent scandal of the Satyam-Maytas deal appears to be a resounding slap in the face of corporate governance and has intensified the focus of governmental regulators and the inspection of public stakeholders to the core issues affecting governance in the corporate sector.

Ironically, in the recent scandal of Satyam Computer Services, the promoters, who were minority shareholders themselves, holding a less than 10% stake in the company, influenced the majority shareholders to go ahead with the deal to buyout Maytas Properties and take a 51% stake in Maytas Infrastructure for a collective amount in the range of US$1.6 billion, without the approval of the other minority shareholders. However, this appears to be a rare case since minority shareholders are typically sidelined.

In India, where management and ownership are generally unseparated, the effective control of the management or the board is questionable.

Be it public sector units, multinational companies or India business groups, it is common practice in each of these establishments for the majority shareholders to make all the decisions, including but not limited to the structuring of businesses, the transfer of assets between group companies, the preferential allotment of shares to the dominant shareholder, payments for services such as royalties to closely held group companies, and mergers and restructuring of companies in the same group.

The intervention of regulators to safeguard minority rights becomes essential in this situation. Both company and securities regulators require the disclosure of information and audit to minority shareholders. Securities regulators in their disclosure and investor protection guidelines provide among other things, in the case of public issues, a restriction on the pricing imposed on preferential allotments below the average market price during the previous six months. This time frame may be reduced when the stock market as a whole has fallen sharply over the six-month period.

In addition, securities regulators have framed regulations against takeovers, restricting dominant shareholders from selling their entire stock share. These regulations impose an obligation on the acquirer of a significant stake in a company to offer to purchase 20% of the issued capital of the target company from the public shareholders at a price not below what was paid for the controlling stock. The main purpose of such regulation is to provide minority shareholders with a timely opportunity to exit a listed company in the event of a substantial change in the management or control.

An additional safeguard is the requirement of major decisions by a special majority of the shareholders by value. Minority shareholders, in extreme situations, have the right to approach the courts and the Company Law Board to enforce their ownership rights.

However, regulators face a difficult dilemma. Subjecting decisions which need to be taken quickly and smoothly to the process of regulatory review would be seen as the micromanagement of routine business decisions which lie beyond the regulators' mandate or competence.

Shareholder disenchantment becomes a serious concern when the minority shareholders are large institutions, especially if they are financially oriented. Foreign investors demand greater disclosure and transparency and act as gatekeepers to the capital markets. It would be prudent if domestic financial institutions (FIs) required similar disclosure and transparency measures in order for them to effectively exercise their powers.

The debt holder has a greater incentive and ability to monitor the actions of the company. This ability is further strengthened if the debt holders are FIs which usually require collateral against any borrowings. Any serious instances of mis-governance reduce the future earnings of the company or the value of its assets and thereby reduce the ability of a company to service its debt.

In essence, what makes FIs more attractive than regulatory interventionists is that the market is not bound by broad rules and can exercise business judgment. While regulators can impose penalties, FIs can effectively introduce sanctions by restricting a company's ability to raise money from the market. A denial of funds is also a very powerful sanction an FI can use, except where the company is cash rich.

To effectively monitor majority shareholders, regulators can further enhance the ability of FIs to augment the scope, frequency, quality and reliability of information disclosed to minority shareholders. Regulators can also promote an efficient market for corporate control, reform bankruptcy and related laws, and restructure or privatize domestic FIs to help make them more vigilant guardians, strengthening the role of a company secretary to fulfil their true managerial role.

With regard to Satyam, whatever might have been the objective, it would be interesting to see how this corporate governance issue is addressed and what repercussions follow. Nonetheless, it begs the question of what additional provisions are necessary to make sound and practical corporate governance the winner.

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