Chapter 2

The Evolution of Business Groups, Institutional Framework in India, and Related-Party Transactions

Introduction

This chapter provides the background on the evolution of business groups and the institutional framework in India. It begins by discussing family control of business groups, followed by the facts on the evolution and transformation of these business groups. The next section looks at the Indian economy, while the fourth section provides information on the accounting standard setting process in India. The fifth section draws attention to the weak enforcement system in India, which is followed by a discussion on the rules pertaining to RPTs. The last section summarizes the main themes outlined in the chapter.

Family control

Chua, Chrisman, and Sharma (1999, 25) define a family business as 'a business governed or/and managed on a sustainable, potentially cross-generational, basis to shape and perhaps pursue the formal or implicit vision of the business held by members of the same family or a small number of families.'

Most Indian business groups started as family businesses. They moved aggressively after Independence in 1947 and their operations became well diversified. For instance, the Birla group was established by Seth Shiv Narayan Birla in 1870 as a small cotton and jute trading business. Over the years, the group has diversified its operations into petrochemicals, textiles, telecommunications, cement, automobiles, and financial services, and the group now consists of more than 40 companies. Although each firm within the group is a separate legal entity, control still resides with the promoter families. In the case of the Birla group, Kumar Mangalam Birla, the only son of Aditya Birla, is the current chairman. Considering the nature of these business groups (family controlled), the literature on family firms would be relevant to examine the attributes of Indian business groups. The terms 'business groups' and 'family firms' will be used interchangeably in this study. Khanna and Yafeh (2007) identify that groups are generally family firms and their behaviour can be understood better from this perspective.

The literature on property rights suggests that the legal system shapes the structure of property rights. Fan and Wong (2002) view share ownership rights as property rights, with shareholders being entitled to certain rights. First, the shareholder has control rights. Second, the shareholder has cash-flow rights, and finally, the right to transfer the shares. The value of the shares depends on the enforcement of such rights. The enforcement is undertaken by the owner and the state (Fan and Wong, 2002). The individual owners play a vital role in enforcing property rights in economies with less effective property rights. This view suggests that controlling shareholders have the power and incentives to enforce corporate contracts. In contrast, minority shareholders lack the power and incentives to enforce such contracts. As a consequence, the benefits of concentrated ownership are greater in countries with less developed legal systems to enforce property rights (Shleifer and Vishny, 1997). Consistent with La Porta, Lopez-de-Silanes, and Shleifer (1999) and given that in India the legal enforcement mechanism is weak, it is reasonable to expect concentrated ownership to be generally in the hands of the family.

Evolution and transformation of business groups since Independence (1947)

It is evident from the studies presented in the previous chapter that groups tend to overcome the imperfections of capital, product, and labour markets (Ghemawat and Khanna, 1998; Khanna and Palepu, 1999, 2000b; Khanna and Rivkin, 2001). Financial intermediaries such as investment bankers, financial analysts, and efficient stock exchanges were missing in underdeveloped India in the period immediately following Independence. In such an environment, business groups generated capital and managerial talent from internal markets (Kali and Sarkar, 2005).

In the absence of well-functioning business markets, these business groups could use their political connections for their private interest (Ghemawat and Khanna, 1998). For instance, the Tata Group benefitted from the Nehru (Congress) government after Independence by getting involved in several

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projects as part of nation building, in return for supporting the Congress in the freedom movement (Kedia et al., 2006). Business groups that are viewed as government supported, continued to enjoy favourable terms in the transition phase of the Indian economy. There is evidence of groups exercising their power to oppose institutional changes. The formation of the Bombay Club is an example of industrialists' attempt to lobby for restricting the entry of multinationals in the Indian market (Tripathi, 2004). However, the ties between business groups and the government do not seem to be smooth. The business groups were also harmed by certain restrictions imposed on them by the government. For example, anti-big business group legislation, such as the Monopolies and Restrictive Trade Practices (MRTP) Act, came into being (Khanna and Yafeh, 2007). It appears that the relationship between business groups and the government changed over time, as the economic environment changed for the country as well as for the business groups.

Business groups have been encouraged by the governments in emerging economies to stimulate economic growth. For example, the Indian government's policy of entry barriers for foreign firms and a high level of government intervention in the private sector helped the growth of diversified business groups in the pre-reform era (Kedia et al., 2006). Guillen (1997) highlights the role of the government's industrial policy and export-led strategy for the growth of Korean *chaebols*. Peng (2001) highlights the role of the Chinese government in the formation of business groups. Existing literature suggests that government involvement has been very important in the formation of business groups in emerging economies: Latin America (Strachan, 1976), Indonesia (Schwartz, 1992), China (Keister, 1998), Pakistan (White, 1974), and South Korea (Chang and Choi, 1988; Guillen, 1997).

The business reforms in the early 1990s changed the market conditions in India and, therefore, we will analyse the transformation of business groups in two parts; the pre- and post-reform eras.

Pre-reform era

The pre-reform era was strictly regulated, and the government intervened extensively in the business sector. Many regulatory mechanisms, such as the Industrial Policy Resolution (1956), the MRTP Act (1969), and the Industrial Licensing Policy Inquiry Committee (1969), were put in place to monitor the private sector and restrict the entry of foreign investors (Majumdar, 2004). For instance, the entry of private businesses was restricted to certain areas under the industrial policy resolutions issued in 1948 and 1956. Furthermore, business firms faced the problem of weak contract enforcement as a result of inadequate rules and regulations (Khanna and Palepu, 1997). The problems discussed above challenged the survival of business firms. Li, Ramaswamy, and Pecherot Petitt (2006) report that diversified business groups could add more value compared to individual firms in such situations. The business groups diversified into wide areas to overcome market deficiencies and imperfections (Khanna and Palepu, 1997). For instance, the financial resources of one firm can be used by another, which substitutes for the funding role of the external capital market, and labour can similarly be mobilized between firms (Li et al., 2006). Irrespective of their unrelated business activities, business groups manage to add value. The value addition of business groups might be a result of increased institutional relatedness (IR). Imports were discouraged with very high duties and complicated quota and licensing requirements (Mohan, 1992). The restrictions were imposed on foreign investment under the MRTP Act, 1969 (Dandekar, 1992; Vachani, 1997). The favoured licensing policies and lack of competition facilitated these business groups' profits (Mohan, 1992).

Post-reform era

The market conditions changed significantly in the early 1990s as a result of liberalization and deregulation reforms. In 1991, the then finance minister, Manmohan Singh, initiated several changes. The abolition of regulation and licensing gave a boost to the Indian economy (Kedia et al., 2006). For example, it resulted in the reduction of excise and import duty from 100 per cent in 1991 to about 30 per cent in 2000, and the MRTP Act was abolished. Private business firms were allowed to enter into new areas which were earlier reserved for the public sector. Furthermore, foreign investment was encouraged. Tariffs to imports were reduced and restrictions on direct foreign investment (DFI) were also relaxed (Joshi and Little, 1996). The deregulation and increased globalization changed business practices in India. If business reforms in the 1990s opened new industries for business groups which were earlier reserved for the government sector, it also exposed business groups to local and foreign competition. Licenses secured by the groups became valueless (Manikutty, 2000), as new firms were allowed to enter the market without any license. The changed regulation forced business groups to compete not only with local firms but also with foreign firms, since the restrictions on foreign investment were relaxed. Financial resources became less critical with the inflow of FDI and deregulation of markets, and business groups were less advantaged by their internal capital markets.

The changed approach, which led to business restructuring, was a response to the deregulated and liberalized market. For instance, the Tata group went through a significant restructuring around 1998 and reduced its business segments to almost half (Kedia et al., 2006). This is consistent with the resource-based view which suggests that firms tend to diversify into related products (MacDonald, 1985; Montgomery and Hariharan, 1991). In contrast, the Thapar group tried to maintain a much more diversified business and consequently failed to perform well. Kedia et al. (2006) ranked the Thapar group amongst the low value-added groups in the post-reform era. The Mahindra group decided to concentrate on automobiles and related products and carried out the divestment of its elevator and graphics businesses (Manikutty, 2000). The restructuring of the business portfolios was done to build strength in their core sectors and it proved successful. For example, Tata Steel spent Indian Rupees (INR) 23 billion (US$377 million) to increase its production capacity from 2.7 million to 3.5 million tonnes of steel per annum (Manikutty, 2000). Tata Engineering and Locomotive Company (TELCO) established a design facility to develop a small car named Indica. The design was developed in 31 months at a cost of INR 1.7 billion (Manikutty, 2000). Ranbaxy increased its Research and Development (R&D) expenditure from 3 per cent in 1993 to 7.5 per cent in 1999 (Ghemawat and Kothavala, 1998) to move away from generic drugs to new molecular and branded formulations. Today, Ranbaxy is known for being an integrated and research-based international pharmaceutical group.

In a highly competitive environment, these family groups made efforts to obtain better synergies between the group resources. The Tata Group established Tata Administrative Services with the objective of serving group firms with highly professional managers (Khanna, Palepu, and Wu, 1998). Furthermore, the Tata group recruited top managers in a concerted fashion and rotated them where needed (Khanna and Palepu, 1997). Similarly, the Birla group transformed Birla Management Centre into a corporate centre for deriving synergies from the member firms. The Mahindra and Reliance groups also established strategic units for the group as a whole (*Business Today*, August 22, 1999). The Tata group also established a venture capital fund for member firms with a funding of INR 1.26 billion (Khanna and Palepu, 1997).

Another change in these family groups is in employing professionals at the top level. The second generation of these families is more educated than the founders of these groups. Manikutty (2000) reports that K. M. Birla, head of Birla group, is a qualified chartered accountant (CA) and he also obtained an MBA from London Business School. Both Ambani brothers, Mukesh and

Anil, have MBA degrees from Stanford University and the Wharton School of the University of Pennsylvania, respectively. Moreover, the approach of these groups seems to be changing from being family-centred to business-centred (Singer and Doronho, 1992). The culture of these groups was earlier seen as autocratic, and personal loyalty was emphasized rather than professionalism. These family groups have realized the value of professional managers, and have started employing them in higher positions. For example, the Birla group hired a former director from Levers and a former CEO of Blow Blast Limited in 1997 (*Business Today*, 7 October 1999). These professionals are not only recruited into top positions but also empowered with more freedom and authority to make business decisions (Barker, 1992) which were earlier restricted in the hands of the family.

Indian economy

The Indian economy, which is considered to be the world's 11th largest economy today in terms of nominal gross domestic product (GDP), has evolved gradually but steadily over decades. It is now one of the world's fastest growing economies. To understand how the Indian economy reached where it is today, we need to examine its history.

Pre-colonial age

Before India became a colony of the British, agriculture was the main source of economic activity and income for the people. As one of the world's oldest civilizations, India was blessed with all the important factors required for a productive agricultural system, from fertile land to abundant water bodies to a favourable climate. A planned economic system had existed even in the oldest of Indian civilizations like Indus Valley Civilization, the Aryan Civilization, the Mauryan Empire, the Gupta Empire, and most other dynasties. Although coins were also issued in some dynasties, the barter system formed the main form of trading in those times. The economic rule required all the farmers and villagers to provide the kings or the landlords with a part of their crops.

Even during Muslim rule, the Indian economy largely depended on agricultural produce. The Mughal Empire established some trade relations with the British, French, and Portuguese merchants during the latter part of the Mughal period. Finally, the British East India Company came into existence, following the Battle of Plassey, giving rise to colonial rule in India.

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While reading the history of the Indian economy, one will find that the colonial era formed an integral part of the Indian economy. During this phase, a notable change was witnessed in the process of taxation in the form of revenue taxes and property taxes that led to large-scale economic breakdown. Terrible losses were suffered by many industries, including the Indian handicrafts industry.

During this period, the financial and banking system as well as free trade was created, a single currency system with exchange rates was established, standardization of weights and measures took place, and also a capital market was formed. Apart from these institutional attributes, infrastructure and new telegraph lines were established. Transportation also improved as railway lines and roads were constructed. Foreign investment in India also increased before Independence; however, the role of foreign capital diminished after 1947 as a result of the sale of British interests to Indian entrepreneurs. For instance, the number of business groups controlled by the British fell from 61 in 1938 to 25 in 1962 (Chhibber and Majumdar, 1999).

Post-Independence to the 1990s

In the post-Independence era, great attention was paid to bolstering the economic system of India. This era saw great development in sectors like agriculture, village industries, mining, and defence. There was an overall improvement in the standard of living of people in rural areas as new roads, dams, and bridges were built, and access to electricity increased.

Furthermore, the government formulated five-year plans, under which it implemented several economic reforms and policies. To make the economy both diverse and self-sufficient, the government also acted to increase the quantity and quality of the export items and minimize the volume of imports.

Business regulations, central planning, and nationalization of the industries in mining, electricity, and infrastructure was also given due attention by political leaders during this period.

The 1960s witnessed yet another significant economic reform, which helped the country to become self-sufficient in food grain production. The Green revolution movement came into being, which aimed at dealing with issues such as afforestation, increased irrigational projects, improved seed usage, better farming techniques, and the use of fertilizers.

Rajiv Gandhi, the then prime minister, took the first step in the 1980s to liberalize the market. He passed tenure under which restrictions on a number of sectors were eased, pricing regulations were abolished, and efforts were made to improve the GDP of the country.

From the 1990s to the present time

With the dissolution of the Soviet Union, which was India's main trading partner, the so-called golden sparrow, India, had to deal with a huge balance of payment problems. The situation worsened since government loans were increasing and the IMF was demanding a bailout loan. Before the 1990s, strict regulations and high tariffs existed in the Indian private sector and imports were restricted. In the 1980s, India's share of worldwide trade fell below 0.5 per cent because of its anti-trade policies.

The economic conditions changed significantly with the election of the new government of Narasimha Rao in 1991. The newly elected finance minister, Manmohan Singh, reversed policies that had complex regulations and licensing requirements. Furthermore, lower tariff rates protected domestic industries. For example, the tariff rate for the manufacturing sector was reduced from 71 per cent to 36 per cent. Undoubtedly, this proved to be a great boon to the Indian economy, since FDI was welcomed, public monopolies were reduced significantly, and banking, service, and tertiary sectors were developed.

India has always been a capital-scarce economy for a number of reasons. First, India lacks natural resources like oil and other minerals. Overpopulation further makes the resources insufficient to sustain economic growth. Second, India failed to attract high foreign investment. In the last 25 years, the magnitude of foreign investment in India amounts to less than 25 per cent of foreign investment in China. Foreign investment was restricted before the 1990s and it was only after the reforms in the early 1990s that the market was deregulated, and steps were taken to attract foreign capital. Now, liberalized India has become one of the most attractive destinations for foreign investment. Ernst and Young's 2010 European Attractiveness Survey ranks India as number 2 following China in attracting FDI in the coming three years. The Indian government continues to relax regulations on foreign investment. For example, the government has empowered the Foreign Investment Promotion Board (FIPB) to approve FDI proposals up to US$258.3 million. Earlier, any proposal above US$129.2 million was subject to the approval from Cabinet Committee of Economic Affairs (CCEA). Third, India failed to concentrate on export-oriented business, which resulted in low foreign currency growth. Unlike China, India could not capitalize on low-cost economic activities.

Indian accounting standard setting process

Having been a British colony for over 100 years, accounting standards in India are modelled on the British standards. The main professional body in India is the Institute of Chartered Accountants in India (ICAI) which was established in July 1949 under the Chartered Accountants Act, 1949. It is the world's second largest accounting body after the American Institute of Certified Public Accountants (AICPA) in terms of membership, with 220,000 members as of 29 June 2013.

To regulate public companies, the Company Act, 1913 was introduced in India based on the English Companies Act, 1908. This statute, however, had gone through several amendments. The Companies Act, 1956 allows ICAI to develop accounting standards and every entity is required to comply with these accounting standards. Section 211 (3A) of the Companies Act, 1956 requires every profit and loss statement and balance sheet to comply with the accounting standards. Furthermore, Section 211 (3C) clarifies that 'accounting standards' means the standards issued by the ICAI.

The Indian accounting standard setting process is subject to direct or indirect oversight by several regulatory bodies, such as the Securities and Exchange Board of India (SEBI), National Advisory Committee on Accounting Standards (NACAS), Insurance Regulatory and Development Authority (IRDA), and the Reserve Bank of India (RBI) (Khatri and Master, 2009). The Companies Act, 1956 provides guidance on financial accounting matters, and the provisions of the company law will prevail in case of any inconsistency between particular accounting standards and the company legislation. Furthermore, Indian courts have the power to endorse particular accounting treatments.

The ICAI established the Accounting Standards Board (ASB) in 1977 to formulate accounting standards and integrate them, to the extent possible, with International Financial Reporting Standards (IFRS). The board of the ASB is represented by members from all interest groups, including industry, financial institutions, professional bodies, academia, government, and other regulatory bodies. The Associated Chambers of Commerce and Industry (ASSOCHAM), the Confederation of Indian Securities (CII), and the Federation of Indian Chambers of Commerce and Industry (FICCI) represent the industry group. Academics from the Indian Institute of Management (IIM), Institute of Company Secretaries of India, Institute of Cost and Works Accountants of India, and other universities are also present on the ASB. The RBI, the CAG, the Central Board of Excise and Customs, and the Ministry of Company Affairs represent the government.

Indian accounting continues to be driven by the legal form of the transaction, and not by the substance of transactions. For instance, the upfront fee charged by telecom service firms is recognized as income under Indian GAAP because it is non-refundable by contract. On the contrary, the income would be deferred over the estimated period of the service contract under IFRS. The reason is that customers pay the activation fee not for any services received but in anticipation of future services. Furthermore, the group firms are required to prepare consolidated financial statements under the IFRS to present a true and fair view. The Indian GAAP only mandates the preparation of consolidated financial statements for listed firms, and only annual statements and not interim financial statements.

Indian Accounting Standard (AS) 24 requires the disclosure of RP relationships, type of transactions, and amount. The Indian GAAP requires disclosure of RPT amounts, whereas IFRS are more focused on qualitative information and requires firms to disclose the terms of RPTs. There is more discussion on rules pertaining to RPTs in one of the sections of this chapter below. The Indian GAAP allows long-term deposits and advances to be disclosed under current assets and, thus, fails to provide information on current and non-current portions, and consequently, the liquidity position of the firm.

In many accounting standards, such as valuation of inventories (AS 2), depreciation accounting (AS 6), intangible assets (AS 26), impairment of assets (AS 28), and provisions, contingent liabilities, and contingent assets (AS 29), flexibility is involved and professional judgment is exercised to a certain extent. The fixed assets can be revalued under Indian GAAP and this provision highlights the inherent subjectivity involved with the revaluation process. The fair value is currently limited to impairment of assets, mark-to-market treatment for derivatives, and measurement of retirement benefits. Therefore, property, plant, and equipment (PPE), intangible assets, investment properties, and other financial assets can be measured at fair value. The discretion provided by the standards specified above can be used differently by family-controlled group firms to achieve their reporting objectives.

It is not only the discretion provided by accounting standards but also the weak enforcement of the regulation which might facilitate personal reporting objectives. La Porta et al. (1998) measure legal enforcement in terms of rule of law, corruption, and risk of expropriation. They also estimate the quality of national accounting standards. With reference to corruption, the Indian score is 4.58, whereas countries like Canada and New Zealand score 10. The risk of expropriation is higher in India with a score of 7.75, whereas the UK, USA, and Canada attain scores of 9.71, 9.98, and 9.67 respectively. The

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Indian score is 4.17 for rule of law, whereas countries like the USA and UK score 10. For interpretation purposes, it is important to note that a lower score depicts lower efficiency for the respective measures. Indian accounting standards obtain a score of 57, whereas the UK, Singapore, and Australia score 78, 78, and 75 respectively for the quality of their accounting standards. It is reasonable to expect that accounting information might be influenced by reporting incentives in India, especially when accounting standards are poor and the legal enforcement system is weak.

The Satyam scandal, which analysts have called India's own Enron scandal, represents the perfect case of false account details. On 10 January 2009, the shares of the company plunged to INR 11.50, which was their lowest level since March 1998 compared to a high of INR 544 in 2008. Similarly, in 2008, the shares of the company on the New York Stock Exchange traded at US$29.10 whereas, in March 2009, they were trading at nearly US$1.80.

In the period of one week, some $2 billion of cash that belonged to 3 lakh shareholders disappeared. The company was filed against in multi-million-dollar lawsuits, its founder (Raju) was jailed, and shareholders' net worth plummeted from a positive INR 8,529 crore to a negative INR 278 crore.

Before the scandal came to be in the public eye, Raju had been boosting the valuation of the company so that he could borrow more money against his shareholding and keep the company in the top league of IT service providers. However, when the company's share prices plunged in January 2009, Raju failed to pay up and, thus, lenders began to sell shares. As a result, the promoters' (Raju's) holding fell to 3.6 per cent in comparison to 26 per cent in 2001.

The accounting information was found to have been manipulated. Satyam had been inflating profits for many years by inflating cash and bank balances of INR 5,040 crore. Court questioning also revealed that the accrued interest of INR 376 crore was not present, and that the debtors' position of INR 490 crore was exaggerated. Raju also had understated liabilities by INR 1,230 crore on account of funds.

The auditors, PricewaterhouseCoopers, in an attempt to distance themselves from the issue, declared that false information provided by Satyam management may have rendered their audit report inaccurate.

Weak enforcement system

Chakrabarti et al. (2008) report that the Indian judicial system is extremely slow, and the country's courts are overburdened. Despite the fact that India has 10,000 courts, excluding tribunals and special courts, it lacks the required number of judicial officers. India has just over 10 judges per million citizens, whereas the US has a comparative figure of 107 judges and Canada over 75 judges per million people. Moreover, the same courts deal with civil and criminal matters and criminal matters receive priority. This results in further delays in economic disputes. For example, Hazra and Micevska (2004) reveal that 3.2 million cases are pending in the High Courts and 23 million in the lower courts of India.

Another important aspect of investor protection is securities market regulation. The SEBI has significant problems in enforcing compliance with the law. Bose (2005) shows that SEBI took action in only 481 cases between 1999 and 2004. In contrast, the US Securities and Exchange Commission (SEC) initiated 2,789 cases during the same period. Furthermore, the decisions in 30 to 50 per cent of appeals before higher authorities, such as the Securities Appellate Tribunal or the Finance Ministry, go against the SEBI.

Slow debt recovery makes contract enforcement ineffective for creditors. The introduction of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and Debt Recovery Tribunals are aimed to accelerate the judicial process. The enactment of SARFAESI allows debt holders to seize the assets of a defaulting borrower. However, the borrower has the right to approach Debt Recovery Tribunals, the Debt Recovery Appellate Tribunal or High Court, which can delay the process for 3 to 4 years. In India, it takes 10 years, on an average, to go through the bankruptcy process and recovery rates are very low (Kang and Nayar, 2004).

In the absence of a strong enforcement system, businesses operate with informal mechanisms based on reciprocity and reputation (Khanna and Palepu, 2000b). The rights of minority shareholders can be compromised by controlling shareholders in private deals. This environment, with weak legal enforcement and widespread corruption, is highly conducive to the expropriation of minority shareholders.

Rules pertaining to RPTs

RPTs comprises transactions between a firm and an RP, where the related party would have the power to influence corporate decision making and may secure better terms than in the case of arm's-length transactions. As per the OECD Principles of Corporate Governance (2004), related parties can include firms that control or are under common control of the firm, significant shareholders including their family members, and key management personnel. Transactions between two firms controlled or owned by the same shareholder, often regarded as group-affiliated firms, are very common in India and present a potential conflict of interest. These transactions can result in situations where they are used as a means to channel funds from one firm to another and business opportunities can be lost to an RP at the cost of minority shareholders (OECD, 2014). However, not all RPTs are detrimental to the interests of the firm or minority shareholders. Some transactions can facilitate business purposes.

RPTs can be further decomposed into several categories, which include loans and guarantees, asset transfers, sale and purchase of goods and services, and bailouts (OECD, 2014). Some RPTs are more prone to abuse than others. For example, Berkman , Cole, and Fu (2009) suggest that the issuance of a loan guarantee is unambiguously a tunnelling practice. Lo, Wong, and Firth (2010) focus on RP sales to examine financial statement distortions. They report that firms with a higher percentage of parent directors are more likely to manipulate transfer prices. Srinivasan (2013) reports loans and deposits as a major RPT using a small sample of Indian firms listed on the BSE. Khanna and Yafeh (2005) and Jian and Wong (2010) use RP sales to investigate propping as RP sales are one of the most frequently made RPTs in their sample.

The fact that RPTs can impose costs on the firm or its minority shareholders gives rise to the question of how legal systems can prevent the abusive use of RPTs. One way of addressing the abusive use of RPTs is the prohibition of these transactions. Prohibition of RPTs has two main drawbacks. First, it would rule out value-creating RPTs with a view to reducing transaction costs and second, it may not be effective unless the prohibition of other forms of tunnelling is in place (Enriques, 2015). In the case of prohibition of RPTs, controlling shareholders can use equivalent substitutes to extract private benefits.

The other way to address tunnelling via RPTs is by establishing procedural safeguards to minimize the risk without stifling value-enhancing transactions. Most countries provide rules on how to enter into RPTs and related disclosure requirements. For example, countries like Hong Kong and the UK require shareholder approval for different types of RPTs. Furthermore, Belgium and Singapore require that the companies make an independent evaluator's opinion available to shareholders to supplement the disclosure on RPTs or help them in their vote on the RPTs. Voluntary use of independent lawyers or investment banks in the negotiation process is a common practice and such advice usually includes a fairness opinion (Enriques, 2015). In some countries, the fairness opinion is required by law to be disclosed. For example, if a fairness opinion is released, it has to be disclosed in Italy. However, the value of such fairness opinions may be limited. Outside experts, be they lawyers or investment banks, may be less independent than they appear, as they rely more on other advisory and investment banking roles than providing fairness opinions (Davidoff, 2005). While the effectiveness of fairness valuations is doubtful, the information on which the fairness opinions are based, like the management's projection of future cash flows and assumptions, can be particularly helpful (Enriques, 2015). Delaware in the US is the only main jurisdiction that has developed a wide body of case on law on this issue. Most other countries appear to be less detailed in their requirements relating to fairness disclosure.

Considering the potential to abuse RPTs, OECD (2012) emphasizes three mechanisms which represent good practices in the presence of controlling shareholders: first, minority-shareholder approval for different types of RPTs to protect the rights of minority shareholders; second, the power of minority shareholders in selecting board members of their choice; and third, the fiduciary duty of the controlling shareholder towards minority shareholders and the firm.

In India, shareholder approval is not required for RPTs, except for the issuance of shares, other than rights or bonus issues. In other countries, such as Australia, not only is the majority of minority approval required but also the regulator's comment on the proposed resolution. Shareholder approval is required under the Listing Rules of the Stock Exchange of Hong Kong (SEHK) and there is a similar requirement in Singapore under Chapter 9 of the Listing Rules of Singapore Stock Exchange for shareholder approval. In Canada, a formal valuation from a qualified and independent evaluator and majority approval by minority shareholders are necessary to approve RPTs. There is a similar requirement in the UK for approval of RPTs. It is evident that the minority shareholders in India do not have the benefit of a shareholder approval requirement. Nevertheless, RPTs require board approval. All non-equity RPTs are required to be reviewed by an audit committee. Clause 49 of the Listing Requirements issued by the SEBI states that audit committees should comprise at least three members and be at least two-thirds independent. Clause 49 does not only give directions on the composition of audit committees but also outlines that all members should be financially literate and at least one should have accounting and financial management experience.

It is critical to understand the role of independent directors when they are given the duty to stop abusive use of RPTs. The mere title 'independent' is not enough to fulfil the assigned duty, when they could be under enormous pressure from controlling shareholders. First, these independent directors are appointed by controlling shareholders and this may compromise their independence. Khanna and Mathew (2010) report that, in their small sample, independent directors viewed their role as strategic advisors to controlling

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shareholders, not as monitoring management and controlling shareholders. Second, the non-executive independent directors acknowledge their reliance on promoter families because of their directorships in other group-affiliate firms. Sarkar and Sarkar (2009) note that independent directors hold 67 per cent of their directorships in group affiliates and about 43 per cent of their directorships are concentrated in the same business group.

Chakrabarti, Subramanian, and Tung (2010) analyze the resignations of independent directors in the wake of the Satyam scandal. In this event study, resignations of independent directors led to lower returns; however, such an impact was insignificant for family-held firms. This suggests that independent directors are not regarded as effective in the presence of promoter families, mainly because of the reasons listed above.

In terms of directors' duties, the Companies Act of India, 1956 does not outline the duties of directors in great detail. It does not explicitly deal with RPTs except for self-dealing. As directors are in a position of trust, they should not exercise their powers for personal advantage. Section 300 of the Companies Act restricts directors from voting or participating in any board discussions regarding matters they are directly or indirectly related with. The company law does not make reference to the problems arising from acting on group strategies at the cost of the company. Nonetheless, the minority shareholders can apply to the Company Law Board against any oppression and mismanagement.

It is not just that the Indian market lacks mechanisms such as shareholder approval, directors' independence, clear role of directors; legal enforcement has been problematic too. OECD (2012) reports that 20 million cases are pending in the lower courts and 3.2 million cases are pending in the high courts. As both civil and criminal matters are tried in the same courts, economic disputes suffer greater delays. Furthermore, litigants might have to bear the cost of the action but the rewards are often paid to the firm, if the judgment is in favour of the litigant. The SEBI has greater responsibility when enforcement is weak through overburdened courts.

The jurisdiction of SEBI is limited to cases pertaining to issuance and transfer of securities. Matters of oppression and mismanagement by the majority fall under the powers of the Company Law Board/Ministry of Corporate Affairs. MCA/CLB had 60,000 pending cases at the beginning of year 2009–2010 (OECD, 2012). Widespread corruption in government departments does not make it any easier for minority shareholders.[4]

[4] Dutta (1997), La Porta et al. (1998), and OECD (2012) emphasize the problem of corruption in India.

New requirements under the Companies Act, 2013 and SEBI guidelines

There have been some recent regulatory changes in relation to RPTs and corporate governance. Under Clause 49 of the Listing Requirements of SEBI, all material RPTs require shareholder approval through special resolution. Any transaction with an RP that exceeds 5 per cent of the annual turnover or 20 per cent of the net worth of the company as per last audited financial statements, whichever is higher, will be considered material. Furthermore, Clause 35B of the Listing requirements has been changed to provide for an e-voting facility for all shareholder resolutions, which allows minority shareholders to express their views.

There have been more changes under the Listing Requirements and Companies Act, 2013 on independent directors. An independent director can only serve two consecutive terms of five year each. There is also a restriction on the maximum number of boards a person can serve on as an independent member. The maximum number of directorships one person can take is seven, and three in the case of individuals serving as a full-time director in any listed firm. However, the listed firms were required to abide by the above-mentioned changes from October 2014 and companies were subject to the old regulations for the sample period of this study (2008–2012).

Section 188 of the Companies Act, 2013 contains a provision requiring approval of disinterested shareholders and prohibits interested shareholders from voting on transactions with related parties. However, experience in countries like Israel has shown that classifying shareholders as disinterested may pose practical difficulties (OECD, 2014). Each shareholder who votes in an AGM will be required to notify the company about his or her personal interest in the transaction prior to the vote, which will help the company to classify the shareholder as interested or disinterested. Further, minority shareholders often own a small fraction of the shares and lack incentive to challenge the controlling shareholders. The Russian experience in the 1990s may imply that dysfunctional enforcement institutions can also deprive the majority of minority clause of its 'self-enforcing' appeal (Enriques, 2015). Despite the introduction of new laws under the Companies Act, 2013, we believe that minority shareholders are still at the risk of expropriation through RPTs due to practical difficulties and lack of incentive. Therefore, we firmly believe that the results will not materially change despite this provision, and the findings are still relevant in the current context.

The Companies Act, 2013 requires companies to obtain shareholder approval only for transactions above the 5 per cent threshold. Transactions below this threshold only require disclosure, which does not have to go further than the nature of the RP relationship, the amount of the transaction, the name of the RP, and other related information to assess the transaction.

Summary

This chapter presented the institutional framework in India. It highlighted family dominance in Indian business groups and the transformation of groups from family businesses to well-diversified groups that consist of many listed firms. Furthermore, the weak enforcement system makes the Indian setting more conducive for the expropriation of minority shareholders. The analysis of regulations pertaining to RPTs also highlights the potential abuse of such transactions. The rights of minority shareholders are not protected by shareholder approval requirements for different types of RPTs. However, all RPTs are required to be reviewed by an audit committee. Therefore, non-executive independent directors are assigned the key responsibility of stopping the abusive use of RPTs; however, the influence of controlling shareholders might impair the independence of non-executive directors in monitoring management and controlling shareholders. Overall, the weak enforcement system, inadequate protection of minority shareholders, and the excessive influence of controlling families on non-executive directors make the Indian setting conducive for the expropriation of minority shareholders. A major aim of this study is to determine whether such expropriation occurs, and its consequences.